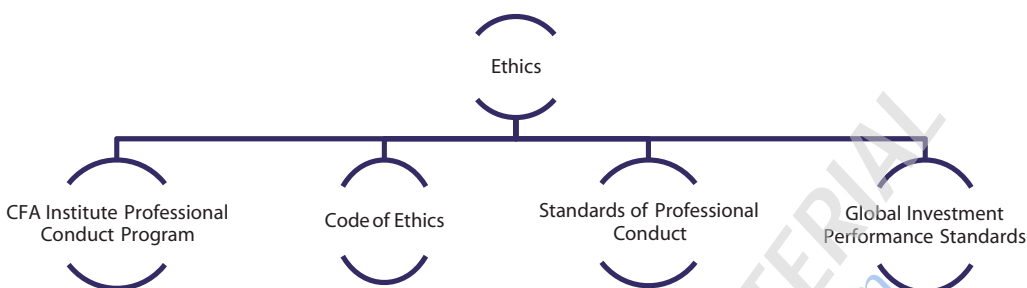


STUDY SESSION 1

ETHICS AND PROFESSIONAL STANDARDS



Topic:	Ethics
Weight:	15%
Study session(s):	1
Readings:	1–4

THE BIG PICTURE

Just as ethics are an important part of investment management, analysis, and research, they are an important part of the CFA examination and curriculum. Included along with ethics are the Global Investment Performance Standards (GIPS), which are principles detailing how performance results are measured and reported.

The ethics section is 15% of the syllabus by weighting, yet is often overlooked by delegates who focus on the calculations later in the syllabus. It is a purely written section mostly testing the CFA Institute professional practice handbook, but the questions are usually scenario based and as such can often be quite tricky.

Whereas ethics comprises 15% of the Level I exam, it is 10% of the Level II and Level III exams. In other words, the effort expended to learn about the Code of Ethics, the Standards of Professional Conduct, and GIPS is well worth it – because you will see it again. And again.

CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

Candidates are responsible for not only being able to recite the Code of Ethics and the Standards of Professional Conduct [keywords: describe, state, explain] but also for understanding how the Code and Standards are

applied in investment management and research [keywords: demonstrate, distinguish, recommend]. Be sure to practice the application of these to different situations.

Whereas the Code of Ethics provides the broad framework for conduct, the Standards are more specific with respect to how the Code is operationalized for CFA Institute members and CFA candidates. For example, the Code of Ethics states “Place the integrity of the investment profession and the interests of clients above their own personal interests,” and the Standards expand on “III. Duties to Clients” with explanations on “Loyalty, Prudence, and Care,” “Fair Dealing,” “Suitability,” “Performance Presentation,” and “Preservation of Confidentiality.”

The key to the Code and Standards is to remember:

- The Code and Standards apply to both CFA Institute members and CFA candidates
- Always put the client, the profession, and one’s employer ahead of oneself
- Be professional, knowledgeable, and objective
- Comply with securities laws

GIPS

The basic idea of GIPS is to facilitate the comparison of investment performance. The beneficiaries of GIPS are investors and investment management firms, with the benefits arising primarily from the clear, understandable, and comparable results. Investment management firms comply on a voluntary basis, but they can also employ a third party to verify their claim on compliance to GIPS. A key element of GIPS is that they form the ethical principles of performance reporting.

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Code of Ethics and Standards of Professional Conduct

STUDY SESSION 1 READING 1

LEARNING OUTCOME STATEMENTS

Application LOS	Knowledge LOS
	1a Describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards
	1b State the six components of the Code of Ethics and the seven Standards of Professional Conduct
	1c Explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard

KNOWLEDGE LEARNING OUTCOME STATEMENTS

1a Describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards

The program is fundamental to the values of the CFA Institute. The key points to note are:

- The program is a model for measuring the ethics of investment professionals globally
- All members and candidates must abide by the Code and Standards
- They are encouraged to notify their employer of this responsibility

Violations of the Code and Standards may result in disciplinary sanctions by the CFA Institute. Sanctions include:

- Revocation of membership
- Revocation of candidacy in the CFA program
- Revocation of right to use the CFA designation

