soleadea

LEVEL 1: ETHICS

Reading 58 (3rd out of 5): STANDARDS I - VII

Difficulty: **medium**

Benchmark Study Time: **14h**

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- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

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1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
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NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

ETHICS – STANDARD I – PROFESSIONALISM

STANDARD I (A) – KNOWLEDGE OF THE LAW

It is crucial for you to know what legal provisions apply to your profession and how they may affect your professional activities. It is particularly important when you are involved in cross-border trading. **You should become familiar with all relevant laws and regulations that may apply to the situation both in your own country and in the country you are trading with.**

If there are no relevant laws in the country you trade with or the law applicable in this country is less strict than, say, the law of your own country, you will have to follow the law that is stricter, namely the law of your home country. And what happens if your home country's regulations are not as strict as the principles included in the Code and Standards? It means that the requirements of the Code and Standards are stricter and that they should be used instead. **CFA members and candidates are always required to follow the strictest regulations of all.**

Example

Mrs. Koko, a CFA candidate, resides in a country that has more lax transaction regulations than it is specified in the Code and Standards. She is conducting some transactions in a country with more strict transaction regulations than stated in the Code and Standards. The law of the country where Mrs. Koko resides applies, but it states that the law of locality where transactions are conducted governs. In this situation Mrs. Koko *most likely* should:

a. abide by the Code and Standards.

b. abide by the law of the country of her residence.

c. abide by the law of the country where she conducts the transactions.

Answer c is correct. Mrs. Koko should abide by the law of the country where she conducts her transactions because it provides the strictest regulations related to cross-border transactions (even stricter than it is demanded by the Code and Standards).

Example

Which of the following is *most likely* correct?

a. Performing a legal activity may result in the violation of the Code and Standards.

b. The Code and Standards are always the source of the most strict rules and regulations.

c. Activities that are considered lawful are always in compliance with the Code and Standards.

Answer a is correct. The fact that an activity is lawful and allowed under certain jurisdiction does not mean it is in compliance with the Code and Standards because some countries have more lax regulations than the rules included in the Code and Standards. Thus, performing a legal activity may sometimes lead to a breach of the Code and Standards. It is not true, however, that the Code and Standards are always the source of the most strict rules and regulations. Some countries may have laws more strict than the provisions of the Code and Standards. In such a case, those stricter laws should be obeyed.

<u>There are a couple of things that come as a result of what we have just mentioned:</u>

- CFA members and candidates must not take part in any actions considered to be wrong by the Code and Standards even if under a certain jurisdiction they are thought to be legal.
- CFA members and candidates must not assist in any sort of actions violating the Code and Standards.
- As a CFA member or candidate, you must dissociate from any action considered a violation under the Code and Standards. In practice, it means that you need to communicate the violation fact to your supervisor to allow him to stop the unethical or illegal conduct and take further steps to prevent such situations from happening in the future. You should also keep a record of the event and dissociate from it as soon as possible. It means you have to make it clear that you are not involved in or related to the illegal or unethical activity in any way.

Example

Under the Code and Standards, if your colleague assists in unethical investment activity and you know about it, you should *most likely*:

a. report the violation to the supervisor.

b. ask your colleague decisively to dissociate from the unethical activity and not report the violation because it is bad manners to tell on your colleague.

c. observe if your colleague participates in the unethical activity and report the violation if he does, but you need not report the violation if your colleague only assists in the activity.

Answer a is correct. Under the Code and Standards, **any instance of assistance or participation in an unethical or illegal activity should be reported so that proper measures can be taken**. CFA Institute also encourages that even potential violations be reported by CFA members and candidates and all other market participants both to governmental authorities and to CFA Institute if a need arises. It should be done to protect the integrity of the market.

Questions:

- What does it mean when we say that CFA members and candidates must abide by the provisions of the Code and Standards?
- How to stay in compliance with the Code and Standards and limit the possibility of violation?

Answer:

CFA members and candidates have to **know and follow not only the Code of Ethics and the Standards of Professional Conduct but also any other rules and principles formulated by CFA Institute**, such as the CFA Institute Articles of Incorporation or Bylaws.

As a CFA member or candidate, you should **stay informed and keep track of any changes in the law that governs your professional activities.** Also, you should always refer to written acts and statutes containing current laws and regulations or seek advice whenever you have any doubts. Additionally, the creation and regular reassessment of your own compliance procedures can be helpful.

When a company adopts the Code and Standards, it should also regularly review and distribute its compliance procedures to employees. And if the company does not adopt the Code and Standards, it should devise its own code of ethics and revise it on a regular basis. The company should also have well-thought-out procedures for reporting violations. It is also a good idea that companies provide information on all relevant legal issues or organize training for their employees when necessary.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD I (B) – INDEPENDENCE AND OBJECTIVITY

Standard I (B) makes it clear that **CFA members and candidates practicing the financial profession should by all means necessary strive to preserve their independence & objectivity**. To ensure that their research or investment recommendations or any other investment actions are free of bias, financial professionals should not accept any gifts or any additional compensations for their work. Why is it so? Because such benefits may influence or may be perceived to influence independence & objectivity.

Example

Isabel is a junior analyst with a Sydney brokerage. She is preparing a recommendation for a client. She has already thoroughly analyzed a number of securities and the client's IPS. Her supervisor pushes her to include the stock of Win-nin Company in her recommendation. Isabel thinks that Win-nin Company is a good investment but she is convinced that the stock is not a "buy" suitable for her client. She thinks the matter over and decides to include the Win-nin Company stock in her recommendation. If all employees at the Sydney brokerage are obliged to abide by the Code and Standards, Isabel has *most likely*:

a. violated the Code and Standards because of compromising her professional independence.

b. made the right choice because under the Code and Standards she must not disobey her supervisor.

c. not violated the Code and Standards but only under the condition that she manages to find an explanation for why the client should invest in the stock of Win-nin Company.

Answer a is correct. Standard I (B) requires that Isabel maintains independence and objectivity in performing her professional duties. If her supervisor makes her compromise either the former or the latter, she should not follow such instructions. We know that Isabel has analyzed her client's IPS and that she believes that investing in Win-nin Company stock is not suitable for her client. This is why we may suspect that finding an explanation to why the client should invest in the stock of Win-nin Company may be like finding an excuse for herself rather than making a good recommendation for the client. And the Code and Standards clearly say that client interest should always come first.

<u>Question:</u>

- What would you do if your client (an individual, and not a corporation) wanted to give you something?

Let us say that your client is a manufacturer of dolls and he wants to give you a doll that you could present to your daughter. This way he wants to appreciate your job. Will you accept the doll? Before you make your decision, you should distinguish between modest gifts and gifts that are not so modest anymore. **You may consider accepting**

a modest gift, especially if it is from an individual client because its effect on other clients' interests is scarce if any.

When CFA members or candidates decide to accept a gift from their clients (either individual or corporate), they are obliged to disclose it. As a rule, **the disclosure should take place before the gift is accepted.** But, if for any reason, you were unable to disclose acceptance, you should do it afterward as soon as you can. Your disclosure will enable your employer to judge whether the gift might have biased your conduct and to what degree.

As we have said, not always will you reject gifts or other benefits from your clients, but you may accept a gift too hastily, or perhaps you may not be aware of the value of the gift you accepted. This is why it is so important that **you report to your supervisor whenever you accept a gift or any kind of consideration.**

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD I (C) – MISREPRESENTATION

This standard tells us not to misrepresent anything that has been said or written.

There is a general rule under the Code and Standards which says that the **professional duties of every CFA member or candidate lie particularly with clients and the market**. By violating Standard I (C), you harm both your clients and the market. Every misrepresentation that you make is like cheating your clients. If you say something that is not true, it damages your reputation and makes your service less reliable. Your words and actions may have a bad and manipulative effect on the market. As a result, you destroy the trust of your clients and the integrity of the market as such.

This is why Standard I (C) makes it clear that **CFA members and candidates must not knowingly make any false statements or omit any important information**. It refers to any means or channels of communication, be it a written report, an oral presentation, or a phone conversation.

