2019 CFA® Exam Prep

IFT High-Yield Notes®

Ethics

Level I

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R1 Ethics and Trust in the Investment Profession

Ethics definition

- The word ethics is derived from the Greek word 'ethos,' which means character.
- Ethics means making good choices.
- Ethics includes a set of moral principles and rules of conduct that help guide our behavior.

Role of a code of ethics in defining a profession

Profession is the final development of an occupation.
Profession is:

- based on specialized knowledge and skills.
- based on service to others.
- practiced by members, who share and agree to adhere to a common code of ethics.

In any given profession, the code of ethics openly communicates the established principles of the profession and how its members are expected to behave. It serves as a benchmark for the minimally acceptable behavior required of members of a group in service to others. It helps in building public confidence that members of the profession will use their skills and knowledge for the benefit of their clients.

Challenges to ethical behavior

- One challenge is that people tend to believe that their ethical standards are above average. This leads to overconfidence bias and therefore people place too much importance on internal traits.
- However, studies show that external factors (situational influences) are the main determinant of ethical behavior. They shift our focus to the immediate rather than long-term impacts of a decision. The three main types of situational influences are:
  - Money & prestige.
  - Loyalty to employer and/or colleagues.
  - Strong compliance culture.

Need for high ethical standards in the investment industry

- High ethical standards are always important. However, they are of particular importance in the investment industry, because this industry is based almost entirely on trust. Also the products and services of this industry are intangible in nature.
- Clients trust investment professionals to use their skills and knowledge to serve clients and protect client assets.
- If investment professionals adhere to high ethical standards, all stakeholders gain long-

term benefits.

Ethical v/s legal standards

- Legal and ethical conduct is not always the same.
- Law is not always the best mechanism to reduce unethical behavior because:
  - Legal standards are often created to address past ethical failings. They do not provide direction for an ever changing and increasingly complex world.
  - Laws are often rule based.
  - Laws will vary across countries.
- Ethical conduct goes beyond legal standards.

Framework for ethical decision making

A framework for ethical decision making can help people look at and assess a decision from different perspectives. This enables them to make good decisions, and to limit unplanned consequences.

A general ethical decision making framework has the following four steps:

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

R2 Code of Ethics and Standards of Professional Conduct

CFA Institute Professional Conduct Program

Structure

All CFA Institute **members** and **candidates** must comply with the **Code** and **Standards**. The CFA Institute **Board of Governors** maintains oversight and responsibility for the PCP. The **Disciplinary Review Committee (DRC)** is responsible for enforcement of Code and Standards.

- DRC is a volunteer committee of CFA charterholders.
- DRC partners with Professional Conduct staff to establish and review professional conduct policies.
- DRC is also responsible for reviewing conduct when there is a potential violation.

The CFA Institute Bylaws and Rules of Procedure for Professional Conduct (Rules of Procedure) form the basic structure for enforcing the Code and Standards.

Process for Enforcement

Professional Conduct inquiries can come from:

- Self-disclosures by members/candidates on their annual Professional Conduct Statements.
- Written complaints received by the Professional Conduct staff.
- Evidence of misconduct received through public sources such as media or regulatory notices.
- A report by a CFA exam proctor.
- Analyzing exam material and monitoring social media.

Once an inquiry is initiated, the Professional Conduct staff may:

- Request a written explanation from the member/candidate.
- Interview the member/candidate, the complainant or other third parties.
- Collect documents and records relevant to the investigation.

After investigating, the Professional Conduct staff may:

- Take no disciplinary action.
- Issue a cautionary letter.
- Propose a disciplinary sanction.

If a disciplinary sanction is proposed, the member/candidate can either accept or reject the sanction. If rejected, the matter is referred to a panel of Disciplinary Review Committee members for a hearing. The panel then determines if a violation occurred and if so, what sanction should be imposed.

Sanctions imposed may include:

- Public condemnation.
- Suspension of membership and revocation of CFA charter (for members).
- Prohibition from further participation in the CFA Program (for candidates).

