

LM01 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

A profession is an occupational community having specialized knowledge and skills. A profession is different from craft guilds and trade bodies in two ways, i.e. unlike trade bodies, members of professions are required to uphold high ethical standards and their mission is to serve society.

The common characteristics that help establishing the confidence and credibility in professionals and their organizations include the following:

- Professions normalize practitioner behavior
- Professions provide a service to society
- Professions have high entry standards
- Professions are client focused
- All members of a profession possess a body of expert knowledge
- Professions encourage and facilitate continuing education
- Professions monitor professional conduct to maintain integrity and reputation of an industry
- Professions are collegial and respect the rights, dignity, and autonomy of others
- Professions are recognized oversight bodies
- Professions encourage the engagement of members

CFA Institute is the largest body for investment management professionals. CFA Institute candidates and charterholders are required to meet the highest standards among those established by CFA Institute, regulators, or the employer.

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

- Trust is the key in investment management and the trust is established by acting with care, due diligence, and judgment for clients. The investment management profession combined with ethical corporate governance plays a vital role in the growth and development of the capital market. When market participants have trust in the investment management professionals, it leads to efficient capital market and smooth functioning which in turn helps in the development of the economy.

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?

LM02 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

LM04 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 regulations.
- 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 acceptable.

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.

LM04 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?

Any firm that actually manages assets can claim compliance once it has satisfied all requirements of the standards. Asset owners can make a claim of compliance if they compete for business. If they do not compete for business but report their performance to an oversight body, they may choose to comply with the GIPS standards for asset owners.

Who benefits from compliance?

The GIPS standards benefit:

- asset managers and their prospective clients
- asset owners and their oversight bodies

Key concepts of the GIPS standards for firms

- The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of investment performance.
- Meeting the objectives of fair representation and full disclosure is likely to require more than simply adhering to the minimum requirements of the GIPS standards. Firms should also adhere to the recommendations to achieve best practice in the calculation and presentation of performance.
- Firms must comply with all applicable requirements of the GIPS standards, including any Guidance Statements, interpretations, and Questions & Answers (Q&As) published by CFA Institute and the GIPS standards governing bodies.

- The GIPS standards do not address every aspect of performance measurement and will continue to evolve over time to address additional areas of investment performance.
- The GIPS standards require firms to create and maintain composites for all strategies for which the firm manages segregated accounts or markets to segregated accounts.
- The GIPS standards rely on the integrity of input data, the quality of which is critical to creating accurate performance presentations. The underlying valuations of portfolio holdings drive performance. It is essential for these and other inputs to be accurate. The GIPS standards require firms to adhere to certain calculation methodologies to allow for comparability across firms.

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.

Fundamentals of compliance

Several core principles create the foundation for the GIPS standards, including properly defining the firm, providing compliant presentations to all prospective clients, adhering to applicable laws and regulations, and ensuring that information presented is not false or misleading.

Definition of the firm: The GIPS standards state “The firm should adopt the broadest, most meaningful definition of the firm. The scope of this definition should include all

geographical (country, regional, etc.) offices operating under the same brand name, regardless of the actual name of the individual investment management company.”

Definition of discretion: The firm’s definition of discretion establishes criteria to judge which portfolios must be included in a composite and is based on the firm’s ability to implement its investment strategy. If client-imposed restrictions interfere with the implementation of the intended strategy, then the portfolio is non-discretionary and must not be included in a firm’s composite.

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. A firm cannot perform its own verification.