Plagiarism

The problem of plagiarism is quite extensively covered in Standard I (C).

The general rule is that you should **always give the source whether it is a quotation or a graph**. What is more, if there is more than one author, you should refer to it in a proper way. Also, make sure that you actually give the name rather than state, let us say, that the research was conducted by some prominent analyst in the field. If you use somebody else's texts, quote them. It is better to take a piece of text, quote it, and include the reference than to change the text a bit and sign it as yours. You plagiarize not only when you use somebody's text word for word without acknowledging it. You plagiarize also when you use the text and make your amendments to it and fail to make a proper reference.

Example

Which of the following *least likely* constitutes an element of defining plagiarism for the purposes of the Code and Standards provisions?

a. Citing someone else's ideas verbatim with a short reference to the author in footnotes.

b. Using someone else's analyses without acknowledging the author but with your own changes in wording.

c. Quoting conclusions from a report written by a particular analyst after words like: "According to some experts …"

Answer a is correct. Plagiarism is mainly understood as using someone else's ideas word for word without giving the source. However, it also includes many other practices, such as only slight changes in wording or not giving a proper reference when we use a specific quotation and using it in the context like "According to some experts …".

One more thing worth mentioning is that when you use some reports or papers to produce your own report it is also a good idea to keep copies of the materials you use in your work. They form a kind of background for your findings and complement your documentation.

Presenting information

Standard I (C) also emphasizes the importance of preserving due care while using third-party information or services of outside managers. **Every piece of information should be appropriately used and presented**. Note that if the materials you use include any misrepresentation you will bear the responsibility. As far as the services of outside managers are concerned, it is a good idea to disclose this fact to the client. Needless to say, you must not attribute the findings of such a manager to yourself.

In your relationship with the client, you are responsible for conveying information in the right way. You should be particularly careful when talking about possible returns on investment. You must not guarantee any return on volatile instruments.

Example

Under the Code and Standards, guaranteeing the rate of return on investment at a given level is:

a. allowed only for equity.

b. forbidden because it may be misleading to investors.

c. forbidden but only for such volatile investments of which the investor has too little knowledge.

Answer b is correct. CFA exam curriculum clearly states that "Standard I (C) prohibits members and candidates from guaranteeing clients any specific return on volatile investments." Making such guarantees may indeed mislead investors.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD I (D) – MISCONDUCT

Standard I (D) says about reputation and professional competence and indicates their importance and, in consequence, bans any intentional misconduct, such as fraud, deceit, lies, stealing, and so on.

To make sure that investment professionals pay proper attention to their professional conduct, **firms should enforce their ethical codes and compliance procedures.** Employees should know what happens if the rules set in the company are violated.

Although Standard I (D) deals mainly with professional conduct, it is important that those employed in the financial industry be honest individuals who care about the well-being of others.

Example

Victor is a CFA candidate and a portfolio manager with a prestigious brokerage house. He is also an ecology activist and often organizes the so-called "green" marches. Lately, as an organizer of such an event, he got arrested because the police suspected that the event takes place without a permit. Under the Code and Standards:

a. Victor did not violate Standard I (D), which does not regulate cases of civil disobedience being the result of personal beliefs.

b. Victor violated Standard I (D) because of his misconduct that badly influenced his professional competence and integrity.

c. Victor violated Standard I (D) because as a portfolio manager he should not get involved in any events that may reflect badly on investment professionals.

Answer a is correct. Generally, Standard I (D) is not meant to regulate cases of civil disobedience as a result of personal beliefs. Thus, Victor did not violate the provisions of Standard I (D). Nevertheless, as a CFA candidate and a portfolio manager at a prestigious brokerage house, Victor should always pay attention to his professional conduct, which should be impeccable. The violation of ethical standards of professional conduct will lead to the breach of the Code and Standards.

According to Standard I (D), you may be in breach of this Standard also if you fail to do something that was your duty. Let us say you are an analyst and you did not properly analyze the risk associated with investing in a stock of a certain company, yet you made a recommendation to your client. You neglected your duties and, thus, violated Standard I (D).

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

ETHICS – STANDARD II – INTEGRITY OF CAPITAL MARKETS

STANDARD II (A) – MATERIAL NONPUBLIC INFORMATION

When working in finance, say as an analyst, you will have access to extensive information. A good analyst can **find information and draw conclusions** that others will not be able to find or draw so easily. That is why to perform your duties professionally, you have to be able to distinguish between different types of information, namely between information that you may act upon and information that you must not use under any circumstances:

for use		not to be used
public information		material nonpublic information
nonmaterial nonpublic information		

As presented above, there is nothing wrong with using information considered to be common knowledge, i.e., public information. Also, information that is not known to the general public but is considered nonmaterial may be freely used. **Using material non-public information is, however, prohibited.**

<u>Question:</u>

- How do we know that we are dealing with material non-public information?

The main factor that distinguishes material non-public information from nonmaterial non-public information is **the influence on the price of a security**. But not every piece of information will affect the price and not every piece of information will affect the price to the same extent. To identify material non-public information, you should take into account the **source of the information and its nature.**

<u>Material non-public information – examples:</u>

- bankruptcies,
- mergers and acquisitions,
- annual reports and auditor reports,
- innovation-oriented initiatives,
- tender offers,
- contracts with customers, etc.

Example

Which of the following *least likely* constitutes material nonpublic information about a company?

a. Inside information about things such as bankruptcy or acquisition

b. Information about innovation-oriented initiatives, tender offers, or contracts with customers

c. Information about a possible merger and change in management spread by some rivals of the company

Answer c is correct. Even though information about things such as a merger or change in management is generally classified as material nonpublic information, not always will it constitute one. If the information takes the form of speculation made by the company's competitors, it is highly probable that it is unreliable. The degree of the reliability of information is very important when it comes to qualifying information as material nonpublic information. **Unreliable information does not constitute material nonpublic information**. Things such as bankruptcies, acquisitions, innovation-oriented initiatives, tender offers, or contracts with customers (especially very important ones before their execution) are enumerated among examples of material nonpublic information.

To sum up: **Using public information as well as nonmaterial non-public information for investment actions is beyond any violation**. Based on these types of information, analysts are allowed to form their own opinions. This kind of approach is called a *mosaic theory*. From different bits and pieces of information available to analysts, they draw their conclusions and, thus, can provide a valuable service to their clients. Sometimes a conclusion drawn by an analyst may turn out material by its very nature. If it comes as a result of a well-performed analysis, this conclusion will not be considered material non-public information. In order not to be accused of using material non-public information, it is very important to document the whole process of such an analysis properly.

<u>There are three more things to remember:</u>

- Although material nonpublic information is said to influence the price of a security, ANY trading based on this kind of information is banned – not only in securities but also in different instruments, e.g., in options on these securities.

- As an investment professional, you should also be aware of possible selective disclosure. Sometimes a company may – willingly or unwillingly – spread some information among analysts before it is spread to the public. In such situations, acting upon the information before it is properly disseminated is disallowed. The Code and Standards say that when you know about material nonpublic information, you should encourage its prompt and equitable dissemination.
- Possessing material nonpublic information should be appropriately regulated. Relevant compliance and disclosure procedures should be adopted by firms. Firewalls should be developed to prevent the exchange of material nonpublic information between different departments and employees. Also, relevant training should be provided to make employees aware of possible problems related to material nonpublic information and its identification.

Example

Which of the following statements is the *most appropriate* according to Standard II (A)?

a. Trading on inside information is permissible only in the short run.

b. If information is disclosed to a wide group of analysts during firm meetings, it is made public.

c. Even if an investment research report is considered material, it does not have to be made public before it is used.

Answer c is correct. Since it is highly probable that the inside information may be material and give its holder an unfair advantage, answer A is not the most appropriate one. Moreover, disclosing information to a wide group of analysts during a firm meeting does not make it public. But if an investment research report is considered material, it does not mean it has to be made public before it is used. Sometimes a conclusion drawn by an analyst may turn out material or is thought to be material. If the report comes as a result of a thorough analysis, the report need not be treated as material non-public information. Proper documentation of the whole analysis process may prove very useful in such a situation, though.