Six Codes of Ethics and Seven Standards of Professional Conduct

Six Codes

Members/Candidates must:

- Act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.

- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

Seven Standards

I. Professionalism
II. Integrity of Capital Markets
III. Duties to Clients
IV. Duties to Employers
V. Investment Analysis, Recommendations, and Actions
VI. Conflict of Interest
VII. Responsibility as a CFA Institute Member or CFA Candidate

R3 Guidance for Standards I-VII

Ethical responsibilities required by the Code and Standards

I. Professionalism

A. Knowledge of the law

- Understand and comply with all applicable laws, rules and regulation.
- In a case of a conflict, comply with the stricter law.
- Do not knowingly participate in any violation. Disassociate from such activity.

B. Independence and objectivity

- Use reasonable care and judgment.
- Maintain independence and objectivity.
- Do not offer, solicit or accept gifts; however, small token gifts are ok.

C. Misrepresentation

- Do not guarantee investment performance.
- Avoid plagiarism (the practice of taking someone else's work or ideas and passing them off as one's own).
- Do not omit important facts.

D. Misconduct

- Do not lie, cheat, steal or behave in a manner that affects your professional reputation or integrity.

II. Integrity of capital markets

A. Material nonpublic information

- Do not act or help others to act on material nonpublic information. (Information

which would be likely to affect a stock's price once it becomes known to the public).
- However, mosaic theory (material public information + nonmaterial nonpublic information) is not a violation.

B. Market manipulation
- Do not manipulate prices/trading volumes to mislead other market participants.
- Do not spread false rumors.

III. Duties to clients

A. Loyalty, prudence, and care
- Act with reasonable care and exercise prudent judgment.
- Place client's interest before your employer or your interests.
- Soft dollars must be used for the benefit of the client.
- Seek best execution.
- Vote proxies in the best interest of clients.

B. Fair dealing
- Do not discriminate against any clients when disseminating recommendations and taking investment action.
- Different level of service is allowed, as long as it does not negatively affect any client.
- Different service levels should be disclosed to all clients and prospects.

C. Suitability
- In advisory relationships, develop and update an IPS periodically. Understand the client's risk profile.
- In fund/index management, ensure that investments are consistent with the stated mandate.

D. Performance presentation
- Do not misstate performance.
- Make detailed information available on request.

E. Preservation of confidentiality
- Maintain confidentiality of current, former and prospective clients.
- Unless (1) disclosure is required by law (2) information concerns illegal activities by a client (3) client permits the disclosure.

IV. Duties to employers

A. Loyalty
- Do not harm your employer.

- Obtain written consent from the employer before starting an independent practice.
- Do not take confidential information, client lists, financial models etc. when leaving an employer.

B. Additional compensation arrangements

- Do not accept gifts, benefits or compensation that will create a conflict of interest with your employer.
- You may accept if you obtain written consent from all parties involved.

C. Responsibilities of supervisors

- Prevent employees under your supervision from violating applicable laws, rules, regulations and the Codes and Standards.

V. Investment analysis, recommendations, and actions

A. Diligence and reasonable basis

- Have a reasonable and adequate basis for any investment analysis, recommendation or action (even when using a third party research).

B. Communication with clients and prospective clients

- Tell clients about your investment process.
- Distinguish between fact and opinion.

C. Record retention

- Maintain records (Standards recommend storing records for at least 7 years).

VI. Conflicts of interest

A. Disclosure of conflicts

- Disclose conflict of interest in plain language.

B. Priority of transactions

- Client transactions come before employer transactions which come before personal transactions.
- Avoid front running.
- Fee-paying family member should be treated no different than any other client.

C. Referral fees

- Disclose referral arrangements to clients, prospective clients and employers.
- Disclosure of referral fees helps the clients evaluate any possible partiality shown in the recommendation of service.

VII. Responsibilities as a CFA Institute member or CFA candidate

A. Conduct as participants in CFA Institute programs

- Don't cheat on the exams.
- Keep questions and exam information confidential.