1b State the six components of the Code of Ethics and the seven Standards of Professional Conduct

The Code of Ethics

“Members of CFA Institute and candidates for designation must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets
- Place the integrity of the investment profession and the interests of clients above their personal interests

- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and on the profession
- Promote the integrity of and uphold the rules governing capital markets
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals”

Standards of Professional Conduct

- I. Professionalism
 - A. Knowledge of the Law
 - B. Independence and Objectivity
 - C. Misrepresentation
 - D. Misconduct
- II. Integrity of Capital Markets
 - A. Material Non-public Information
 - B. Market Manipulation
- III. Duties to Clients
 - A. Loyalty, Prudence, and Care
 - B. Fair Dealing
 - C. Suitability
 - D. Performance Presentation
 - E. Preservation of Confidentiality
- IV. Duties to Employers
 - A. Loyalty
 - B. Additional Compensation Arrangements
 - C. Responsibilities of Supervisors
- V. Investment Analysis, Recommendations, and Actions
 - A. Diligence and Reasonable Basis
 - B. Communication with Clients and Prospective Clients
 - C. Record Retention
- VI. Conflict of Interest
 - A. Disclosure of Conflicts
 - B. Priority of Transactions
 - C. Referral Fees
- VII. Responsibilities as a CFA Institute Member or CFA Candidate
 - A. Conduct as Members and Candidates in the CFA Program
 - B. Reference to the CFA Institute, the CFA Designation, and the CFA Program

1c Explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard

This simply requires knowledge of the Standards and the Code, ready to apply to scenarios in Reading 2.

Reading 1 sample question

(Answers on p. 297)

The Standard covering “Communication with client and prospective clients” is least likely to require that:

- (A) Analysts distinguish between fact and opinion in their reports
- (B) Clients must be informed promptly about any changes to the investment process
- (C) Analysts always show at least ten years of historic information in their reports

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LEARNING OUTCOME STATEMENTS

Application LOS	Knowledge LOS
2a Demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity	
2b Distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards	
2c Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct	

APPLICATION LEARNING OUTCOME STATEMENTS

2a Demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity

2b Distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards

2c Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct

The emphasis in this reading is on applying the Standards to situations that members face, rather than being able to recite the Standards from the handbook. As such, spend your review time here with the case studies and examples that are shown throughout the handbook rather than learning the names and numbers of each Standard.

Within each Standard there are several examples of how the Standard would be applied in specific situations. Make sure you understand each example and the rationale for the conclusions reached. There are then plenty of practice questions at the end of the reading that you should complete.

Reading 2 sample question

(Answers on p. 297)

A discretionary fund manager of an equities fund invests new cash received in T-bills. Is this necessarily a breach of the Code and Standards?

- (A) Yes, as it is an equities fund
- (B) No, as the T-bills may be a temporary investment
- (C) No, as the fund manager is only guided towards, not legally bound to, equity investments

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LEARNING OUTCOME STATEMENTS

Application LOS	Knowledge LOS
	3a Explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards
	3b Explain the construction and purpose of composites in performance reporting
	3c Explain the requirements for verification

KNOWLEDGE LEARNING OUTCOME STATEMENTS

3a Explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards**Why were the GIPS standards created?**

Global Investment Performance Standards were devised for the following reasons:

- The investment community had great difficulty making meaningful comparisons on the basis of accurate investment performance data
- Misleading practices hinder comparability
- Representative accounts
- Reporting only top-performing accounts
- Survivorship bias (i.e. ignoring performance of funds that no longer exist)
- Presenting an “average” performance history
- Excluding poor-performing portfolios
- Varying time periods
- Selecting time periods to favor results
- Practitioner-driven set of ethical principles
- Establish a standardized, industry-wide approach for calculating and presenting historical investment results
- Help avoid misrepresentation of performance by investment firms

Who can claim compliance?