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STANDARD II (B) – MARKET MANIPULATION

The aim of Standard II (B) is **to secure the market and its participants against the adverse effect of manipulation.**

There are two major issues that you need to associate with this Standard. The first one is information-based manipulation and the other is manipulation based on transactions.

Information-based manipulation is when you spread false information to obtain some unfair gain at somebody else's expense. **Transaction-based manipulation**, on the other hand, is when you aim at obtaining this unfair gain through artificially conducted transactions. In both cases what decides about whether an action is a manipulation or not is the intent that lies behind the action.

Example

Management boards of Sweet-Tooth and EcoFood had a verbal agreement concerning the acquisition of Sweet-Tooth by EcoFood. It turned out, however, that the annual reports of Sweet-Tooth were not as good as the managing directors of EcoFood had expected. In this case, the acquisition was withheld. Inez Verdura, one of the managing directors at Sweet-Tooth and a CFA charterholder, let the journalist speculate about the acquisition during a phone conversation she had after the decision was made. Inez was hoping that the speculations will strengthen the position of the Sweet-Tooth's stock, which will in consequence draw EcoFood management's attention to Sweet-Tooth once again and help finalize the intended acquisition. In this situation, Inez *most probably*:

a. violated Standard II (B) by letting the journalist speculate.

b. violated Standard II (B) by undermining the integrity of the market.

c. did not violate Standard II (B) because she did not spread any misleading information.

Answer b is correct. The way Inez acted was unethical and detrimental to the whole situation. Her intentions were evil and, thus, she is at fault – she violated Standard II (B). First and foremost, the violation undermines the integrity of the market. Inez's weak will was the direct cause of violating Standard II (B). The mere speculation of the journalist did not need to end up in violation.

Example

Dorris, CFA, works in an investment banking firm. The CEO of GoldenAge, Inc. is one of the major clients of the firm. As it happens, the CEO has many long call options on the shares of B&A Bro, Inc. in his portfolio. The options are out-of-the-money and their maturity date is drawing near. Dorris is asked to "find a solution to the problem". She decides to carry out a number of transactions between the accounts of those of the clients who possess the shares of B&A Bro, Inc. Which of the following statements is the *most adequate* according to the Standards?

a. Dorris breached Standard II (B) by carrying out artificial transactions.

b. Dorris did not breach any of the Standards because she fulfilled her duty by taking care of the interests of one of the major clients, which is a top priority in the profession.

c. Dorris did not breach any of the Standards because she fulfilled her duty by taking care of the interests of those clients who possessed the shares of B&A Bro, Inc. by making the price of the shares go up and, thus, bringing profits to the clients.

Answer a is correct. Dorris breached Standard II (B) because the transactions she conducted were artificial. Her actions were aimed at manipulation – by carrying out the transactions between the accounts, she wanted the call options to become in-the-money. Of course, as a result of her actions, the price of the shares most probably went up and brought profits to the clients who possessed the shares of B&A Bro, Inc. Probably, also the CEO of GoldenAge, Inc. might have been satisfied, as he did not lose money on the options he had in his portfolio. Nevertheless, Dorris did not fulfill her duty towards her clients and the market properly and committed a violation.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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ETHICS – STANDARD III – DUTIES TO CLIENTS

STANDARD III (A) – LOYALTY, PRUDENCE, AND CARE

Duties to clients are covered in detail in Standard III, which sets out common guidelines to be followed regardless of different legal regulations, cultural backgrounds, or fiduciary duties that affect relationships with clients. While regulations, duties, and customs differ worldwide, the **guidelines established by Standard III constitute the common benchmar**k to be accepted by all CFA members and candidates.

As a CFA member or candidate, you must act in an appropriate manner – according to Standard III (A) this **includes preserving loyalty in relationships with your clients** and **basing actions on prudence and reasonable care.**

According to the Code and Standards, client interest always comes first. Remember that you are always obliged to act to the benefit of your clients and that their interests are of paramount importance.

Example

According to Standard III (A), when providing services to the client it is *most likely* that a Member or Candidate:

a. may use client brokerage to purchase research services that will benefit the investment manager himself/herself.

b. should inform the client about not getting the best execution before satisfying the client's directed brokerage request.

c. may pay higher commissions for buying products for the client if it is for the benefit of the client or the investment manager.

Answer b is correct. In the case of the so-called directed brokerage, you should inform the client if the best execution cannot be achieved. Generally, client brokerage should be used to the client's advantage and if you buy with the brokerage some goods or services that will serve you and not the client, you should make sure that the client knows how to address a potential conflict. Also, you should not pay more for goods or services than you normally pay when you buy analogous goods or services, especially if it does not turn to the client's advantage.

Altogether, **Standard III (A) ensures that the client is given professional and loyal assistance in his investment actions and that is your responsibility to ensure that he really is**. When we think about the maze of legal regulations and the whole complexity regarding the system of financial services, we should understand that clients can be often unsure of what to do and how to behave. It is your role to make investing as safe an adventure as possible.

Example

Ashley Winston, a CFA candidate and an independent portfolio manager, often handles her trading activities through the brokerage because she is frequently given more beneficial prices when she places her orders with William Hue, a broker at Lucrative Investing House, Inc. and an old acquaintance of hers. To be in compliance with Standard III (A), it is *most likely* that Ashley should:

a. always accept the same prices for both client and private transactions.

b. never direct her clients' transactions to Lucrative Investing House, Inc. because of the conflict of interest.

c. make sure that transactions handled through Lucrative Investing House, Inc. are consistent with the client's investment parameters.

Answer c is correct. If transactions handled through Lucrative Investing House, Inc. are consistent with the client's investment objectives, circumstances, and the like, Ashley may place her orders with William. The potential conflict of interest that arises as a result of their acquaintance should be, however, properly disclosed to clients. As far as prices for transactions carried out by Ashley are concerned, it is not true that she should ALWAYS accept the same prices for both client and private transactions. Imagine that she is given more beneficial offers when she conducts transactions for her clients than when she carries out some transactions to her own account – surely Ashley should not make her clients pay more than necessary (more beneficial prices for client transactions than for her own transactions are ok).

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD III (B) – FAIR DEALING

As a CFA member or candidate, you have to **treat all your clients fairly**, which means that you must not favor one client over the other. The provisions of Standard III (B) account for the possibility that services provided to various clients may differ, but it also states that these differences in service provided by the professional should be known to all clients, and not only to the selected group of clients.

When an investment recommendation is given, you should make sure that information will be disseminated to all of your clients simultaneously. Although it is not possible to reach each and every client at the same time, you should make sure that no selective or discriminatory disclosure takes place when a recommendation or any other investment information is spread. To ensure that it is really possible, the space of time between issuing the recommendation to make an investment and its dissemination should be as short as possible.

When an investment action is taken, the **distribution, allocation, or any other investment action must follow procedures that ensure equitable treatment of clients**. It is also important that you **take into consideration the criterion of suitability** while making investment decisions for your clients.

Example

According to Standard III (B), it is recommended that fair-dealing compliance procedures be set and followed. Which of the following statements is the *least appropriate* for the purposes of Standard III (B)?

a. The time frame between decision and dissemination should be as short as possible.

b. Selective disclosure is banned unless the client's investment objectives suggest otherwise.

c. The number of people who know about a recommendation before its dissemination should be limited.

Answer b is correct – it is the least appropriate statement. Selective disclosure is ALWAYS banned regardless of the client's investment objectives. It is true that the time frame between decision and dissemination should be as short as possible and that the number of people knowing about a recommendation before its dissemination should be limited.

