## Study Sessions

## READING 1. CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

## The candidate should be able to:

# describe the structure of the CFA Institute Professional Conduct Program and the disciplinary review process for the enforcement of the Code of Ethics and Standards of Professional Conduct;

CFA Institute (CFAI) Board of Governors maintains oversight and responsibility for the Professional Conduct Program (PCP), which along with the Disciplinary Review Committee (DRC) is responsible for the enforcement of the Code and Standards.

CFAI Bylaws and Rules of Procedure for Professional Conduct (Rules of Procedure) form the basis structure for enforcing the Codes and Standards.

The CFA Institute Professional Conduct Program (PC) staff conducts inquiries related to professional conduct. These events can trigger an inquiry:

1. Self-disclosure by members or candidates on their annual Professional Conduct Statements
2. Written complaints about a member or candidate’s professional conduct
3. Evidence of misconduct by a member or candidate that the Professional Conduct staff received through public sources
4. A report by a CFA exam proctor of a possible violation during the examination
5. Analysis of exam materials and monitoring of social media by CFA Institute

Once an inquiry has begun, the PC staff might request an explanation from the member or candidate and:

1. Interview the member or candidate
2. Interview the complainant or other third parties
3. Collect documents and records relevant to the investigation

The PC staff might decide that:

1. No disciplinary sanctions
2. Issue a cautionary letter
3. Discipline the member or candidate

# explain the ethical responsibilities required by the Code of Ethics and the Standards of Professional Conduct, including the sub-sections of each standard.

* Six components of the Code of Ethics
  1. **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.
  2. **Place the integrity** of the investment profession and the **interests of clients above their own personal interests**.
  3. **Use reasonable care and exercise independent professional judgment** when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
  4. Practice and encourage others **to practice in a professional and ethical manner** that will reflect credit on themselves and the profession.
  5. **Promote the integrity and viability of the global capital markets** for the ultimate benefit of society.
  6. **Maintain and improve their professional competence** and strive to maintain and improve the competence of **other investment professionals**.
* Seven Standards of Professional Conduct
  1. Professionalism
     1. Knowledge of the Law
     2. Independence and Objectivity
     3. Misrepresentation
     4. Misconduct
  2. Integrity of Capital Markets
     1. Material Nonpublic Information
     2. Market Manipulation
  3. Duties to Clients
     1. Loyalty, Prudence and Care
     2. Fair Dealing
     3. Suitability
     4. Performance Presentation
     5. Preservation of Confidentiality
  4. Duties to Employers
     1. Loyalty
     2. Additional Compensation Arrangements
     3. Responsibilities of Supervisors
  5. Investment Analysis, Recommendations, and Actions
     1. Diligence and Reasonable Basis
     2. Communication with Clients and Prospective Clients
     3. Record Retention
  6. Conflicts of Interest
     1. Disclosure of Conflicts
     2. Priority of Transactions
     3. Referral Fees
  7. Responsibilities as a CFA Institute Member or CFA Candidate
     1. Conduct as Participants in CFA Institute Programs
     2. Reference to CFA Institute, the CFA Designation, and the CFA Program

## READING 2. GUIDANCE FOR STANDARDS I–VII

## The candidate should be able to:

# demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by interpreting the Code and Standards in various situa­tions involving issues of professional integrity;