- Any investment management firm may choose to comply with GIPS
 - Voluntary compliance
 - Not typically required by legal or regulatory authorities
- Investment firm
 - Must manage assets
- Plan sponsors and consultants
 - Cannot make a claim of compliance

- Can claim to endorse the GIPS
- Software vendors
 - Cannot be compliant
- Firm-wide process
 - Cannot be achieved on a single product or composite
- Two options:
 - Comply or do not comply

Who benefits from compliance?

Benefits two main groups:

- 1 Investment management firms
- 2 Prospective clients
 - Provide reassurance to prospective clients about track record of the investment management firm
 - Record is complete and fairly presented
 - Allows global competition for compliant firms
 - Investors have a greater level of confidence in integrity of performance management
 - Can more readily compare firms

3b Explain the construction and purpose of composites in performance reporting

Composites

Key concepts:

- Required use of composites
 - An aggregation of discretionary portfolios into a single group that represents a particular investment objective or strategy
 - Must include all actual, fee-paying discretionary portfolios managed in accordance with the same investment objective or strategy
- Firms cannot choose portfolios to include or exclude
- Establish criteria on an ex-ante basis (before the fact, not after)

3c Explain the requirements for verification

Verification

- Firms are responsible for their claim of compliance and for maintenance of the claim
- Firms self-regulate
- Firms may voluntarily hire an independent third party to verify claim
- Primary purpose
 - Provide assurance that a firm has adhered to the GIPS on a firm-wide basis
 - Verification
 - Entire firm; not on specific composites
- Has the firm complied with all the composite construction requirements of GIPS on a firm-wide basis?
- Are the firm's processes and procedures designed to calculate and present performance results in compliance with the GIPS standards?
- Performed only by qualified independent third parties

Reading 3 sample question

(Answers on p. 297)

Abraham Management was established five years ago and has complied with GIPS in presenting information about the performance of its assets under management for this time. The firm has commissioned its internal audit department to test whether the firm has complied with composite construction criteria firm-wide and has the policies and procedures to calculate performance in accordance with GIPS. It put a note on its marketing materials stating “Abraham Management have complied with GIPS standards and have had the compliance verified.” Abraham Management is:

- (A) in full compliance with GIPS
- (B) in violation of GIPS because it has not presented at least ten years’ information
- (C) in violation of GIPS because the firm cannot provide its own verification

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Introduction to the Global Investment Performance Standards

STUDY SESSION 1 READING 4

LEARNING OUTCOME STATEMENTS

Application LOS	Knowledge LOS
	4a Describe the key features of the GIPS standards and the fundamentals of compliance
	4b Describe the scope of the GIPS standards, with respect to an investment firm's definition and historical performance record
	4c Explain how the GIPS standards are implemented in countries with existing standards for performance reporting, and describe the appropriate response when the GIPS standards and local regulations conflict
	4d Describe the nine major sections of the GIPS standards

KNOWLEDGE LEARNING OUTCOME STATEMENTS

4a Describe the key features of the GIPS standards and the fundamentals of compliance

4b Describe the scope of the GIPS standards, with respect to an investment firm's definition and historical performance record

4c Explain how the GIPS standards are implemented in countries with existing standards for performance reporting, and describe the appropriate response when the GIPS standards and local regulations conflict

4d Describe the nine major sections of the GIPS standards

Note that the examinable portion of Reading 4 is actually very short. There is a large optional section, denoted with blue lines, that is not examinable. The key to this reading is to memorize the main components of the GIPS framework. These are listed in detail in the early part of the reading before the optional section.

Following the optional section is a set of sample disclosures – these provide an excellent interactive way of committing the GIPS rules to memory.

Reading 4 sample question

(Answers on p. 297)

Ames Capital is a global financial services firm incorporated in the United States of America. Each overseas branch of the firm operates through separate legal entities under the name Ames Capital except for in Europe where the company operates through a single subsidiary called Europa Wealth. Europa Wealth has head offices in Geneva but branches in 15 other European countries. For the purposes of GIPS compliance the definition of the firm includes:

- (A) all legal entities called Ames Capital only
- (B) all legal entities called Ames Capital and the head office of Europa Wealth
- (C) all legal entities called Ames Capital, the head office of Europa Wealth and all of Europa Wealth's branches

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