The main idea behind Standard III (B) is that you are always obliged to **provide fair and impartial service to all of your clients.** To make it possible, it is good to develop a list of clients and regularly go over their accounts to make sure that none of them is given unfair treatment. Also, any policies applicable either to different levels of services and different fees or to trades allocations or any other investment actions should be communicated to all of the clients.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD III (C) – SUITABILITY

Whenever you find yourself in an advisory relationship with your client, you will be obliged to create a document referred to as an **Investment Policy Statement (IPS)**. IPS is a document of high significance both to you and to your client and it is required that every client has his or her Investment Policy Statement. In the so-called IPS, you describe your client's objectives and expectations and all that you need to know to be able to perform your duties well.

The IPS should outline:

- the financial situation of the client,
- his or her personal data important from the point of view of making investment decisions (e.g., age and occupation),
- the client's risk tolerance,
- his or her investment objectives (e.g., return requirements or liquidity needs),
- investment constraints (e.g., time horizon, tax concerns, liquidity needs, legal and regulatory aspects, or any unique circumstances).

Moreover, the IPS should:

- state any formal obligations between the parties, namely their roles and responsibilities, and
- regulate an obligation to review and evaluate the IPS at specified periods.

The IPS should have a **written form** and it should be **regularly updated**, at least once a year. Also when some major changes to the client's investment path are planned, the client's IPS should be reviewed and amended if necessary.

Full disclosure of any investment-related information on the part of the client is also crucial.

When making decisions concerning the suitability of a given investment recommendation or action, apart from the investor's characteristics also **the structure of the portfolio is significant**. What it means is that the portfolio should be diversified – it reduces the level of risk associated with investing. As far as investment risk is concerned, it should be carefully judged by professionals staying in advisory relationships with clients. Some investments, such as those with high leverage or limited liquidity, should be chosen for clients with great prudence.

Example

Joe Silvermann, an investment analyst, stated that buying shares of Evenemental, SA is a risky transaction but it potentially offers a high return. A portfolio manager, CFA, that relies on Silvermann's recommendation:

a. must purchase the shares only for those clients who have low risk aversion.

b. must take into consideration the portfolio and objectives of the client before purchasing the shares.

c. must not purchase the shares for his clients because he must act with reasonable care and prudence when dealing with his clients.

Answer b is correct. Before purchasing any shares, a portfolio manager must always take into consideration the whole portfolio of the client and his or her investment policy statement, including investment objectives. The portfolio manager should decide to make a purchase only if the transaction is suitable for the client. Why is purchasing the shares of Evenemental, SA only for those clients who have low risk aversion a wrong decision then? We know from Silvermann's recommendation that it is a risky transaction and that it potentially offers a high return. It should satisfy investors who are not afraid of taking the risk. After the portfolio manager analyzes the whole portfolio of the client and his or her IPS, however, it may turn out that the shares of Evenemental, SA are not suitable for the client, even if the client is a risk-taker. Thus, buying the shares for all clients with low risk aversion without prior analysis is a negligent decision. In fact, the portfolio manager will be guilty of negligence also when he decides not to purchase the shares for his clients. He should act with reasonable care and prudence and buy the shares of Evenemental, SA only for those of his clients for whom the shares are suitable and in the amount consistent with the client's portfolio.

To sum up: When advising your clients, you have to take their unique requirements, risk profiles, and any other relevant information into account to give suitable recommendations and take suitable investment actions on behalf of your client.

As an investment professional you have to **be aware of the level of client portfolio diversification and take it into consideration in taking investment actions for your client.**

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD III (D) – PERFORMANCE PRESENTATION

Investment performance has to be presented to clients in a credible way. **No misrepresentation or selection of information is allowed.** To comply with Standard III (D), CFA members and candidates are encouraged to follow the Global Investment Performance Standards (GIPS). Still, it is also possible to remain in compliance with the Standard without strict adherence to the GIPS standards. Then, it is necessary to follow some generally accepted principles, such as including closed accounts in performance measurement and presentation or explaining the methodology of performance presentation, e.g., stating that the presentation takes the form of a simulation.

To quote the Code and Standards, performance information must be "fair, accurate and complete". It concerns both individual and pooled accounts. It is your duty to ensure that your performance is always adequately presented – both to your clients and to your prospective clients.

Example

Performance presentation made to clients:

a. must be always extensive,

b. may be concise but must include reference to additional information.

c. may be concise and should include reference to additional information.

Answer c is correct. Performance presentation need not be long and extensive. It may be brief and concise, but then detailed information should be given to clients whenever they request it. As far as references are concerned, it is well perceived if they are included in the presentation.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD III (E) – PRESERVATION OF CONFIDENTIALITY

In an advisory relationship with the client, you will often receive some private or otherwise special information from the client. In such cases, **you are obliged to maintain the confidentiality of information** regardless of whether you are still working for the client, whether you ended working for the client or whether it is your prospective client.

There are some situations, however, that require that the obligation to remain confidential is compromised. These are:

- when your client is somehow associated with illegal activity,
- when the law states clearly that information must be revealed,
- when your client consents that you disclose certain information.

In such situations, you either may or are obliged to give information that you must otherwise keep secret and confidential.

Example

Eve Liebermann, an independent research analyst and a CFA candidate, sought prospective clients. Her first action was to obtain from a prospective client an e-mail consent to receiving her offering. She also sent a form on client objectives that the interested individuals were to fill in and send back to Eve so that she was able to prepare an individualized offering for the prospective client. Some of the individuals filled in the forms and sent them back. Abel Bauer, a hedge fund manager and a friend of Eve's, asked her to let him see her e-mail correspondence with the prospective clients that sent her the filled-in forms. To remain in compliance with Standard III (E), Eve *most likely* should:

a. not allow Abel to see the e-mail correspondence with her prospective clients by any means.
b. allow Abel to see the e-mail correspondence but only if the prospective clients consent to the disclosure.
c. allow Abel to see the e-mail correspondence but only if he promises that he will not use the information in any way.

Answer b is correct. Generally, information obtained from your clients or prospective clients should be held in confidence. If, however, the client or prospective client agrees to your spreading the information, you may disclose it. Thus, Eve will be allowed to show Abel the e-mail correspondence but only if she gains consent from the prospective clients.

Not all information obtained from the client is confidential, however. Nevertheless, to remain in compliance with Standard III (E), it would be best not to disclose any of the information received from clients unless this information is shared with a clear aim to benefit the client.

Standard III (E) also draws attention to the possible problems of **accidental disclosures**. Because nowadays information is generally stored on computers and shared through electronic means of communication, it is especially important to **ensure that the information is safe and cannot be accessed by unauthorized persons.**

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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ETHICS – STANDARD IV – DUTIES TO EMPLOYERS

STANDARD IV (A) – LOYALTY

Standard IV describes proper conduct with respect to the employer, as well as the responsibilities of the supervisor.

As a CFA candidate, you are obliged to **act to the benefit of your employer and not to deprive your employer of the skills you possess.** The employer-employee relationship should be governed by specifically formulated principles that should be followed as long as they are not in conflict with the Code and Standards or any applicable laws and regulations.

Nowadays, firms tend to adopt the **Code and Standards** as their ethics policy. In such a case, as a CFA candidate (or member), you can stay loyal both to your employer and to the provisions of the Code and Standards at the same time. If a company does not adopt the Code and Standards, it develops its own compliance procedures. In this situation, you are bound to obey the company's compliance procedures as long as no conflicting procedures are developed. In case of any conflicts, you **are obliged to obey the stricter rule**, so you must follow the principles set by the Code and Standards or the applicable law.

Also, note that the Code and Standards account for certain somewhat exceptional situations. If a conflicting situation between the employer and the employee arises as a result of unethical, illegal, or otherwise detrimental behavior on the part of the employer, Standard IV (A) allows the employee to act against the employer. This is described by the term *whistleblowing.* The conflicting situation may occur for example when there is a conflict between your idea of the client's best interest and the idea dictated to you by your employer.

Example

Whistleblowing allows every CFA member or candidate in some situations to:

a. disobey the employer's policies.

b. place the interests of a group of clients over the interests of the rest of the clients.

c. gain some personal advantage but only if the conflict of interest is properly disclosed.