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| Standard | Meaning | Examples |
| **I(A) Professionalism: Knowledge of the Law** | Comply with all applicable laws, rules, and regulations (including the CFA institute Code of ethics and Standards of Professional Conduct).  In the event of conflict, comply with the more strict law, rule, or regulation.  Do not knowingly participate in or assist in, but rather dissociate from any violation of such laws, rules, and regulations. | Laura works for a multinational investment advisor based in the US, but lives and works in the tiny island nation of Dr. Moreau. In the Island of Dr. Moreau, the laws state that no investment advisor registered and working in that countries can participate in IPOs for the advisor’s personal account. Laura believes that as a US citizen working for a US company, she should only comply with US law, and ignore Dr. Moreau’s laws. She believes that as a charterholder, as long as she adheres to the Code and Standards requirement that she disclose her participation in any IPO to her employer and clients when such ownership creates a conflict of interest, she is meeting the highest ethical requirements. **Conclusion: Laura is in violation of Standard I(A). Both the Island’s laws prevent her from participating in IPO activities, and she must follow the stricter requirements of the local law rather than the requirements of the Code and Standards. (Following the highest requirements.)**  Michael works for a brokerage firm and is responsible for the underwriting of securities. He is made aware that the financial statements he filed with the regulator overstate the issuer’s earnings. Michael seeks the advice of the brokerage firm’s general counsel, who states it would be difficult for Michael to be shown involved in any wrongdoing. **Conclusion: Michael should report the situation to his supervisor, seek an independent legal opinion, and determine whether the regulator should be notified of the error. (Notification of a violation.)**  Kenya’s firm advertises its past performance record by showing the 10-yr return of a composite of its client accounts. Kenya discovers that the composite omits the performance of firms that have left the composite during the 10-yr period, even though the description of the composite indicates all firm accounts have been included. Washington is asked to use promotional material that includes the erroneous performance number when soliciting business for the firm. **Conclusion: Kenya would be assisting in violating Standard I(A) if she were to use the inflated performance numbers when soliciting clients. She must dissociate herself form the activity, and bring the issue to her supervisor if discussing this with the person responsible is not an option. Of her firm is unwilling to recalculate performance, she must refrain from using the misleading promotional material, and notify the firm of her reasons. If the firm insists that she use the material, she should consider whether her obligation to dissociate from the activity requires her to seek other employment. (Dissociation from a violation.)**  New clients to Amanda’s firm are seeking investments that comply with Islamic law. The marketing materials for the firm don’t currently specify whether or not the fund is a suitable law for this clientele. **Conclusion: No violation, but Amanda will need to be aware of the differences between cultural and religious laws and requirements as well as the different governmental laws and regulations. She and the firm could be proactive in acknowledging areas where the new fund may not be suitable for clients. (Keeping informed of the latest laws and regulations based on religious tenets.)**  Colleen has been using social media to send out announcements of her views on investment information. Prior to her use in such a fashion, the local regulator had issued new requirements governing online communications, which appear to be in conflict with Coleen’s use. **Conclusion: Colleen has violated Standard I(A) because her actions do not comply with existing guidance and regulation. (Failure to maintain knowledge of the law.)** |
| **I(B) Professionalism: Independence and Objectivity** | Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in 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  Note: Receiving gift, benefit, or consideration from a client can be distinguished from gifts given by entities seeking to influence a member or candidate to the detriment of other clients. When possible, prior to accepting “bonuses” or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients. If notification is not possible prior to acceptance, M&C must disclose to employer benefits accepted previously from clients.  Other sources of pressure:  Buy-side clients: Portfolio managers might exert pressure on analysts’ independence and objectivity, by threatening analysts’ reputation, etc. Analysts must be wary of this.  Fund managers & custodial relationships: Do not exchange gifts during fund manager hiring process, when you’re on EITHER side  Issuer-paid research: Best to receive a flat fee; compensation should not be performance-based. Analysts must fully disclose potential conflicts of interest, including the nature of their compensation.  Travel funding: Best practice is for M&C to always use commercial transportation at theirs or their firm’s expense, rather than accept paid travel arrangements.  Performance Measurement and Attribution: Within a firm, analysts might find their independence and objectivity threatened. If analysts perceive that own managers have strayed from mandate, or composites are being played with to mask poor results, they must disclose this. If they are being asked to hide performance declines, they must refuse. | Steven, a mining analyst, is invited to join a group of his peers in a tour of mining facilities. The company arranges for group flights, and accommodation. **Conclusion: Steven is not necessarily violating Standard I(B). Analysts must be on guard in these situations to ensure their independence and objectivity is not impinged upon.** **(Travel Expenses.)**  Warner, an analyst, offers credit guidance to purchasers of fixed-income securities. Her compensation is closely linked to the performance of the corporate bond department. Near the quarter’s end, Warner’s firm has a large inventory position in the bonds of Company X, which they have been unable to sell because of Milton’s recent announcement. Salespeople have asked her to contact large clients to push the bonds. **Conclusion: If she pushes the bonds, Warner will violate Standard I(B). Warner must first be able to justify that the market price has already adjusted for the operating problem. (Research independence and sales pressure.) NOTE: Pressure on research independence can come from intrafirm sources, as well as clients.** |
| **I(C) Professionalism: Misrepresentation** | Members and Candidates must not knowingly make any misrepresentations related to investment analysis, recommendations, actions, or other professional activities.  Standard I(C) prohibits members and candidates from guaranteeing clients any specific return on volatile investments.  Members and Candidates must disclose their intended use of external managers, and must not represent those managers’ investment practices as their own.  On social media, members and candidates should only provide the same information they are allowed to distribute to clients and potential clients through other traditional forms of communication.  Other misrepresentations include: Qualifications or credentials, services provided by firms, characteristics of an investment, Omissions (e.g., cherry-picking inputs to a composite); Plagiarism (E.g., using materials prepared by others without acknowledging the source of the material). Plagiarism can be oral as well, such as through group meetings.  Cures for Plagiarism: Members and candidates should disclose whether the research being presented to clients comes from another source—whether within or outside the member’s or candidate’s firm.  Note: Members or candidates may use research conducted or models developed by others within the same firm without committing a violation. | Anthony McGuire is hired by publicly traded companies to electronically promote their stocks. McGuire creates a website that promotes his research efforts as a seemingly independent analyst. McGuire posts a profile and a strong buy recommendation for each company on the website indicating that the stock is expected to increase in value. He does not disclose the contractual relationships with the companies he covers on his website, in the research reports he issues, or in the statements he makes about the companies in internet chat rooms. **Conclusion: McGuire has violated Standard I(C) because the website is misleading to potential investors. The omission of the true relationship between himself and the companies he covers constitute a misrepresentation. (Disclosure of issuer-paid research.) McGuire has also violated Standard VI(A) Disclosure of Conflicts by not disclosing the existence of an arrangement through which he receives compensation in exchange for his services.**  Yao is responsible for the creation and distribution of the marketing materials for his firm. Yao creates and distributions a presentation of performance by the firm’s Asian equity composite that states the composite has 350B in assets. In fact, the composite has only 350B in assets, and the higher figure on the presentation is a result of a typo. The material is distributed to investors. Yao catches the mistake. **Conclusion: Yao must take steps to cease distribution of the incorrect material and to correct the error by information those who have received the erroneous information. Because Yao did not knowingly make the misrepresentation, however, he did not violate Standard I(C). (Correction of unintentional errors.)**  Ricki Marks sells mortgage-backed derivatives called “interest-only strips” to clients, to whom she describes them as “guaranteed by the US government”. Although the underlying mortgages are guaranteed, neither the investor’s investment nor the interest stream on the IOs is guaranteed. When interest rates decline, causing an increase in prepayment of mortgages, interest payments to the IO’s investors decline, and these investors lose a portion of their investment. **Conclusion: Marks has violated Standard I(C), by misrepresenting the terms and character of the investment.**  **(Misrepresentation of investment.)**  Paul runs a two-person investment management firm. Paul’s firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged by smaller firms for those firms’ clients. Paul’s firm distributes these reports to clients as its own work. **Conclusion: Paul can rely on third-party research that has a reasonable and adequate basis, but he cannot imply that he is the author of such research. If he does, he is violating Standard I(C).** **(Plagiarism)**  Through the news, Ray learns about a study that she would like to cite in her research. Should she cite both the mainstream intermediary source, as well as the author of the study itself when using that info? **Conclusion: In all instances, a member or candidate must cite the actual source of the information. If Ray does not use any interpretation of the report from the news, the newspaper is just a conduit of the original info, and does not need to be cited. (Plagiarism.)** |
| **I(C) Professionalism: 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. | Carmen manages a mutual fund, and is also an environmental activist. As the result of her participation in nonviolent protests, Garcia has been arrested on numerous occasions for trespassing on the property of a petrochemical plant. **Conclusion: Generally, Standard I(D) is not meant to cover legal transgressions resulting from acts of civil disobedience in support of personal believes – because such conduct does not reflect poorly on the member’s or candidate’s professional reputation, integrity, or competence.**  Howard is a security analyst who submits inflated reimbursement forms to his company. **Conclusion: Howard has violated Standard I((D).** |