B. Reference to CFA Institute, the CFA designation, and the CFA program

- Fill professional conduct statement and pay membership dues annually.
- References to partial designation not allowed (wrong usage: I am a CFA Level I). However, you can say that you have passed Level I, II or III.
- Not to be used as a noun. Only use it as an adjective.
- Do not state that holders of CFA charter are better than others or that they produce better investment results.

R4 Introduction to Global Investment Performance Standards

Overview of GIPS

GIPS stands for 'Global Investment Performance Standards'.

Why were the GIPS standards created?
In the past, investment performance presentations were misleading. Questions about the accuracy and credibility of data made comparisons among different investment firms difficult. Common misleading practices included:

- Representative accounts: Using only the best performing portfolios to represent the firm's overall performance.
- Survivorship bias: Excluding accounts that performed poorly and were consequently terminated.
- Varying time periods: Selecting time periods during which the fund had exceptional performance.

The GIPS standards were created to prevent misrepresentation of performance. They establish an industry-wide, standard approach for calculation and presentation of investment performance.

What parties do the GIPS standards apply to?
GIPS apply to investment management firms. Compliance to GIPS is voluntary and not required by any legal or regulatory authorities.

Who is served by the standards?

- Existing and prospective clients of investment management firms: They get credible and standard data. This allows them to have more confidence in reported performance and makes comparisons among firms easy.
- Investment management firms: Compliance with GIPS helps firms with their marketing activities. It can also strengthen the firm's internal controls.

Construction and purpose of composites

GIPS standards require the use of composites.

- A composite is formed by grouping portfolios that represent a similar investment strategy, objective or mandate.

  For example, if you are managing 100 accounts and one of your strategies is to invest in large cap value stocks, and you use this strategy for 70 accounts. Then these 70 accounts will form one composite. Similarly, if you have another strategy to invest in small cap growth stocks; and you use this strategy for the remaining 30 accounts. Then these 30 accounts will form another composite. You will have to report performances of these two composites separately.

- A composite representing a particular strategy must include only fee-paying, discretionary portfolios that the firm has managed in accordance with this particular strategy.

  For example, if you are managing funds for a charity organization and not charging them any fees, then this account should not be included because it is a non-fee paying account. Similarly, if you are managing an account for a large client, where you cannot use your discretion and the client tells you what securities to buy and sell. Then you should exclude this account because it is a non-discretionary account.

- GIPS standards require that the criteria for classifying portfolios into composites are decided before the composite performance is known and not after the fact. This prevents firms from choosing only their best performing portfolios in the composite.

Requirements for verification

Firms that claim compliance with GIPS self-regulate themselves. To increase confidence in the firm's claim of compliance, a firm may voluntarily hire an independent third party to perform verification.

Verification tests:

- Whether the investment firm has complied with all the composite construction requirements on a firm-wide basis; and
- Whether the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The requirements for verification are:

- Verification applies to the entire firm, not on selected composites.
- An independent third party must perform verification. It cannot be performed by the firm itself.

R5 The GIPS Standards

Key features of the GIPS standards & the fundamentals of compliance

Key Features of GIPS

The objectives of GIPS are:

- To establish best practices for calculating and presenting investment performance.
- To obtain global acceptance of a single standard.
- To promote the use of accurate and consistent data.
- To promote fair competition among investment firms.
- To promote self-regulation.

The key features of GIPS standards are:

- In order to claim compliance, firms must adhere to all the requirements of the GIPS standards. Partial compliance is not allowed.
- In addition to adhering to the minimum requirements, firms should also adhere to the recommendations to achieve best practice in the calculation and presentation of performance.
- All actual, discretionary, fee-paying portfolios should be included in at least one composite to prevent cherry-picking.
- The accuracy of performance presentation depends on the accuracy of input data. It is, therefore, essential that the inputs are accurate. Hence, GIPS standards require firms to adhere to certain calculation methodologies and to make specific disclosures.