Answer a is correct. Whistleblowing takes place when not for your benefit but to protect the interests of your clients or the integrity of the market, you decide to disobey the policies established at your workplace.

Remember that in the context of Standard IV (A) it is crucial that your actions do not cause any harm to your employer. You must **remain loyal to your employer in every situation consistent with generally accepted ethical norms and relevant rules and procedures**.

This no-harm rule has to be taken into account when undertaking any competitive activity. For example, if you wished to commence an independent practice while working for your employer, you would be obliged to notify him about it. Also, you must not start to provide such services unless you gain permission from your employer.

According to Standard IV (A), you are allowed to make preparations when you decide that you want to undertake a new challenge and leave your previous job, but you will violate the Standard if you undertake the job or contact your prospective clients before your resignation becomes effective. You should also keep in mind that you are forbidden to contact any clients as long as the contact details come from your ex-employer's records or files. You may contact your prospective clients when the information about them is publicly available. In addition, after you depart your job you may use files that you created at your previous employer only if you receive a written consent to do that.

Remember, that **Standard IV (A) generally requires that you be loyal to your employer**. But you also need to bear in mind that your responsibility lies first and foremost with the client and the market. The employer is of secondary importance here.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD IV (B) – ADDITIONAL COMPENSATION ARRANGEMENTS

Standard IV (B) regulates additional compensation for the work performed. According to this standard, **CFA members and candidates must not accept any gifts or compensations that might compromise their decisions or actions unless all parties involved agree to it in writing**.

Why is it so? The reasons are threefold:

- First of all, a possible conflict of interest may occur when such a gift or compensation is accepted.
- Secondly, additional compensation for work may hinder the objectivity requested from investment professionals.
- Last but not least, it may also affect the real costs of services provided by the professional.

For these reasons, every situation in which a benefit is offered to an investment professional should be **disclosed to the employer**. This will allow the employer to make a judgment about whether the compensation received affects the duties performed by the employee.

Example

According to Standard IV (B), CFA members and candidates must not accept any gifts or compensations that might compromise their decisions or actions unless all parties involved agree to it in writing. With respect to the above, which of the following refrain-from eventualities is *the least* appropriate?

a. A possible avoidance of a conflict of interest

b. A possible hindrance of the required objectivity

c. A possible influence on the real costs of provided services

Answer a is correct. The reasons for which CFA members and candidates must not accept any gifts or compensations that might compromise their decisions or actions unless all parties involved agree to it in writing are as follows: (i) a possible occurrence of a conflict of interest, (ii) a possible hindrance of the required objectivity, (iii) a possible influence on the real costs of provided services. For these reasons, every situation in which a benefit is offered to an investment professional should be disclosed to the employer. This will allow the employer to make a judgment about whether the compensation received affects the duties performed by the employee. Also, note that the possible avoidance of a conflict of interest constitutes an effect rather than a reason.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD IV (C) – RESPONSIBILITIES OF SUPERVISORS

If you happen to become a supervisor, as a CFA member or candidate you are obliged to **carry your supervisory responsibilities in accordance with the Code and Standards.** That is why you will need to have an in-depth knowledge of all the provisions of the Code and Standards to be able to identify situations of potential violations and to prevent them.

There are three steps that every supervisor should take care of:

- construct an effective compliance program,
- monitor the effectiveness of the compliance program, and
- enforce this compliance program.

An effective compliance program will prevent your employees from violating any relevant laws and regulations. So, you will have to formulate specific and adequate procedures that your employees will have to follow.

Question:

- What does it mean to formulate adequate procedures?

To quote the CFA exam curriculum: "Adequate" procedures are those designed to meet industry standards, regulatory requirements, the requirements of the Code and Standards, and the circumstances of the firm." Thus, such procedures will differ between the companies and will depend on such factors as services provided by the company or the size of the firm. Compliance procedures should **elaborate on specific conduct allowed in the company** and – in this sense – should complement the more general code of ethics. The language of compliance procedures should be **easy to understand** and every employee should know the procedures and have access to them in case of any doubt. After all, a compliance program may be effective only when people are familiar with it.

After compliance procedures are established, they should be **periodically monitored and evaluated.** If a violation occurs, it may mean that the procedures are insufficient and that there is a need for restrictions. When a violation takes place, you should act without delay and start an inquiry to find out what exactly happened and what was the reason. You should also report the violation to the senior supervisor and make sure that adequate steps are taken to prevent similar violations from repeating. Moreover, in situations when you are aware of actual or possible violations, you should not evade your supervisory responsibility because of insufficient compliance procedures. It is up to you to ensure that the program is sound and that it performs its function well.

The last step that every supervisor should take is to try to the best of their abilities to **enforce the program effectively**. Life is a complex experience and various scenarios may unfold but it is your duty to do your best as a supervisor to prevent any wrongdoing or misconduct from happening under the circumstances that are known to you at a given moment.

Example

Assume that you are a CFA charterholder and a supervisor. As the supervisor, you are an immediate subordinate to the Department Director. In this situation, you *least likely* exercise your supervisory responsibility with respect to possible violations of:

a. the Code and Standards.

b. any relevant laws or regulations.

c. the company's compliance policy mainly.

Answer c is correct. As a supervisor, you need to prevent and detect any possible violations of any relevant laws or regulations, including the Code and Standards and the company's compliance policy.

Every company has its hierarchy. Below a situation is presented in which supervisory responsibilities over a group of employees are delegated to a person who becomes the supervisor of this group and is subordinate to his or her direct supervisor at the same time. Consider this example from the perspective of the supervisor who is higher in rank.

Example

René François works at a large financial institution and acts as the supervisor of over 50 employees. He is directly subordinate to Catherine Lieux, a CFA charterholder, who is the supervisor of the whole department consisting of 200 employees. Under the provisions of the Code and Standards, if one of the 50 people supervised by René commits a violation, Catherine *most probably*:

a. will not be in breach of the Code and Standards because the supervision over the employee is delegated to René.

b. will not be in breach of the Code and Standards but only if she properly instructed René of his responsibilities and effectively implemented relevant documents and programs as a department supervisor.

c. will always be in breach of the Code and Standards even if she took all necessary steps in preventing violations under her supervision, such as instituting relevant documents and programs, because she is the head of the whole department.

Answer b is correct. Delegating supervision over a number of employees to René does not relieve Catherine of her responsibilities as the department supervisor. To fulfill her responsibilities without fault, she has to instruct her subordinate of his duties with respect to preventing and detecting violations and she must make all her efforts to ensure that violations are prevented and detected in time by introducing an effective compliance policy. Even though Catherine does not discharge supervisory duties personally, she is still responsible for the proper supervision of employees. However, according to Standard IV (C) if Catherine institutes an effective compliance policy and makes sure it is followed (namely she does not ignore any premise of possible wrongdoing), she will not be responsible for a potential violation.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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ETHICS – STANDARD V – INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

STANDARD V (A) – DILIGENCE AND REASONABLE BASIS

The level of diligence and reasonable basis depends on numerous factors including the position and the relation to the client. The more you are involved in the relationship and the decision made, the greater diligence you should apply to your actions. Before making a recommendation or an analysis, you should **address all aspects connected with the subject of your recommendation or analysis**. You should also have a reasonable basis that supports your decisions and actions. To achieve this you should make use of various resources and not base your conclusions on one source of information only. For example, you should not use results obtained using quantitative models only because – as with every method – it has its limitations. Moreover, you should use current data rather than archaic ones. By assuming this kind of due diligence and reasonable basis, you will be able to reach thorough conclusions suitable for your clients.

Another important thing that you have to remember deals with using secondary or third-party research in your work. Every time you use material prepared by someone else, be it your colleague or someone from outside the firm you work for, you should analyze the information included in such material and ask yourself whether you think the information is reliable enough to be used for your investment analysis or recommendation.

Sometimes companies decide to delegate some tasks to outside firms or advisers. To comply with Standard V (A), you need to make sure that your company possesses appropriately described criteria that allow making a good choice of such an outside specialist.