| **II(A) Integrity of Capital Markets: 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.  Note: Information is “material” if its disclosure would probably have an impact on the price of security, or if reasonable investors would want to know the information before making an investment decision. Info is “nonpublic” until it is available to the market place in general (not just a select group of investors).  Notes:  “Mosaic theory”: The analyst are free to use conclusions from the analysis of large quantities of info from many sources, even if those conclusions might have been material inside information had they been communicated to the analyst.  Social media: Not always public, as some have memberships. Worth checking.  Members and candidates may provide compensation to individuals for their insights into industries without violating Standard II(A), BUT must make sure they are not requesting or acting on confidential information received from external experts, which is in violation of security regulations. | Frank Barnes, decides to accept a tender offer and sell the family business at a price almost double the market price of its shares. He shares this with his sister, who conveys it to her broker, Alex, who immediately buys the stock for himself. **Conclusion: Frank’s sister has violated Standard II(A) by communicating the inside information to her broker. Alex has also violated by acting upon (buying) the stock for himself. (Acting on nonpublic information).**  Sam, an analyst, is participating via telephone conference call with a client on a secondary offering. Throughout the call, several other folks at the company walk in/out of the conference room, and learn about the impending stock movement. They trade the stock on behalf of the firm’s clients and in proprietary accounts. **Conclusion: Sam has violated Standard II(A) because he failed to prevent the transfer and misuse of material nonpublic information to others in his firm. (Controlling nonpublic information.)**  Leah is trying to decide whether to hold or sell shares of an oil and gas exploration c that she owns in several fo the funds she manages. Her doctor casually follows the markets, and mentions that the company might be bought out; Leah decides to buy more stock in the oil and gas exploration company. **Conclusion: The source of information is unreliable, so the information cannot be considered material. Leah is not prohibited from trading the stock on the basis of this information. (Determining Materiality.)**  John covers the furniture industry. Looking for a buy recommendation, he talks to designers and retailers to figure out which furniture styles are trendy and popular. He discovers that one of the companies he analyzes, SFC, may be in financial trouble. He issues a sell recommendation for it. **Conclusion: John arrived at his conclusion about the earnings drop on the basis of public information and on pieces of nonmaterial nonpublic information. Trading based on John’s correct conclusion is not prohibited by Standard II(A).** **(Mosaic theory.)** |
| **II(B) Integrity of Capital Markets: 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.  Market manipulation can be 1) information-based or 2) transaction-based. | Ron manages two funds, and starts trading stock back and forth between his two funds to increase the price. **Conclusion: Ron is basing his returns on artificial distortion of both trading volume and price. He is violating Standard II(B) when doing so. (Creating artificial price volatility.)**  Allen creates user profile on several online forums and starts rumors about potential mergers for several of the smaller companies in the portfolio. Others buy as the price increases. **Conclusion: Allen has violated Standard II(B) even though he did not personally profit from the market’s reaction to the rumor. (Information manipulation.)**  ABC is exchange is trying to demonstrate that it has the best liquidity. To do so, it enters into agreements with members in which they commit to a minimum trading volume in exchange for reductions of regular commissions. **Conclusion: ABC has violated Standard II(B) by misleading participants about the actual liquidity of the market. If it fully discloses its agreement with members to boost transactions over some initial launch period, it will not violate the standard.** |
| **III(A) Duties to Clients: 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 employers’ or their own interests.  If Members and Candidates have “custody” or client assets, a heightened level of responsibility arises – they must manage any pool of assets in their control in accordance with the terms of the governing documents (e,.g., trust documents, investment management agreements).  Always keep in mind who the ultimate “client” is, and realize to whom the duty of loyalty is owed. In the context of an investment manager managing the personal assets of an individual, the client is easily identified. When the manager is responsible for the portfolios of pension plans or trusts, however, the client is not the person or entity, but the beneficiaries of the plan or trust – the duty of loyalty is owed to the ultimate beneficiaries.  Soft commission policies: When a member or candidate pays a higher brokerage commission than he or she would normally pay to allow for the purchase of goods or services, this is violation of duty of loyalty to the client.  A member or candidate is obligated to seek best price and best execution, and be assured by the client that the goods and services purchased will benefit the account beneficiaries. They should disclose to client if he/she may not be getting best execution from the directed brokerage.  Voting of proxies. Proxies have economic value to the client, so members and candidates must ensure that they vote prudently. | First Country bank serves as trustee for the Miller Company’s pension plan. Miller is the target of a hostile takeover attempt by Newton, and Miller’s managers have approached Julian, an investment manager at First Country, with an offer to bring First Country more business if Julian buys Miller’s common stock in the open market to ward off Newton’s takeover attempt. Although Julian believes the stock is overvalued, he purchases the stock to support Miller’s managers, maintain Miller’s good favor toward the bank, and realize additional new business. The stock purchases cause Miller’s market price to rise to such a level that Newton retracts its takeover bid. **Conclusion: By acting on behalf of his employer, Julian has violated Standard III(A). He has used the pension plan to perpetuate existing management, and benefit himself, to the detriment of plan participants and the company’s shareholders. (Identifying the Client.)**  JNI, an investment manager, uses the brokerage services of Thompson, Inc. Most of JNI’s trading activity is handled through Thompson because the executives of the two firms have a close friendship. Thompson’s commission structure is high in comparison with other firms’, and its abilities are considered average. **Conclusion: JNI executives are breaching their responsibilities by using client brokerage for services that do not benefit JNI clients, and by not obtaining the best price and best execution for their clients. In so doing they are violating Standard III(A). (Client commission practices.)**  Adam Dill recently joined an investment management team. To assist, his father and brother open new fee-paying accounts. After a few years, an IPO comes to market that is a suitable investment, but Dill does not receive the amount of stock requested. To avoid any appearance of a conflict of interest, he does not allocate any shares to his brother’s account. **Conclusion: Adam has violated standard III(A) because he is not acting for the benefit of his brother’s account as well as his other accounts. Dill is disadvantaging specific clients. (Managing family accounts.)**  Teresa Nguyen, an investment performance analyst, corrects an omission of a trade that will cause her firm to be terminated owing to underperformance in prior periods. Nguyen knows this news is unpleasant, but informs the appropriate individuals that the report needs to be updated before releasing it to the client. **Conclusion: Nguyen’s actions conform with the requirements of Standard III(A). (Client loyalty.)** |
| **III(B) Duties to Clients: 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.  NOTE: The point of this section is to refrain from affecting market value by following the standard above.  If different service levels are offered by members and candidates, they must 1) not disadvantage or negatively affect clients, and 2) should be disclosed to clients and prospective clients, and should be available to everyone. (I.e., not selectively offered.)  Investment Recommendations: Members and candidates should encourage their firms to prevent selective or discriminatory disclosure, and should inform clients about what kind of communications they will receive. This applies to changes to initial recommendations as well.  Investment Actions: When making investments in new offerings, or in secondary financings, Members and candidates should distribute the issues to all customers for whom the investments are appropriate in a manner consistent with the policies of the firm for allocating blocks of stock. If the issue is oversubscribed, then the issue should be prorated to all subscribers. This action should be taken on a round-lot basis to avoid odd-lot distributions. If the issue is oversubscribed, members and candidates should forgo any sales to themselves or their immediate families in order to free up additional shares for clients, UNLESS these accounts are managed similarly to the accounts of other clients of the firm.  Members and candidates should disclose to clients and prospective clients the documented allocation procedures they or their firms have in place, and how the procedures would affect the client or prospect. | Brad is a computer industry analyst who about to issue a “buy” recommendation for a company. While the report is being reviewed, brad schedules lunch with several of his best clients to discuss the company. He mentions the purchase recommendation to be finalized the following week. **Conclusion: Brad has violated Standard III(B) by disseminating the purchase recommendation to select clients a week before this recommendation is made available to all clients.** **(Selective Disclosure)**  Weng uses email to issue a new recommendation to all his clients. He then calls his three largest institutional clients to discuss the recommendation in detail. **Conclusion: Weng has not violated Standard III(B) because he widely distributed the recommendation and provided the information to all clients prior to discussions with a select few. (Additional Services for select clients.)** |
| **III(C) Duties to Clients: Suitability** | When members and Candidates are in an advisory relationship with a client, they must:   1. Make a reasonable inquiry into a client’s or perspective 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. 2. 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 3. **Judge the suitability of investments** in the context of the client’s total portfolio.   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. | Caleb Smith has two clients, who have different risk tolerances. Smith recommends investing 20% of both portfolios in zero-yield, small-cap, high –technology equiaty issues. **Conclusion: The investment may be appropriate for one client but not another. Smith is violating Standard III(C) by applying one client’s investment strategy to another’s given their different risk/return objectives. (Investment Suitability – risk profile.)**  Louis Perkowski manages a high-income mutual fund. He purchases zero-dividend stock in a financial services company because he believes the stock is undervalued. **Conclusion: The product Louis purchased, a zero-coupon bond, does not seem to fit the mandate of the fund that he is managing. Unless the fund’s disclosures allow this type of investment, Louis has violated Standard III(C). (Following an investment mandate.)**  Jessica McDowell, investment adviser, suggests to Brian, a risk-averse client, that covered call options be used in his equity portfolio. The purpose would be X, Y, Z, including the portfolio’s value. McDowell educates Brian about all possible outcomes. **Conclusion: When determining suitability of an investment, Jessica has maintained a primary focus on the characteristics of the client’s entire portfolio, not just the characteristics of single securities being added. Jessica has properly considered the investment in the context of the entire portfolio, and has thoroughly explained the investment to the client. (Investment Suitability—entire portfolio.)** |