Fundamentals of Compliance

- The GIPS standards must be applied on a firm-wide basis.
- Total firm assets must include the fair value of all accounts – fee-paying as well as non-fee-paying, discretionary as well as non-discretionary. Total firm assets must include assets assigned to a sub-advisor, provided that the firm has discretion over the selection of the sub-advisor.
- Changes in a firm's organization must not affect historical GIPS performance.
- When jointly marketing with other firms, the firm claiming compliance must ensure that it is clearly defined as separate from noncompliant firms.
- Firms must document in writing their policies and procedures used to comply with GIPS.
- Only allowed statement is *'ABC has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS)'*. Partial compliance is not allowed. Statements such as "in accordance with GIPS", "calculated as per GIPS methodology" are not allowed.
- Firms must provide compliant presentations to every prospective client. Firms must provide a complete list of composites along with their description to any prospective

clients that make such a request.

Investment firm's definition and historical performance record

Investment Firm's Definition

- Firms must be defined as an investment firm, subsidiary or a division that is held out to clients and prospects as a 'distinct business entity'.

  A **distinct business entity** is a sub-division within a company that is completely autonomous from the rest of the company. It has a separate product line or different services from the rest of the company. Also, it has complete control over how it utilizes its assets and organizes its management.
- If a firm has different geographic locations, all doing business under the same name, then the definition of the firm must include branches from all locations.

Historical Performance Record

- Initially:
  - A firm must present a minimum of five years of compliant presentation.
  - If the firm or composite has been in existence for less than five years, the presentation should include performance since inception.
- After initial compliance:
  - The firm must add one year of compliant presentation each year,
  - So that the firm eventually presents a minimum performance history of ten years.

GIPS and local regulations

- In countries where there are no investment performance regulations, use and promote the GIPS standard.
- In countries where there are existing laws and regulations regarding performance presentation, adhere to GIPS in addition to the local laws.
- In case of a conflict with the local laws, follow the local law but disclose the conflict.

Nine major sections of the GIPS standards

The nine major sections of the GIPS standards are:

0. **Fundamentals of compliance**: This section discusses issues related to the definition of the firm, documentation of policies and procedures, complying with GIPS updates, a proper reference to claim compliance, a proper reference to verification done by a third party.
1. **Input data**: To get full, fair and comparable presentations, the input data must be consistent. This section provides details on how you need to handle input data.
2. **Calculation methodology**: If a firm wants to calculate the returns on its composites it has to follow a certain calculation methodology. This section will provide instructions

on what method should be used to calculate returns. The same method needs to be used across the firm.

3. **Composite construction**: To create a composite, you group together portfolios that are managed with the same investment mandate. Only discretionary and fee-paying accounts should be included in composites. This section tells us what additional criteria should be fulfilled while creating composites. The end objective is that we should create composites that are meaningful and asset-weighted.
4. **Disclosures:** While showing investment presentations, certain information must be disclosed. This section gives us details on what disclosures are required to stay in compliance.
5. **Presentation and reporting**: This is the most important section for an investment firm. To be compliant, an investment management firms prepares and reports investment performance data in accordance with the GIPS requirements. This section tells us what those requirements are.

   Note: Sections 6, 7 and 8 are add-ons to the main sections only if you have these types of investments in your portfolio.
6. **Real estate**: Applicable if you have real estate in your portfolio. This section provides the details.
7. **Private equity**: Applicable if you have PE investments. They must be valued as per the GIPS Private Equity Valuation Principles. This section provides the details.
8. **Wrap Fee/ separately managed account (SMA) portfolios**: Performance record of all wrap fee / SMA portfolios must be included in appropriate composites.

   A **separately managed account** is a portfolio where the securities are directly owned by the investor, and the investment manager only executes trades on the investor's behalf. Such accounts also usually have a comprehensive charge levied by the investment manager for providing a bundle of services such as investment advice, investment research, brokerage services etc. This charge is called a wrap fee.