Example

In their decision-making process, CFA members and candidates developing an investment recommendation for their clients are *least likely* allowed to use:

a. quantitative research models.

b. secondary research, that is research provided by reliable outside firms and institutions.

c. possibly nonobjective third-party research consulted and approved by other colleagues in the firm.

Answer b is correct. Though financial models have their limitations, they are commonly used in the decision-making process. It is important to understand how they work and to be aware of their drawbacks. Secondary and third-party research is also widely used. Research provided by outside firms and institutions is an illustration of third-party research, however, and not secondary research. Secondary research is provided by someone inside the firm. Possibly nonobjective research may be used if it is done in good faith, e.g., if it has been properly consulted.

Group work

When you work in a group, it is the whole group that is responsible for final results and decisions. It is possible that the mutual effort will lead to conclusions that are contrary to your individual opinion. If you feel, however, that the results and decisions are reached through consensus and the whole process is thorough and professional, there is no need to overtly disagree with the results of work.

Example

Great Innovation Project, Ltd. hired a group of analysts to provide the company with research on some securities in a certain branch of the market. Sandra, a CFA charterholder, is the chief analyst in the group and is responsible for the research outcome and its communication to Great Innovation Project, Ltd. As the work proceeds, it turns out that there are some conflicting opinions in the group over Sandra's analysis of one of the major securities. Sandra finds herself in the minority and the group decides to include the opposing analysis in the report. To comply with Standard V (A), Sandra should:

a. dissociate from the results of the analysis and not include her name in the report because every analyst should always give recommendations that reflect his or her own opinion.

b. not dissociate from the results of the analysis and may include her name in the report if she is comfortable with the process of reaching the analysis conclusions and its adequate basis.

c. not dissociate from the results of the analysis and must include her name in the report because she is the head of the group and is responsible for the research outcome and its communication to Great Innovation Project, Ltd.

Answer b is correct. Analysts should always give recommendations that reflect their own opinions unless they are taking part in group research. In group research situations, always group consensus conclusions are reached which may differ from individual opinions of particular analysts. If, however, the analyst believes that the opinion is well-founded and it has a reasonable and adequate basis, he or she need not dissociate from the final result even if it is in conflict with his or her own opinion. If the above is not the case and, say, the final result has no adequate basis, the analyst should demand that his or her name is not included in the report even if he or she is the chief of the group.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD V (B) – COMMUNICATION WITH CLIENTS & PROSPECTIVE CLIENTS

Standard V (B) requires that you communicate to the client all information important for him or her to make sensible investment decisions and to understand the whole investment process. Thus, when making an analysis or a recommendation, you must explain to your client how the process is arranged and what rules are applied to the process. You should also include in your communication all factors relevant in a certain investment situation and tell apart opinion from fact whenever necessary.

To take care of your client in accordance with Standard V (B), you should **make sure that the client is well informed**, that he understands such major issues as the nature of different investments both in isolation and when included in the portfolio, and that he or she knows what constitutes a fact and what constitutes an opinion.

Clients should also know where they can find more information about the issues covered in a report or what are the limitations of methods used for constructing a recommendation. Additionally, if the client's assets are managed by some outside advisers, the client should be duly informed about this fact. This will make him aware of the complexity of the investment process and investment products. Last but not least, clients should have performance presentation documents presented to them upon request.

Example

Élodie, a level III CFA candidate, is a portfolio manager with a large London financial corporation. She presents a recommended stock list that she compiled a few days ago to her new client. What will Élodie *least likely* do if she does not want to find herself in violation of the Code and Standards?

a. Élodie will inform the client about where to look for further information.

b. Élodie will make sure that the stock list suits the client's investment objectives.

c. Élodie will give the list to another client if her new client will not be interested in it.

Answer c is correct. Standard V (B) requires that for recommendations presented in capsule form (such as recommended stock lists) additional information should be given so that the client knew where to find more details concerning the list. First, you should make sure your recommendations are appropriate for the client, and only then should you take any action.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

STANDARD V (C) – RECORD RETENTION

Standard V (C) requires that CFA members and candidates **keep a record of their investment-related communication with clients** (and prospective clients). Documentation must be prepared thoroughly – it should support investment recommendations, analyses, and actions performed for the client and substantiate the relationship with the client. The particular form that the documentation should take depends on the specified services you provide to your clients.

The documentation you maintain should be comprehensive and it should be stored in such a way as to prevent it from getting lost. These documents serve as a source of additional information supporting your work and they provide legitimate grounds for your reports, analyses, and recommendations.

Example

The Code and Standards require that CFA members and candidates develop and keep records of their investment-related actions. In keeping with Standard V (C):

a. such documentation may include both personal notes and third-party research reports.

b. such documentation may include third-party research reports but it should leave out personal notes.

c. such documentation may include personal notes but it should leave out third-party research reports.

Answer a is correct. According to Standard V (C), supporting documentation maintained by CFA members and candidates should include any relevant information in any form, be it personal notes or third-party research reports.

Example

Margaret, CFA, works in a small financial firm. Her position requires that she stays in an advisory relationship with a client. Thus, she retains all necessary documents relating to all her actions and communications when dealing with her clients. Lately, she has been proposed a new post with a large financial corporation. She is considering its acceptance. Under the Standards, Margaret is *most likely*:

a. allowed to take the records with her to her new workplace.

b. not allowed to take the records with her to her new workplace.

c. allowed to take the records with her to her new workplace but only if her former employer agrees to it in writing.

Answer c is correct. According to Standard V (C), Margaret must not take any records with her because all records kept by any of the employees are the property of the firm and cannot be used in another company unless the former employer expressively agrees to it. Only explicit consent of Margaret's employer will enable her to use the information contained in the documents that she created.

What is of key importance here is that **all documents that you develop and keep are, in fact, the property of your employer** (that is the firm that you work for). So, if you decide to leave your job and try your hand somewhere else, you will not be allowed to take your files with you, even though you are the author of the documents. When working for the firm, you provide service to the clients on behalf of the company and that is why all the records stay with your employer. If, however, your former employer expressively agrees that you may take the files with you, you may use them for your future professional activity.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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ETHICS – STANDARD VI – CONFLICTS OF INTEREST

STANDARD VI (A) – DISCLOSURE OF CONFLICTS

Standard VI (A) explains what a CFA member or candidate should do when he or she encounters a conflict of interest and how this conflict should be disclosed.

To keep your reputation untarnished, Standard VI (A) tells you to disclose any potential and actual conflicts of interest. Such disclosure should be made in an appropriate manner. What does "appropriate manner" mean here? Three major features are hidden in the meaning:

- First of all, the disclosure should be made in plain language. You should make sure that your disclosure is conveyed in a way that is understandable by all parties involved (be it a client, the employer, or any other person). After all, the disclosure can be approved as delivered only if the person to whom it is made understands it.
- Secondly, the disclosure that you make should be complete. It means that you must disclose all information that you think is relevant in a given situation. The disclosure must not be selective. After all, the disclosure can be approved as complete only if no important details are left out.
- Thirdly, the disclosure should be effective. This is very important! You should make sure that the person to whom you make the disclosure received it and became familiar with it. After all, the disclosure can be approved as effective only if it reaches all parties involved.

Note that Standard VI (A) is closely connected with Standard I (B): Independence and Objectivity. A conflict of interest mustn't harm the independence and objectivity of a CFA member or candidate. That is why appropriate disclosure is so significant.

<u>Question:</u>

What happens if a conflict of interest occurs?

In case of a conflict of interest, a prompt disclosure should be made:

- to the employer, and
- to the client.

Disclosing the conflict to the employer is crucial because it allows him/her to make a judgment as to the degree of influence that the conflict might have had on you and your actions. Also – what is equally important – by informing your supervisor of the conflict of interest, as an employee of your company, you enable the company to act appropriately – if necessary – to avoid any possible consequences of this conflict.

Also, your client should be properly informed of any matter that may be considered a conflict of interest. The reason is to allow the client to make a judgment on whether the service provided by you is – in his or her opinion – free of bias.