| **III(D) Duties to Clients: Performance Presentation** | Members and Candidates must make reasonable efforts to ensure investment performance communications are fair, accurate and complete.  Avoid misstating performance or misleading clients and prospective clients about the investment performance of a member’s or candidate’s performance record. | Aaron is, following a successful few years at GP Financial, now a VP at Mastermind Advisors. In developing Mastermind’s advertising and marketing campaign, Aaron prepares an advertisement that includes the equity investment performance he achieved at G&P financial. The advertisement for Mastermind does not identify the equity performance as being earned while at GP. The advertisement is distributed to existing clients and prospective clients of Mastermind. **Conclusion: Aaron has violated Standard III(D) by distributing an ad that contains material misrepresentations about the historical performance of Mastermind. He would not have had he shown where the performance took place and his specific role in achieving that performance, while at GP Financial.** |
| **III(E) Duties to Clients: 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 2. Disclosure is required by law 3. The client or prospective client permits disclosure of the information | Lynn Moody is an investment officer at the Lester Trust Company. She has an advisory customer who has talked to her about giving appx $50k to charity to reduce her income taxes. Moody is also treasurer of the Home for Indigent Widows, which is planning its annual giving campaign. Moody recommends that HIW’s vice president call her advisory customer for a donation. **Conclusion: even though the connection was well-intended, Moody violated Standard III(E) by revealing confidential information about her client.**  **(Disclosing confidential information.)** |
| **IV(A) Duties to Employers: Loyalty** | 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.  Members and candidates are not precluded from entering into an independent business while still employed. However, members and candidates who plan to engage in independent practice for compensation must notify their employer and describe the types of services they will render to prospective independent clients, the expected duration of the services, and the compensation for the services. They should not render services until they receive consent from their employer to all the terms of the arrangement.  When leaving their current employer, they must not engage in activities that would conflict with their duty until resignation is effective. Do not:   * Misappropriate trade secrets * Misuse confidential info * Solicit employer’s clients prior to employment end   Members and candidates must be prepared to protect the integrity of capital markets and the interests of clients from themselves, and even from employers…even when doing so would violate duties to employers. | Emma, a recent college graduate, copies software before she leaves her old employer for her new one. **Conclusion: Madeline violated Standard IV(A) by copying the software without permission. (Ownership of completed prior work.)**  Geraldine Allen, without notice to her employer, registers with gov authorities to start an investment company that will compete with her employer, but she does not actively seek clients. **Conclusion: Geraldine’s actions don’t conflict with the work for her employer if the prep has been done on Allen’s own time outside the office, and if Allen will not be soliciting clients for the business or otherwise operating the new company until she has left her current employer.** **(Starting a new firm.)**  Angel Crome is contemplating leaving her current employer and soliciting clients for a new role. **Conclusion: Crome may contact former clients upon termination of her employment, but is prohibited from using client records built by/kept with her in her capacity as an employee of the prior bank. Client lists are proprietary information of her prior employer, and must not be used for her future employer’s benefit. (Soliciting former clients. Misuse of confidential info.)** |
| **IV(B) Duties to Employers: 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.  Members and candidates should make an immediate written report to their supervisor and compliance officer specifying any compensation they propose to receive for services in addition to the compensation or benefits received from their employer. This written report should state the terms of any agreement under which a member or candidate will receive additional compensation. | Geoff Whitman, a corrupt analyst for a compnay, manages the account of Carol, a client, Whitman is paid a salary by his employer, and Carol pays the company a standard fee based on the market value of assets in her portfolio. Carol proposes to Whitman, “Any year my portfolio achieves a 15% return before taxes, you and your wife can fly to Monaco at my expense, and use my condo.” Whitman does not inform his employer of the arrangement, and vacations as Cochran’s guest. **Conclusion: Whitman has violated Standard IV(B) by not informing his employer, and obtaining written consent from all parties involved. (Notification of client bonus compensation.)** |
| **IV(C) Duties to Employers: 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. | Sam Tabbing works for Charles Henry. Tabbing trades with errors by not providing the brokerages with account # for trades, but no system is in place to catch trading internally. Conclusion: Henry has failed to adequately supervise Tabbing with respect to her trading, and has in addition failed to establish record-keeping and reporting procedures to prevent Tabbing’s violations. As a result, he has violated Standard IV(C). (Supervising trading activities and record keeping.) |
| **V(A) Investment Analysis, Recommendations, and Actions: Diligence and Reasonable Basis** | Members and Candidates must:   1. Exercise diligence, independence, and thoroughness in analyzing, investments, making decisions, and taking investment actions. 2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.   Members and candidates must make reasonable and diligent efforts to determine whether secondary or third-party research is sound.  This applies particularly to quantitative research models and processes, and also extends to the selection of external advisors. |  |
| **V(B) Investment Analysis, Recommendations, and Actions: Communication with Clients and Prospective Clients** | Members and Candidates must:   1. 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. 2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process 3. Use reasonable judgment in identifying which factors are important to their investment analysis, recommendations, or actions and include those factors in communications with clients and prospective clients 4. Distinguish between fact and opinion in the presentation of investment analyses and recommendations | TBD |
| **V(B) Investment Analysis, Recommendations, and Actions: Record Retention** | Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications. | TBD |
| **VI(A) Conflicts of Interest: Disclosure of Conflicts** | Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.  Most common sources of conflicts:   * Cross-departmental pressures * Ownership of stock in companies being recommended to clients * Directorship (e.g., balancing clients and investors) * Business relationships | Investment management firm Dover and Roe sells a 25% interest in its partnership to a multinational bank holding company, Bank of NY. Immediately after the sale, Maggie Hobbs, president of Dover and Roe, changes her recommendation for BoNY’s common stock from “sell” to “buy”. **Conclusion: Maggie should have first disclose the new relationship with BoNY to all Dover and Roe clients. This relationship must also be disclosed to clients each time the firms’ portfolio managers make recommendations or take investment actions with respect to BoNY’s securities. (Conflict of interest and business stock ownership.)**  Carl Fargmon, a research analyst, has been recommending purchase of Kincaid printing company. After his initial report, his wife inherits from a distant relative $500 million of Kincaid stock. He has been asked to write a follow-up report on Kincaid. **Conclusion: Carl must disclose his wife’s ownership of the Kincaid stock to his employer, and in his follow-up report.**  **(Conflicts of interest and personal stock ownership.**  Samantha Snead, portfolio manager, was recently placed under a bonus compensation system that rewards portfolio managers on the basis of performance. In an attempt to boost her performance, she buys stocks for her clients that they don’t need, and are in fact contrary to their investment policy statements. **Conclusion: Snead has violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her owner, which created a conflict of interest between her compensation and her clients’ IPSs. (Conflicts of interest and compensation arrangements.)** |
| **VI(B) Conflicts of Interest: 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.  NOTE: This standard applies to members and candidates who have knowledge of pending transactions, access to nonpublic information, or who take investment actions. Members and candidates are prohibited from conveying nonpublic information to any person whose relationship o the member or candidate makes the member or candidate a beneficial owner of the person’s securities.  Members or candidates may undertake transactions in accounts for which they are a beneficial owner *only after* their clients and employers have had adequate opportunity to act on a recommendation. Personal transactions include those made in own accounts, for family, or in which member or candidate has a direct or indirect pecuniary interest. NOTE: Family accounts that are client accounts should be treated like any other firm account, and should neither be given special treatment nor be disadvantaged because of the family relationship. | Erin Toffler, a portfolio manager, manages the retirement account established with her firm by her parents. Whenever IPOs become available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place any remaining portion in her parents’ account, if the issue is appropriate for them. She has adopted this procedure to that no one can accuse her of favoring her parents. **Conclusion: Toffler has violated Standard VI(B) by breaching her duty to her parents by treating them differently from other clients on the basis of the family relationship. (Family accounts as equals.)**  Ellen Riley, head of firm ABC’s trading department at a brokerage, hears an internal research analyst’s negative research aired on TV regarding a major company her trading desk has a position in. Minutes within hearing this, she has changed positions from long to short. **Conclusion: Ellen did not give customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Ellen’s firm may have moved prices on puts and calls. She has violated Standard VI(B). (Trading prior to report dissemination.)** |
| **VI(C) Conflicts of Interest: 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. | James Handley works for the trust department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust’s brokerage department and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department, but does not disclose to them his referral fee arrangement within the company. **Conclusion: Handley has violated Standard VI(C) by not disclosing the referral arrangement to clients. Standard VI(C) does not distinguish between referral payments from /to third parties, and internal payments occurring within the firm. In the end, clients need to evaluate the partiality shown in any recommendation of services. (Disclosure of interdepartmental referral arrangements.)** |
| **VII(A) Responsibilities as a CFA Institute Member of CFA Candidate: Conduct as Participants in CFA Institute Program** | 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.  Do not disclose specific details of questions appearing on he exam, or broad topical areas and formulas tested or not tested on the exam. | In general, don’t’ write after the exam period end, share exam questions, bring written material into exam room, tell other graders which questions you graded (if you are a grader), use the volunteer capacity at CFA institute to benefit oneself and one’s clients. |
| **VII(B) Responsibilities as a CFA Institute Member of CFA Candidate: 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.  If no longer a member, do not present yourself as one. |  |

# recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

To complete.

## READING 3. APPLICATION OF THE CODE AND STANDARDS

## The candidate should be able to:

# evaluate professional conduct and formulate an appropriate response to actions that violate the Code of Ethics and Standards of Professional Conduct;

To complete.

# formulate appropriate policy and procedural changes needed to assure compli­ance with the Code of Ethics and Standards of Professional Conduct.

To complete.

## READING 4. ASSET MANAGER CODE OF PROFESSIONAL CONDUCT

## The candidate should be able to

# explain the purpose of the Asset Manager Code and the benefits that may accrue to a firm that adopts the Code;

To complete.

# explain the ethical and professional responsibilities required by the six General Principles of Conduct of the Asset Manager Code;

To complete.

# determine whether an asset manager’s practices and procedures are consistent with the Asset Manager Code;

To complete.

# recommend practices and procedures designed to prevent violations of the Asset Manager Code.

To complete.

## READING 5. THE BEHAVIORAL FINANCE PERSPECTIVE

## The candidate should be able to:

# contrast traditional and behavioral finance perspectives on investor decision making;

# contrast expected utility and prospect theories of investment decision making;

# discuss the effect that cognitive limitations and bounded rationality may have on investment decision making;

# compare traditional and behavioral finance perspectives on portfolio construc­tion and the behavior of capital markets.

## READING 6. THE BEHAVIORAL BIASES OF INDIVIDUALS

## The candidate should be able to:

# distinguish between cognitive errors and emotional biases;

# discuss commonly recognized behavioral biases and their implications for financial decision making;

# identify and evaluate an individual’s behavioral biases;

# evaluate how behavioral biases affect investment policy and asset allocation decisions and recommend approaches to mitigate their effects.

## READING 7. BEHAVIORAL FINANCE AND INVESTMENT PROCESSES

## The candidate should be able to:

# explain the uses and limitations of classifying investors into personality types;

# discuss how behavioral factors affect adviser–client interactions;

# discuss how behavioral factors influence portfolio construction;

# explain how behavioral finance can be applied to the process of portfolio construction;

# discuss how behavioral factors affect analyst forecasts and recommend remedial actions for analyst biases;

# discuss how behavioral factors affect investment committee decision making and recommend techniques for mitigating their effects;

# describe how behavioral biases of investors can lead to market characteristics that may not be explained by traditional finance.

## READING 8. MANAGING INDIVIDUAL INVESTOR PORTFOLIOS

## The candidate should be able to:

# discuss how source of wealth, measure of wealth, and stage of life affect an indi­vidual investors’ risk tolerance;

# explain the role of situational and psychological profiling in understanding an individual investor’s attitude toward risk;

# explain the influence of investor psychology on risk tolerance and investment choices;

# explain potential benefits, for both clients and investment advisers, of having a formal investment policy statement;

# explain the process involved in creating an investment policy statement;

# distinguish between required return and desired return and explain how these affect the individual investor’s investment policy;

# explain how to set risk and return objectives for individual investor portfolios;

# discuss the effects that ability and willingness to take risk have on risk tolerance;

# discuss the major constraint categories included in an individual investor’s investment policy statement;

# prepare and justify an investment policy statement for an individual investor;

# determine the strategic asset allocation that is most appropriate for an individ­ual investor’s specific investment objectives and constraints;

# compare Monte Carlo and traditional deterministic approaches to retirement planning and explain the advantages of a Monte Carlo approach.

## READING 9. TAXES AND PRIVATE WEALTH MANAGEMENT IN A GLOBAL CONTEXT

## The candidate should be able to:

# compare basic global taxation regimes as they relate to the taxation of dividend income, interest income, realized capital gains, and unrealized capital gains;

# determine the effects of different types of taxes and tax regimes on future wealth accumulation;

# explain how investment return and investment horizon affect the tax impact associated with an investment;

# discuss the tax profiles of different types of investment accounts and explain their effects on after-tax returns and future accumulations;

# explain how taxes affect investment risk;

# discuss the relation between after-tax returns and different types of investor trading behavior;

# explain tax loss harvesting and highest-in/first-out (HIFO) tax lot accounting;

# demonstrate how taxes and asset location relate to mean–variance optimization.

## READING 10. ESTATE PLANNING IN A GLOBAL CONTEXT

## The candidate should be able to:

# discuss the purpose of estate planning and explain the basic concepts of domes­tic estate planning, including estates, wills, and probate;

# explain the two principal forms of wealth transfer taxes and discuss effects of important non-tax issues, such as legal system, forced heirship, and marital property regime;

# determine a family’s core capital and excess capital, based on mortality proba­bilities and Monte Carlo analysis;

# evaluate the relative after-tax value of lifetime gifts and testamentary bequests;

# explain the estate planning benefit of making lifetime gifts when gift taxes are paid by the donor, rather than the recipient;

# evaluate the after-tax benefits of basic estate planning strategies, including gen­eration skipping, spousal exemptions, valuation discounts, and charitable gifts;

# explain the basic structure of a trust and discuss the differences between revo­cable and irrevocable trusts;

# explain how life insurance can be a tax-efficient means of wealth transfer;

# discuss the two principal systems (source jurisdiction and residence jurisdic­tion) for establishing a country’s tax jurisdiction;

# discuss the possible income and estate tax consequences of foreign situated assets and foreign-sourced income;

# evaluate a client’s tax liability under each of three basic methods (credit, exemption, and deduction) that a country may use to provide relief from double taxation;

# discuss how increasing international transparency and information exchange among tax authorities affect international estate planning.

## READING 11. CONCENTRATED SINGLE-ASSET POSITIONS

## The candidate should be able to:

# explain investment risks associated with a concentrated position in a single asset and discuss the appropriateness of reducing such risks;

# describe typical objectives in managing concentrated positions;

# discuss tax consequences and illiquidity as considerations affecting the man­agement of concentrated positions in publicly traded common shares, privately held businesses, and real estate;

# discuss capital market and institutional constraints on an investor’s ability to reduce a concentrated position;

# discuss psychological considerations that may make an investor reluctant to reduce his or her exposure to a concentrated position;

# describe advisers’ use of goal-based planning in managing concentrated positions;

# explain uses of asset location and wealth transfers in managing concentrated positions;

# describe strategies for managing concentrated positions in publicly traded com­mon shares;

# discuss tax considerations in the choice of hedging strategy;

# describe strategies for managing concentrated positions in privately held businesses;

# describe strategies for managing concentrated positions in real estate;

# evaluate and recommend techniques for tax efficiently managing the risks of concentrated positions in publicly traded common stock, privately held busi­nesses, and real estate.

## READING 12. RISK MANAGEMENT FOR INDIVIDUALS

## The candidate should be able to:

# compare the characteristics of human capital and financial capital as compo­nents of an individual’s total wealth;

# discuss the relationships among human capital, financial capital, and net wealth;

# discuss the financial stages of life for an individual;

# describe an economic (holistic) balance sheet;

# discuss risks (earnings, premature death, longevity, property, liability, and health risks) in relation to human and financial capital;

# describe types of insurance relevant to personal financial planning;

# describe the basic elements of a life insurance policy and how insurers price a life insurance policy;

# discuss the use of annuities in personal financial planning;

# discuss the relative advantages and disadvantages of fixed and variable annuities;

# analyze and critique an insurance program;

# discuss how asset allocation policy may be influenced by the risk characteristics of human capital;

# recommend and justify appropriate strategies for asset allocation and risk reduction when given an investor profile of key inputs.

## READING 13. MANAGING INSTITUTIONAL INVESTOR PORTFOLIOS

## The candidate should be able to:

# contrast a defined-benefit plan to a defined-contribution plan and discuss the advantages and disadvantages of each from the perspectives of the employee and the employer;

# discuss investment objectives and constraints for defined-benefit plans;

# evaluate pension fund risk tolerance when risk is considered from the per­spective of the 1) plan surplus, 2) sponsor financial status and profitability, 3) sponsor and pension fund common risk exposures, 4) plan features, and 5) workforce characteristics;

# prepare an investment policy statement for a defined-benefit plan;

# evaluate the risk management considerations in investing pension plan assets;

# prepare an investment policy statement for a participant directed defined-contribution plan;

# discuss hybrid pension plans (e.g., cash balance plans) and employee stock own­ership plans;

# distinguish among various types of foundations, with respect to their descrip­tion, purpose, and source of funds;

# compare the investment objectives and constraints of foundations, endow­ments, insurance companies, and banks;

# discuss the factors that determine investment policy for pension funds, founda­tion endowments, life and non-life insurance companies, and banks;

# prepare an investment policy statement for a foundation, an endowment, an insurance company, and a bank;

# contrast investment companies, commodity pools, and hedge funds to other types of institutional investors;

# compare the asset/liability management needs of pension funds, foundations, endowments, insurance companies, and banks;

# compare the investment objectives and constraints of institutional investors given relevant data, such as descriptions of their financial circumstances and attitudes toward risk.

