CAIA Ethical Principles

Jake Schmidt, CAIA, manages separate accounts for individual and institutional clients at Bremen Investment Advisors. When placing trades for multiple accounts, Schmidt executes trades for the smallest clients first and largest last. For oversubscribed IPOs, he allocates more shares to larger accounts. Schmidt tells clients that the investment industry's core purpose is matching savers and spenders, while its intrinsic purpose is enhancing societal well-being. With new client DeShawn Jackson, Schmidt only asks about return requirements and proposes annual goal reviews. Schmidt wants to provide information about building client trust, but he is unsure which key elements to disclose.

Question 1 of 7

A. **Explain** whether Schmidt's actions and procedures related to the order in which he executes trades and the way he allocates oversubscribed IPO shares are in compliance with the fiduciary obligation areas of impartiality and loyalty.

(4 points)

Explanation

The four areas of fiduciary obligations are (1) loyalty, (2) prudence and care, (3) diversification, and (4) impartiality. Schmidt's procedures violate impartiality because they systematically favor some clients over others. Executing trades for the smallest accounts first disadvantages larger accounts, while allocating more oversubscribed IPO shares to larger accounts disadvantages smaller accounts. IPO shares should be allocated using a fair and consistently applied method that does not favor particular clients. Based on the facts presented, there is no separate violation of loyalty because no conflict between Schmidt's interests and the clients' interests is described.

(LO 1.1.3)

Question 2 of 7

B. **Explain** whether Schmidt's information on the purpose of the investment industry is correct with respect to the intrinsic and core purposes.

(3 points)

Explanation

Schmidt is incorrect regarding the purposes of the investment industry. The intrinsic purpose is simply matching savers (those with excess capital to invest) with spenders (those who need to borrow capital to achieve their objectives). The core purpose is portfolio management. This involves picking the most appropriate investments that will generate optimal returns over the long term, but within the constraint of acceptable risk levels. The fundamental purpose is to enhance overall societal wealth and well-being.

(LO 1.1.1)

Question 3 of 7

C. **Explain** whether Schmidt's actions related to the review of DeShawn Jackson's investment requirements are sufficient for providing the right investment choices for the client.

(3 points)

Explanation

Schmidt only inquired about Jackson's return requirements. He did not seek additional information on the client's risk tolerance or investment horizon. Therefore, Schmidt currently has insufficient knowledge of his client's objectives. Schmidt should also gather more information on Jackson's total assets to better understand how the new account will combine with other assets.

(LO 1.1.4)

Question 4 of 7

D. Regarding information on the manager-client relationship, **identify** *two* elements that should be included in Schmidt's disclosure to help gain client trust.

(2 points)

Explanation

Gaining a client's trust requires (1) credibility (i.e., the manager is licensed and qualified to provide the service and has met all relevant regulatory requirements), (2) communication (i.e., the manager communicates with clients on a timely and thorough basis, using relevant technology where applicable), and (3) professionalism (i.e., the manager has the ability to deliver the service at the appropriate skill level together with loyalty, care, and prudence).

(LO 1.1.4)

You are an analyst at a global investment firm that has recently expanded its team by hiring several junior professionals. The firm's chief compliance officer has noticed varied interpretations of ethical standards among team members, particularly regarding the application of the CAIA Ethical Principles, managing conflicts of interest, and the importance of organizational culture. To ensure a consistent and high standard of professional conduct, you are tasked with preparing briefing materials for the team that address foundational concepts in investment ethics.

Question 5 of 7

A. **Explain** the difference between ethical principles and legal requirements in the context of the investment profession. Why is it important for investment professionals to adhere to ethical standards beyond what is required by law?

(4 points)

Explanation

Ethical principles are standards of conduct based on moral values and professional codes that guide behavior beyond the minimum required by law. Legal requirements are rules imposed by government authorities that must be followed to avoid penalties.

It is important for investment professionals to adhere to ethical standards because laws may not address every situation, or they may lag behind industry best practices. High ethical standards promote client trust, protect the integrity of financial markets, and help prevent reputational or regulatory risk.

(LO 1.2.2)

Question 6 of 7

B. **Describe** what is meant by a conflict of interest in investment management. **Explain** how conflicts should be managed in accordance with the CAIA Ethical Principles.

(3 points)

Explanation

A conflict of interest arises when a professional's personal interests (or those of the firm) have the potential to interfere with their duty to act in the best interests of clients.

Conflicts of interest should be avoided whenever possible. If a conflict cannot be avoided, it should be managed through due process and transparency within the firm's ethical and governance framework. Any retained conflict should be adequately disclosed to clients.

(LO 1.2.3)

Question 7 of 7

C. **Discuss** the importance of organizational culture in supporting ethical behavior within an investment firm. **State** *two* actions a firm's leadership can take to promote a strong ethical culture.

(4 points)

Explanation

Organizational culture sets the tone for expected behavior and influences whether employees feel empowered to act ethically. A strong ethical culture encourages transparency, open communication, and accountability. There are two actions that leadership can take:

1. Establish and communicate a clear code of ethics and regularly train staff on ethical expectations.
2. Lead by example by demonstrating ethical decision-making in practice and rewarding employees who uphold ethical standards.

(LO 1.2.3)