Example

Paulo Gatto, CFA, works as a portfolio manager at a brokerage in Rome. He received additional compensation for managing his client's portfolio with flying colors. Which of the following is *least likely* the reason why Paulo should disclose the conflict of interest to his employer?

a. To enable his employer to assess the objectivity of his professional actions.

b. To make sure that his employer takes proper record of the conflict of interest in the form Paulo accepts.

c. To allow his employer not to take the unnecessary and perhaps costly risk of breaching ethical or regulatory provisions.

Answer b is correct. Standard VI (A) requires that conflicts of interest be disclosed effectively in plain language that will make the disclosure comprehensible to all interested parties, namely the employer, clients, and prospective clients. Thus, the form of the disclosure should not be manipulated in any way. Such disclosure enables the evaluation of the investment professional's objectivity and minimizes the possible risk that the employer will have to bear the responsibility for the violation.

Example

Jurij Brodka, CFA charterholder, creates a portfolio for his client. The client's IPS expressively describes in what kind of securities the client wants to invest and what is her required risk and return for an investment. Jurij makes the analysis of securities that would fit the client's criteria. He infers that the stock of TakeMe, Ltd. is one of the investments that should be included in his client's portfolio. It so happens that he himself owns some of TakeMe, Ltd. stock. Jurij should *most likely*:

a. choose another stock for his client to avoid any conflict of interest.

b. choose the TakeMe, Ltd. stock for the client's portfolio (it is not relevant to the client that Jurij owns the stock if the stock is suitable for her).

c. choose the TakeMe, Ltd. stock for the client's portfolio (it is relevant to the client that Jurij owns the stock so she should be informed about it prior to investment).

Answer c is correct. Under the Code and Standards, if the stock is suitable for the client and it meets the client's requirement expressed in the IPS, it would be to the great disadvantage of the client not to invest in the stock. However, Jurij should disclose his ownership of the stock to the client to enable her to assess the objectivity of his choice.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD VI (B) – PRIORITY OF TRANSACTIONS

The main idea of Standard VI (B) is to **maintain the right hierarchy of priority of transactions** – always give the priority of transactions to your clients and then to your employer. Leave your personal interest at the very end of the course of your investment actions.

It does not mean that you are banned from investing for your own account, however. Standard VI (B) does not prohibit you from making transactions and earning from them. What it takes care of, nonetheless, is that you **do not leave your client or employer at a disadvantage**. Your duty comes first with the client and then with the employer.

Note that when we talk about your personal account, we also mean the account of your spouse, parent, or any other member of your family (unless – of course – the account has the status of a client account).

Example

Standard VI (B) describes the proper conduct in case of conflicts of interest, which also covers the personal transactions of an investment professional. For the purposes of the Standard, personal transactions *least likely* include:

a. transactions carried out for the parent's account.

b. transactions carried out for the professional's retirement account.

c. transactions carried out for the spouse's account run on general client conditions.

Answer c is correct. Personal transactions are any transactions that benefit you either directly or indirectly. Thus, transactions made for the accounts of your family members will not count as personal only if the accounts are run on general conditions concerning all clients. In our example, the spouse's account is run on general conditions.

Example

Peter works in a financial company as an advisor. His sister wants him to make some transactions on her behalf. Peter explains to her that she needs to open an account with his company and that only then will he be able to carry out some transactions for her. Peter's sister is not willing to do as her brother tells her but she is finally brought round to the idea. In this situation:

a. Peter will not be violating the Code and Standards if he treats his sister like any other client in his company.

b. Peter will not be violating the Code and Standards even if he gives prominence to his sister's transactions over other clients' transactions.

c. Peter will be still violating the Code and Standards despite the precautions he took because his sister's transactions count as personal transactions.

Answer a is correct. If Peter's sister opens an account with his company, Peter will be obliged to treat his sister like any other client – he will not be allowed to give prominence to her transactions, but he will be also forbidden to discriminate against her (say, out of fear of being accused of conducting personal transactions).

Standard VI (B) further elaborates on conflicts of interest, and precisely on conflicts of interest resulting from personal trading. It is required that you **avoid any real or potential conflicts of interest**, or even appearances of such conflicts, that are connected with transactions made for your own account relative to those made on your client's behalf.

There are three major principles that you should always keep in mind as far as possible conflicts of interest and their avoidance are concerned:

- make sure that your client is not disadvantaged by your selling the shares,
- make sure that you will not gain any benefits as a result of recommending the purchase of the shares to the client, and
- make sure that you follow all regulations relevant to the situation.

If you fulfill all these requirements, you may sell your shares even though you made a recommendation to purchase the shares to the client. Once again, we see how important proper disclosure is in such situations – it enables us to avoid any possible conflict of interest regardless of the course of actions that follows.

Example

Finance Wellness, Inc. is a renowned investment banking firm. It is common knowledge that the Code of Ethics and Standards of Professional Conduct are followed in the firm. During her job interview at Finance Wellness, Inc., Úrsula is told that "personal trading is limited in our firm as we fear it might hinder the objectivity of our employees." The person who informed Úrsula about the limitation:

a. must have been mistaken because such practices are forbidden under the Code of Ethics and Standards of Professional Conduct.

b. gave Úrsula a reliable piece of information because the Code of Ethics and Standards of Professional Conduct allow such practices.

c. must have meant compliance procedures for conflict-of-interest situations rather than the limitation in personal trading as such since the firm follows the Code of Ethics and Standards of Professional Conduct.

Answer b is correct. To avoid the possible occurrence of the conflict of interest, the employer is allowed to restrict various actions, even those that give the appearance of the conflict. Personal trading can be counted among such actions.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD VI (C) – REFERRAL FEES

According to Standard VI (C), any referral fees and fee arrangements between you and other dealers, analysts, etc. should be disclosed to the client. This way the client will be able to judge whether by cooperating with other financial professionals, you act to the benefit of the client's account or probably your own pocket. Generally, receiving and offering any benefits, such as fees, gifts, or compensations, for the mere fact of being recommended to the client or recommending someone else's services should be disclosed both to the client and to the employer.

Example

Erina, CFA, works at a brokerage in Tokyo. She recommended her colleague's services to the client, for which she received a previously agreed fee. Which of the following is *least likely* the reason why Erina should disclose the previously agreed arrangements to the client?

a. To enable the client to assess the objectivity of her professional actions.

b. To enable the client to dissociate from the conflict of interest that occurred.

c. To enable the client to understand the whole procedure and potential additional costs related to the service provided.

Answer b is correct. Standard VI (B) requires that referral fees are disclosed to the client. Such disclosure will enable the client to assess the objectivity of an investment professional with respect to his or her professional actions and to understand the whole procedure and potential additional costs related to the service provided. As far as a potential conflict of interest is concerned, it is the employee of the brokerage and not the client that should dissociate from such a situation if it occurs.

To sum up: Remember that virtually everything that can be expected to have an impact on the way you perform your professional duties should be disclosed to the relevant persons – whether it is a real conflict of interest or a situation that may impair your independence and objectivity or fee arrangements applicable to a given situation. It is always better to disclose something (even if it is not required to be disclosed) than to fail to disclose a matter meant for prompt disclosure. You should also remember to provide your clients and employer with updates of the disclosed information whenever appropriate, that is when material changes take place.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

ETHICS – STANDARD VII – RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

STANDARD VII (A) – CONDUCT AS MEMBERS AND CANDIDATES IN THE CFA PROGRAM

Standard VII (A) explains how appropriate and ethical conduct looks like from the point of view of candidates in the CFA Program. It is worth knowing all requirements of the whole Standard VII as it includes issues that CFA candidates should be familiar with already at the point of registering for the level I exam.

Before taking the exam

When you pay for the exam and your name enters the list of level 1 CFA candidates, you have to remember that from this very moment you take responsibility for all your conduct related to the CFA exam. You have to be aware that some information is purely confidential, which means that you will not be allowed to talk about certain things. Also, when doing things you will have to keep in mind that certain actions are simply prohibited.