## READING 14. CAPITAL MARKET EXPECTATIONS

## The candidate should be able to:

# discuss the role of, and a framework for, capital market expectations in the portfolio management process;

# discuss challenges in developing capital market forecasts;

# demonstrate the application of formal tools for setting capital market expecta­tions, including statistical tools, discounted cash flow models, the risk premium approach, and financial equilibrium models;

# explain the use of survey and panel methods and judgment in setting capital market expectations;

# discuss the inventory and business cycles and the effects that consumer and business spending and monetary and fiscal policy have on the business cycle;

# discuss the effects that the phases of the business cycle have on short-term/long-term capital market returns;

# explain the relationship of inflation to the business cycle and the implications of inflation for cash, bonds, equity, and real estate returns;

# demonstrate the use of the Taylor rule to predict central bank behavior;

# interpret the shape of the yield curve as an economic predictor and discuss the relationship between the yield curve and fiscal and monetary policy;

# identify and interpret the components of economic growth trends and demon­strate the application of economic growth trend analysis to the formulation of capital market expectations;

# explain how exogenous shocks may affect economic growth trends;

# identify and interpret macroeconomic, interest rate, and exchange rate linkages between economies;

# discuss the risks faced by investors in emerging-market securities and the coun­try risk analysis techniques used to evaluate emerging market economies;

# compare the major approaches to economic forecasting;

# demonstrate the use of economic information in forecasting asset class returns;

# explain how economic and competitive factors can affect investment markets, sectors, and specific securities;

# discuss the relative advantages and limitations of the major approaches to fore­casting exchange rates;

# recommend and justify changes in the component weights of a global invest­ment portfolio based on trends and expected changes in macroeconomic factors.

## READING 15. EQUITY MARKET VALUATION

## The candidate should be able to:

# explain the terms of the Cobb-Douglas production function and demon­strate how the function can be used to model growth in real output under the assumption of constant returns to scale;

# evaluate the relative importance of growth in total factor productivity, in capital stock, and in labor input given relevant historical data;

# demonstrate the use of the Cobb-Douglas production function in obtaining a discounted dividend model estimate of the intrinsic value of an equity market;

# critique the use of discounted dividend models and macroeconomic forecasts to estimate the intrinsic value of an equity market;

# contrast top-down and bottom-up approaches to forecasting the earnings per share of an equity market index;

# discuss the strengths and limitations of relative valuation models;

# judge whether an equity market is under-, fairly, or over-valued using a relative equity valuation model.

## READING 16. INTRODUCTION TO ASSET ALLOCATION

## The candidate should be able to:

# describe elements of effective investment governance and investment gover­nance considerations in asset allocation;

# prepare an economic balance sheet for a client and interpret its implications for asset allocation;

# compare the investment objectives of asset-only, liability-relative, and goals-based asset allocation approaches;

# contrast concepts of risk relevant to asset-only, liability-relative, and goals-based asset allocation approaches;

# explain how asset classes are used to represent exposures to systematic risk and discuss criteria for asset class specification;

# explain the use of risk factors in asset allocation and their relation to traditional asset class–based approaches;

# select and justify an asset allocation based on an investor’s objectives and constraints;

# describe the use of the global market portfolio as a baseline portfolio in asset allocation;

# discuss strategic implementation choices in asset allocation, including passive/active choices and vehicles for implementing passive and active mandates;

# discuss strategic considerations in rebalancing asset allocations.

## READING 17. PRINCIPLES OF ASSET ALLOCATION

## The candidate should be able to:

# describe and critique the use of mean–variance optimization in asset allocation;

# recommend and justify an asset allocation using mean–variance optimization;

# interpret and critique an asset allocation in relation to an investor’s economic balance sheet;

# discuss asset class liquidity considerations in asset allocation;

# explain absolute and relative risk budgets and their use in determining and implementing an asset allocation;

# describe how client needs and preferences regarding investment risks can be incorporated into asset allocation;

# discuss the use of Monte Carlo simulation and scenario analysis to evaluate the robustness of an asset allocation;

# describe the use of investment factors in constructing and analyzing an asset allocation;

# recommend and justify an asset allocation based on the global market portfolio;

# describe and evaluate characteristics of liabilities that are relevant to asset allocation;

# discuss approaches to liability-relative asset allocation;

# recommend and justify a liability-relative asset allocation;

# recommend and justify an asset allocation using a goals-based approach;

# describe and critique heuristic and other approaches to asset allocation;

# discuss factors affecting rebalancing policy.

## READING 18. ASSET ALLOCATION WITH REAL-WORLD CONSTRAINTS

## The candidate should be able to:

# discuss asset size, liquidity needs, time horizon, and regulatory or other consid­erations as constraints on asset allocation;

# discuss tax considerations in asset allocation and rebalancing;

# recommend and justify revisions to an asset allocation given change(s) in investment objectives and/or constraints;

# discuss the use of short-term shifts in asset allocation;

# identify behavioral biases that arise in asset allocation and recommend methods to overcome them.

## READING 19. CURRENCY MANAGEMENT: AN INTRODUCTION

## The candidate should be able to:

# analyze the effects of currency movements on portfolio risk and return;

# discuss strategic choices in currency management;

# formulate an appropriate currency management program given financial market conditions and portfolio objectives and constraints;

# compare active currency trading strategies based on economic fundamentals, technical analysis, carry-trade, and volatility trading;

# describe how changes in factors underlying active trading strategies affect tacti­cal trading decisions;

# describe how forward contracts and FX (foreign exchange) swaps are used to adjust hedge ratios;

# describe trading strategies used to reduce hedging costs and modify the risk–return characteristics of a foreign-currency portfolio;

# describe the use of cross-hedges, macro-hedges, and minimum-variance-hedge ratios in portfolios exposed to multiple foreign currencies;

# discuss challenges for managing emerging market currency exposures.

## READING 20. MARKET INDEXES AND BENCHMARKS

## The candidate should be able to:

# distinguish between benchmarks and market indexes;

# describe investment uses of benchmarks;

# compare types of benchmarks;

# contrast liability-based benchmarks with asset-based benchmarks;

# describe investment uses of market indexes;

# discuss tradeoffs in constructing market indexes;

# discuss advantages and disadvantages of index weighting schemes;

# evaluate the selection of a benchmark for a particular investment strategy.

## READING 21. INTRODUCTION TO FIXED-INCOME PORTFOLIO MANAGEMENT

## The candidate should be able to:

# discuss roles of fixed-income securities in portfolios;

# describe how fixed-income mandates may be classified and compare features of the mandates;

# describe bond market liquidity, including the differences among market sub-sectors, and discuss the effect of liquidity on fixed-income portfolio management;

# describe and interpret a model for fixed-income returns;

# discuss the use of leverage, alternative methods for leveraging, and risks that leverage creates in fixed-income portfolios;

# discuss differences in managing fixed-income portfolios for taxable and tax exempt investors.

## READING 22. LIABILITY-DRIVEN AND INDEX-BASED STRATEGIES

## The candidate should be able to:

# describe liability-driven investing;

# evaluate strategies for managing a single liability;

# compare strategies for a single liability and for multiple liabilities, including alternative means of implementation;

# evaluate liability-based strategies under various interest rate scenarios and select a strategy to achieve a portfolio’s objectives;

# explain risks associated with managing a portfolio against a liability structure;

# discuss bond indexes and the challenges of managing a fixed-income portfolio to mimic the characteristics of a bond index;

# compare alternative methods for establishing bond market exposure passively;

# discuss criteria for selecting a benchmark and justify the selection of a benchmark;

# describe construction, benefits, limitations, and risk–return characteristics of a laddered bond portfolio.

## READING 23. YIELD CURVE STRATEGIES

## The candidate should be able to:

# describe major types of yield curve strategies;

# explain why and how a fixed-income portfolio manager might choose to alter portfolio convexity;

# formulate a portfolio positioning strategy given forward interest rates and an interest rate view;

# explain how derivatives may be used to implement yield curve strategies;

# evaluate a portfolio’s sensitivity to a change in curve slope using key rate dura­tions of the portfolio and its benchmark;