As a candidate for the CFA exam, before you take it you have to sign the so-called Candidate Pledge where you state that you have not gained any specific knowledge about the exam (e.g., that you did not get access to any specific exam questions or become familiar with any) and that you will not spread any specific information after you complete the exam (e.g., that you will not tell anybody any of the questions you had in your exam). You also pledge not to cheat, which means that you must not communicate with anyone during the exam, be it a person inside or outside the testing room, or look up things on the Internet, or do anything else that can be defined as cheating in the exam. You are also banned from taking anything out from the testing room, including your answers.

If you happen to violate the Pledge or any of the provisions of Standard VII, remember that the Pledge you sign says you are aware of the possibility of being suspended or excluded from the CFA Program altogether. Of course, in the case of any violation on your part, your exam results will be assumed invalid. Be aware that different sanctions and disciplinary actions may apply.

Example

Ada Awry is taking her Level I CFA Exam. She has brought a scrap of paper with her into the exam room, on which she noted a few complex formulas she found difficult to remember. Which of the following statements is the *most adequate*?

a. Ada should not take any scrap of paper with her into the exam room.

b. Ada was right to take the scrap of paper with her but only if she has no intention to use it in the exam (just revise before).

c. Ada was right to take the scrap of paper with her but only if the formulas were deciphered by means of adequate symbols.

Answer a is correct. To remain in compliance with Standard VII (A), Ada should not take any formulas written on a piece of paper with her. If she decides to take it, however, it would be praiseworthy if she has a strong intention not to use it during the exam. Nevertheless, bringing the formulas into the exam room compromises her integrity and it is possible that Ada will have to defy temptation during the exam in order not to break her good intention. Besides, she faces the threat of being accused of cheating during the exam if anyone notices that she has formulas written down.

After you take your exam

That is the time when you may want to talk about whether the exam was difficult and which questions proved the hardest both to you and to others. You may find yourself in trouble if you do this improperly. In order not to violate Standard VII (A), you must not talk too specifically about what was tested in the exam.

Both the contents of specific questions and the whole exam as such are considered confidential and these are things you must not talk about without giving it a previous thought! Of course, you are not banned from expressing your opinion on the exam, or even CFA Institute itself, but you should do it rather judiciously.

Example

Kylie and William have been friends since they were children. Now Kylie lives in Australia and she is taking her Level II CFA Exam in Sydney. William lives in London and he is taking the Level II CFA Exam himself, as well. To remain in compliance with the Standards, when Kylie leaves the exam room, she *most likely*:

a. must not call William by any means.

b. may call William to wish him good luck.

c. may call William and share her first impressions with him.

Answer b is correct. Under the Code and Standards, Kylie will violate Standard VII (A) if she gives William an unfair advantage, which may take place when she starts sharing her impressions about the exam. The Code and Standards do not forbid her to call William altogether.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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STANDARD VII (B) – REFERENCE TO CFA INSTITUTE, THE CFA DESIGNATION, AND THE CFA PROGRAM

Standard VII (B) tells about ways of using the CFA designation and referring to CFA Institute and the designation itself.

You are allowed to use the CFA designation after you obtain the charter, that is after you pass all three levels of the CFA exam and when you meet all the requirements (such as years of work experience). Then, the CFA Institute Board of Governors agrees that the title may be awarded to you. The three capital letters by your name show your competence in finance and you must know how to use them properly. For instance, do not use them in a way that would imply your superiority, e.g., with respect to your colleagues that do not have this kind of a title.

Example

Miron has dreamed of a career in finance since he entered college. Now that he successfully passed his CFA exam (every level at the first attempt!), he is very proud of himself. When he obtained the CFA designation, he finally got his dream job and he feels fulfilled. He decides to create his website where he could share his knowledge with CFA candidates. In the 'About' section on his website, he writes: "My dreams have come true – as a CFA charterholder, I am one of the crème de la crème. Now it is your turn! Together we can make your dreams fulfill!". Miron:

a. did not violate the Code and Standards.

b. violated the Code and Standards because of what he wrote on his website.

c. violated the Code and Standards because of creating his website where he wrote he is a CFA charterholder.

Answer b is correct. Standard VII (B) requires that CFA members and candidates refer to the CFA designation in an appropriate manner. Stating that a CFA charterholder belongs to the crème de la crème is not a proper way of expressing one's pride in earning a CFA certificate.

<u>Question:</u>

How to use the three letters in a formal and proper manner?

- First of all, **the three letters must not be used as a noun**. Thus, you better not refer to a CFA charterholder as a CFA and say: "My supervisor is a CFA". What you need to do is to use the name of the designation in **an adjectival (rather than nominal) context** or directly after the name. In other words, the three magical letters perform a descriptive role rather than function as separate words without any additional context. So, the abbreviation CFA will usually accompany words such as "designation", "candidate" or "Institute" – we say "He earned his CFA designation" or "She's become a CFA candidate".

- Secondly, always **capitalize the three letters** (CFA vs cfa) and do not use any dots in between (CFA vs C.F.A.).
- Thirdly, remember that the name of designation should not be given any prominence also in writing, which means that it should not stand out from the text as more important (e.g., by putting it in bold type).
- Basically, the rule is not to exaggerate or misrepresent the meaning of the designation and **keep to the rules that govern its usage** in writing.

It is also important how you refer to your CFA exam in your résumé. After you pass your level 1 CFA exam, do not get tempted to state something like: CFA, Level 1, 2014. Though passing the first level of the exam is a success, this way of putting the fact may be misleading. It may suggest that you already earned some kind of certificate or title. Of course, you are permitted to inform in your curriculum vitae that you are a candidate in the CFA Program and that you succeeded in passing level 1 of the exam but you should make it clear that you are a candidate and that you have not completed the whole exam yet. Remember that there are no titles for levels.

Example

Irvin is currently looking for a job in finance. He has written his résumé in which he has included information about his candidacy in the CFA Program in the following form:

" (...)

2014 – Level I CFA Exam Candidate,

(...)".

In his cover letter, he decided to elaborate a bit on this point of his résumé and he wrote:

"I am an ambitious person and I like new challenges. This is why I decided to enter the CFA Program, which is known among financial professionals for its strictness both with respect to moral and professional standards."

According to the Code and Standards, Irvin was allowed to make the above statements:

a. in his cover letter, but not in his résumé.

b. in his résumé, but not in his cover letter.

c. both in his résumé and in his cover letter.

Answer c is correct. Irvin used the right format of referring to his candidacy in the CFA Program both in his CV and cover letter. Also, no information that he decided to include should be perceived as violating any of the Standards.

Refer in a proper manner

After you enter the CFA Program, pay attention to how you refer to your participation in it, to the CFA designation and CFA Institute itself. You are allowed to express opinions and share facts concerning your relationship with the exam, designation, or CFA Institute. What you are not allowed to do, however, is to state things that are not facts and to express opinions that compromise the good reputation of the CFA Program, CFA Institute, and anything that relates to it.

Since the three capital letters carry lots of importance and prestige in the financial world, this importance and prestige mustn't be used too freely and without due care. Otherwise, all the merits related to the designation and the exam will gradually lose importance and prestige. For this very reason, CFA Institute takes care of the proper usage of the CFA designation and it is an obligation of every CFA member and candidate to understand the weight of the issue and to give it due prominence.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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ETHICS – SUMMARY

Each Standard is devoted to a separate area relating to the investment profession. The Standards cannot, however, be treated separately or used selectively. They are closely interwoven and you need to see them as a whole. The Code and Standards provide guidelines and requirements that you should follow at any time and any place.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.

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Summarizing key concepts:

☐ Standard I: Professionalism

My summary:

☐ Standard II: Integrity of Capital Markets

My summary:

☐ Standard III: Duties to Clients

My summary:

☐ Standard IV: Duties to Employers

My summary:

☐ Standard V: Investment Analysis, Recommendations, and Actions

My summary:

☐ Standard VI: Conflicts of Interest

My summary:

☐ Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate

My summary:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

✔ Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	