# construct a duration-neutral government bond portfolio to profit from a change in yield curve curvature;

# evaluate the expected return of a yield curve strategy.

## READING 24. FIXED-INCOME ACTIVE MANAGEMENT: CREDIT STRATEGIES

## The candidate should be able to:

# describe risk considerations in investment-grade and high-yield corporate bond portfolios;

# compare the use of credit spread measures in portfolio construction;

# discuss bottom-up approaches to credit strategies;

# discuss top-down approaches to credit strategies;

# discuss liquidity risk in credit markets and how liquidity risk can be managed in a credit portfolio;

# describe how to assess and manage tail risk in credit portfolios;

# discuss considerations in constructing and managing portfolios across interna­tional credit markets;

# describe the use of structured financial instruments as an alternative to corpo­rate bonds in credit portfolios.

## READING 25. EQUITY PORTFOLIO MANAGEMENT

## The candidate should be able to:

# discuss the role of equities in the overall portfolio;

# discuss the rationales for passive, active, and semi-active (enhanced index) equity investment approaches and distinguish among those approaches with respect to expected active return and tracking risk;

# recommend an equity investment approach when given an investor’s investment policy statement and beliefs concerning market efficiency;

# distinguish among the predominant weighting schemes used in the construc­tion of major equity market indexes and evaluate the biases of each;

# compare alternative methods for establishing passive exposure to an equity market, including indexed separate or pooled accounts, index mutual funds, exchange-traded funds, equity index futures, and equity total return swaps;

# compare full replication, stratified sampling, and optimization as approaches to constructing an indexed portfolio and recommend an approach when given a description of the investment vehicle and the index to be tracked;

# explain and justify the use of equity investment–style classifications and discuss the difficulties in applying style definitions consistently;

# explain the rationales and primary concerns of value investors and growth investors and discuss the key risks of each investment style;

# compare techniques for identifying investment styles and characterize the style of an investor when given a description of the investor’s security selection method, details on the investor’s security holdings, or the results of a returns-based style analysis;

# compare the methodologies used to construct equity style indexes;

# interpret the results of an equity style box analysis and discuss the conse­quences of style drift;

# distinguish between positive and negative screens involving socially respon­sible investing criteria and discuss their potential effects on a portfolio’s style characteristics;

# compare long–short and long-only investment strategies, including their risks and potential alphas, and explain why greater pricing inefficiency may exist on the short side of the market;

# explain how a market-neutral portfolio can be “equitized” to gain equity market exposure and compare equitized market-neutral and short-extension portfolios;

# compare the sell disciplines of active investors;

# contrast derivatives-based and stock-based enhanced indexing strategies and justify enhanced indexing on the basis of risk control and the information ratio;

# recommend and justify, in a risk-return framework, the optimal portfolio allo­cations to a group of investment managers;

# explain the core-satellite approach to portfolio construction and discuss the advantages and disadvantages of adding a completeness fund to control overall risk exposures;

# distinguish among the components of total active return (“true” active return and “misfit” active return) and their associated risk measures and explain their relevance for evaluating a portfolio of managers;

# explain alpha and beta separation as an approach to active management and demonstrate the use of portable alpha;

# describe the process of identifying, selecting, and contracting with equity managers;

# contrast the top-down and bottom-up approaches to equity research.

## READING 26. ALTERNATIVE INVESTMENTS PORTFOLIO MANAGEMENT

## The candidate should be able to:

# describe common features of alternative investments and their markets and how alternative investments may be grouped by the role they typically play in a portfolio;

# explain and justify the major due diligence checkpoints involved in selecting active managers of alternative investments;

# explain distinctive issues that alternative investments raise for investment advis­ers of private wealth clients;

# distinguish among types of alternative investments;

# discuss the construction and interpretation of benchmarks and the problem of benchmark bias in alternative investment groups;

# evaluate the return enhancement and/or risk diversification effects of adding an alternative investment to a reference portfolio (for example, a portfolio invested solely in common equity and bonds);

# describe advantages and disadvantages of direct equity investments in real estate;

# discuss the major issuers and suppliers of venture capital, the stages through which private companies pass (seed stage through exit), the characteristic sources of financing at each stage, and the purpose of such financing;

# compare venture capital funds and buyout funds;

# discuss the use of convertible preferred stock in direct venture capital investment;

# explain the typical structure of a private equity fund, including the compensa­tion to the fund’s sponsor (general partner) and typical timelines;

# discuss issues that must be addressed in formulating a private equity investment strategy;

# compare indirect and direct commodity investment;

# describe the principal roles suggested for commodities in a portfolio and explain why some commodity classes may provide a better hedge against infla­tion than others;

# identify and explain the style classification of a hedge fund, given a description of its investment strategy;

# discuss the typical structure of a hedge fund, including the fee structure, and explain the rationale for high-water mark provisions;

# describe the purpose and characteristics of fund-of-funds hedge funds;

# discuss concerns involved in hedge fund performance evaluation;

# describe trading strategies of managed futures programs and the role of man­aged futures in a portfolio;

# describe strategies and risks associated with investing in distressed securities;

# explain event risk, market liquidity risk, market risk, and “J factor risk” in rela­tion to investing in distressed securities.

## READING 27. RISK MANAGEMENT

## The candidate should be able to:

# discuss features of the risk management process, risk governance, risk reduc­tion, and an enterprise risk management system;

# evaluate strengths and weaknesses of a company’s risk management process;

# describe steps in an effective enterprise risk management system;

# evaluate a company’s or a portfolio’s exposures to financial and nonfinancial risk factors;

# calculate and interpret value at risk (VaR) and explain its role in measuring overall and individual position market risk;

# compare the analytical (variance–covariance), historical, and Monte Carlo methods for estimating VaR and discuss the advantages and disadvantages of each;

# discuss advantages and limitations of VaR and its extensions, including cash flow at risk, earnings at risk, and tail value at risk;

# compare alternative types of stress testing and discuss advantages and disadvan­tages of each;

# evaluate the credit risk of an investment position, including forward contract, swap, and option positions;

# demonstrate the use of risk budgeting, position limits, and other methods for managing market risk;

# demonstrate the use of exposure limits, marking to market, collateral, netting arrangements, credit standards, and credit derivatives to manage credit risk;

# discuss the Sharpe ratio, risk-adjusted return on capital, return over maximum drawdown, and the Sortino ratio as measures of risk-adjusted performance;

# demonstrate the use of VaR and stress testing in setting capital requirements.

## READING 28. RISK MANAGEMENT APPLICATIONS OF FORWARD AND FUTURES STRATEGIES

## The candidate should be able to:

# demonstrate the use of equity futures contracts to achieve a target beta for a stock portfolio and calculate and interpret the number of futures contracts required;

# construct a synthetic stock index fund using cash and stock index futures (equitizing cash);

# explain the use of stock index futures to convert a long stock position into syn­thetic cash;

# demonstrate the use of equity and bond futures to adjust the allocation of a portfolio between equity and debt;

# demonstrate the use of futures to adjust the allocation of a portfolio across equity sectors and to gain exposure to an asset class in advance of actually com­mitting funds to the asset class;

# explain exchange rate risk and demonstrate the use of forward contracts to reduce the risk associated with a future receipt or payment in a foreign currency;

# explain the limitations to hedging the exchange rate risk of a foreign market portfolio and discuss feasible strategies for managing such risk.

## READING 29. RISK MANAGEMENT APPLICATIONS OF OPTION STRATEGIES

## The candidate should be able to:

# compare the use of covered calls and protective puts to manage risk exposure to individual securities;

# calculate and interpret the value at expiration, profit, maximum profit, maxi­mum loss, breakeven underlying price at expiration, and general shape of the graph for the following option strategies: bull spread, bear spread, butterfly spread, collar, straddle, box spread;

# calculate the effective annual rate for a given interest rate outcome when a bor­rower (lender) manages the risk of an anticipated loan using an interest rate call (put) option;

# calculate the payoffs for a series of interest rate outcomes when a floating rate loan is combined with 1) an interest rate cap, 2) an interest rate floor, or 3) an interest rate collar;

# explain why and how a dealer delta hedges an option position, why delta changes, and how the dealer adjusts to maintain the delta hedge;

# interpret the gamma of a delta-hedged portfolio and explain how gamma changes as in-the-money and out-of-the-money options move toward expiration.

## READING 30. RISK MANAGEMENT APPLICATIONS OF SWAP STRATEGIES

## The candidate should be able to:

# demonstrate how an interest rate swap can be used to convert a floating-rate (fixed-rate) loan to a fixed-rate (floating-rate) loan;

# calculate and interpret the duration of an interest rate swap;

# explain the effect of an interest rate swap on an entity’s cash flow risk;

# determine the notional principal value needed on an interest rate swap to achieve a desired level of duration in a fixed-income portfolio;

# explain how a company can generate savings by issuing a loan or bond in its own currency and using a currency swap to convert the obligation into another currency;

# demonstrate how a firm can use a currency swap to convert a series of foreign cash receipts into domestic cash receipts;

# explain how equity swaps can be used to diversify a concentrated equity port­folio, provide international diversification to a domestic portfolio, and alter portfolio allocations to stocks and bonds;

# demonstrate the use of an interest rate swaption 1) to change the payment pat­tern of an anticipated future loan and 2) to terminate a swap.

## READING 31. EXECUTION OF PORTFOLIO DECISIONS

## The candidate should be able to:

# compare market orders with limit orders, including the price and execution uncertainty of each;

# calculate and interpret the effective spread of a market order and contrast it to the quoted bid–ask spread as a measure of trading cost;

# compare alternative market structures and their relative advantages;

# explain the criteria of market quality and evaluate the quality of a market when given a description of its characteristics;

# explain the components of execution costs, including explicit and implicit costs, and evaluate a trade in terms of these costs;

# calculate and discuss implementation shortfall as a measure of transaction costs;

# contrast volume weighted average price (VWAP) and implementation shortfall as measures of transaction costs;

# explain the use of econometric methods in pretrade analysis to estimate implicit transaction costs;

# discuss the major types of traders, based on their motivation to trade, time versus price preferences, and preferred order types;

# describe the suitable uses of major trading tactics, evaluate their relative costs, advantages, and weaknesses, and recommend a trading tactic when given a description of the investor’s motivation to trade, the size of the trade, and key market characteristics;

# explain the motivation for algorithmic trading and discuss the basic classes of algorithmic trading strategies;

# discuss the factors that typically determine the selection of a specific algorith­mic trading strategy, including order size, average daily trading volume, bid–ask spread, and the urgency of the order;

# explain the meaning and criteria of best execution;

# evaluate a firm’s investment and trading procedures, including processes, dis­closures, and record keeping, with respect to best execution;

# discuss the role of ethics in trading.

## READING 32. MONITORING AND REBALANCING

## The candidate should be able to:

# discuss a fiduciary’s responsibilities in monitoring an investment portfolio;

# discuss the monitoring of investor circumstances, market/economic conditions, and portfolio holdings and explain the effects that changes in each of these areas can have on the investor’s portfolio;

# recommend and justify revisions to an investor’s investment policy statement and strategic asset allocation, given a change in investor circumstances;

# discuss the benefits and costs of rebalancing a portfolio to the investor’s strate­gic asset allocation;

# contrast calendar rebalancing to percentage-of-portfolio rebalancing;

# discuss the key determinants of the optimal corridor width of an asset class in a percentage-of-portfolio rebalancing program;

# compare the benefits of rebalancing an asset class to its target portfolio weight versus rebalancing the asset class to stay within its allowed range;

# explain the performance consequences in up, down, and flat markets of 1) rebalancing to a constant mix of equities and bills, 2) buying and holding equi­ties, and 3) constant proportion portfolio insurance (CPPI);

# distinguish among linear, concave, and convex rebalancing strategies;

# judge the appropriateness of constant mix, buy-and-hold, and CPPI rebalancing strategies when given an investor’s risk tolerance and asset return expectations.

## READING 33. EVALUATING PORTFOLIO PERFORMANCE

## The candidate should be able to:

# demonstrate the importance of performance evaluation from the perspective of fund sponsors and the perspective of investment managers;

# explain the following components of portfolio evaluation: performance mea­surement, performance attribution, and performance appraisal;

# calculate, interpret, and contrast time-weighted and money-weighted rates of return and discuss how each is affected by cash contributions and withdrawals;

# identify and explain potential data quality issues as they relate to calculating rates of return;

# demonstrate the decomposition of portfolio returns into components attribut­able to the market, to style, and to active management;

# discuss the properties of a valid performance benchmark and explain advan­tages and disadvantages of alternative types of benchmarks;

# explain the steps involved in constructing a custom security-based benchmark;

# discuss the validity of using manager universes as benchmarks;

# evaluate benchmark quality by applying tests of quality to a variety of possible benchmarks;

# discuss issues that arise when assigning benchmarks to hedge funds;

# distinguish between macro and micro performance attribution and discuss the inputs typically required for each;

# demonstrate and contrast the use of macro and micro performance attribution methodologies to identify the sources of investment performance;

# discuss the use of fundamental factor models in micro performance attribution;

# evaluate the effects of the external interest rate environment and active man­agement on fixed-income portfolio returns;

# explain the management factors that contribute to a fixed-income portfolio’s total return and interpret the results of a fixed-income performance attribution analysis;

# calculate, interpret, and contrast alternative risk-adjusted performance mea­sures, including (in their *ex post* forms) alpha, information ratio, Treynor mea­sure, Sharpe ratio, and M2;

# explain how a portfolio’s alpha and beta are incorporated into the information ratio, Treynor measure, and Sharpe ratio;

# demonstrate the use of performance quality control charts in performance appraisal;

# discuss the issues involved in manager continuation policy decisions, including the costs of hiring and firing investment managers;

# contrast Type I and Type II errors in manager continuation decisions.

## READING 34. OVERVIEW OF THE GLOBAL INVESTMENT PERFORMANCE STANDARDS

## The candidate should be able to:

# discuss the objectives, key characteristics, and scope of the GIPS standards and their benefits to prospective clients and investment managers;

# explain the fundamentals of compliance with the GIPS standards, including the definition of the firm and the firm’s definition of discretion;

# explain the requirements and recommendations of the GIPS standards with respect to input data, including accounting policies related to valuation and performance measurement;

# discuss the requirements of the GIPS standards with respect to return calcu­lation methodologies, including the treatment of external cash flows, cash and cash equivalents, and expenses and fees;

# explain the requirements and recommendations of the GIPS standards with respect to composite return calculations, including methods for asset-weighting portfolio returns;

# explain the meaning of “discretionary” in the context of composite construction and, given a description of the relevant facts, determine whether a portfolio is likely to be considered discretionary;

# explain the role of investment mandates, objectives, or strategies in the con­struction of composites;

# explain the requirements and recommendations of the GIPS standards with respect to composite construction, including switching portfolios among com­posites, the timing of the inclusion of new portfolios in composites, and the timing of the exclusion of terminated portfolios from composites;

# explain the requirements of the GIPS standards for asset class segments carved out of multi-class portfolios;

# explain the requirements and recommendations of the GIPS standards with respect to disclosure, including fees, the use of leverage and derivatives, con­formity with laws and regulations that conflict with the GIPS standards, and noncompliant performance periods;

# explain the requirements and recommendations of the GIPS standards with respect to presentation and reporting, including the required timeframe of compliant performance periods, annual returns, composite assets, and benchmarks;

# explain the conditions under which the performance of a past firm or affiliation must be linked to or used to represent the historical performance of a new or acquiring firm;

# evaluate the relative merits of high/low, range, interquartile range, and equal-weighted or asset-weighted standard deviation as measures of the internal dispersion of portfolio returns within a composite for annual periods;

# identify the types of investments that are subject to the GIPS standards for real estate and private equity;

# explain the provisions of the GIPS standards for real estate and private equity;

# explain the provisions of the GIPS standards for Wrap fee/Separately Managed Accounts;

# explain the requirements and recommended valuation hierarchy of the GIPS Valuation Principles;

# determine whether advertisements comply with the GIPS Advertising Guidelines;

# discuss the purpose, scope, and process of verification;

# discuss challenges related to the calculation of after-tax returns;

# identify and explain errors and omissions in given performance presentations and recommend changes that would bring them into compliance with GIPS standards.