CAIA Ethical Principles

Professionalism and Fiduciary Responsibilities

The Investment Industry

Match the industry purpose to the correct definition:

- **Core purpose**
- **Collateral purpose**
- **Intrinsic purpose**
- **Fundamental purpose**

- Matching those with excess capital with those that have a need for capital
- Increasing wealth and managing risk
- Increase societal wealth and well-being
- Provide employment and growth opportunities for investment firms

The Investment Industry

Match the industry purpose to the correct definition:

- **Core purpose**
- **Collateral purpose**
- **Intrinsic purpose**
- **Fundamental purpose**

- Matching those with excess capital with those that have a need for capital
- Increasing wealth and managing risk
- Increase societal wealth and well-being
- Provide employment and growth opportunities for investment firms

© Kaplan, Inc.

The Investment Industry

- **True or false?** Recent IPO/buyback activity suggests the investment industry is not adding value with respect to either its core or intrinsic goals.

- **Define** the following keywords and briefly describe how they are related in the text:
  - Triple bottom line
  - Social-license compact

The Investment Industry

- ***True or false?*** *Recent IPO/buyback activity suggests the investment industry is not adding value with respect to either its core or intrinsic goals.* **False.** Declines in IPO activity and increases in share buybacks suggest that the investment industry is not adding value with respect to its intrinsic goal, however core purposes functions such as wealth and risk management remain valuable.

The Investment Industry

- ***Define*** *the following keywords and briefly describe how they are related in the text:*
  - *Triple bottom line:* A corporate focus on economic, environmental and social value generation.
  - *Social-license compact:* The implied granting of privileges to an industry by society in return for the industry conducting its business in a responsible manner.

Ethical Foundations: Key Definitions

- **Contrast** the following terms:
  - Principal vs. Agent vs. Asset owner
  - Values vs. Ethics
  - Assurance of Quality vs. Trust
  - Principles vs. Rules-based ethics

Ethical Foundations: Key Definitions

- **Contrast** the following terms:
  - Principal vs. Agent vs. Asset owner
    - The **principal** is the ultimate beneficiary of investment assets. **Agents** are employed by others to perform services to the principal. **Asset owners** are those that make allocation decisions for principals (and hence have features of both a principal and agent)
  - Values vs. Ethics
    - **Values** are individual beliefs. **Ethics** are a collective definition of acceptable behaviors adopted by an industry or organization

Ethical Foundations: Key Definitions

- **Contrast** the following terms:
  - Assurance of Quality vs. Trust
    - An assurance of quality is an important part of the value creation equation: purpose + professionalism + **assurance of quality** = value to clients. Trust is one of the four components of an assurance of quality which also combines fiduciary duty, license to operate, and conflict management
  - Principles vs. Rules-based ethics
    - Principles-based ethics focus on general behavior that promotes high levels of conduct. Rules-based ethics list specific rules for behaviors in particular situations.

Ethical Foundations: Key Definitions

- Which of the following concepts specifically fall under carrying out **fiduciary duty** vs. **attaining professionalism**?
  - Loyalty
  - Diversification
  - Adhering to best practice
  - Impartiality
  - Continued learning
  - Avoiding unnecessary risks
  - Diligence and competence
  - Prudence and care

Ethical Foundations: Key Definitions

Fiduciary duty

- Loyalty
- Diversification
- Impartiality
- Prudence and care

Attaining Professionalism

- Continued learning
- Avoiding unnecessary risks
- Diligence and competence
- Adhering to best practice

Fiduciary Duty/Professional Mindset

- **State** two challenges to carrying out fiduciary duty in practice.
- **State** two values driving a professional and fiduciary mindset.
- Briefly **describe** the virtuous cycle of positive forces from the client-first mindset.

Fiduciary Duty/Professional Mindset

- ***State** two challenges to carrying out fiduciary duty in practice.*
  - Any two of:
    - Interpretation may vary by context
    - Interpretation changes over time
    - No globally consistent interpretation of obligations or scope
    - The prioritization of financial performance over ESG factors

Fiduciary Duty/Professional Mindset

- ***State** values driving a fiduciary and professional mindset.*
  - Any two of:
  1. *Ethical and professional behavior* embraced by the firm's culture
  2. *Partnership* with the client
  3. *Client first:* knowing the client and making suitable decisions
  4. *Transparency, integrity and accountability*
  5. *Public responsibility* (clean 'license to operate')

Fiduciary Duty/Professional Mindset

- *Briefly **describe** the virtuous cycle of positive forces from the client-first mindset.*
  - Good portfolio performance benefits clients and builds trust, which benefits the growth of the asset manager's business and the future performance of portfolios.

The Investment Industry

- **True or false?**
  - Public responsibility is a key definitional component of a profession.
  - An investment professional's skill set should include soft-skills and T-shaped skills.
  - When adopting a 'client first mindset' in practice it is important to treat all clients equally.

- **State** *two* reasons why firms fall short in meeting the target of being professional.

The Investment Industry

- ***True or false?***
  - Public responsibility is a key definitional component of a profession. **True.**
  - An investment professional's skill set should include soft-skills and T-shaped skills. **True.**
  - When adopting a 'client first mindset' in practice it is important to treat all clients equally. **False –** a client first mindset has the concept of treating clients *fairly* at its heart in practice. Different clients can and should be treated differently dependent on their circumstances and level of service.
- ***State*** *two reasons why firms fall short in meeting the target of being professional.*
  - Any two of: Unjustified fees, misaligned values or poor communication

The Investment Industry

Match the type of industry with the correct definition:

- **Absent**
- **Misaligned**
- **Professional**
- **Unnecessary**

Good For Industry?	Good for Society?
✓	✓
Partially good	✗
✗	Partially good
✗	✗

The Investment Industry

Match the type of industry with the correct definition:

- **Absent**
- **Misaligned**
- **Professional**
- **Unnecessary**

Good For Industry?	Good for Society?
✓	✓
Partially good	✗
✗	Partially good
✗	✗

Ethics

The Value Creation Equation

Place the following elements in their correct place in the **value creation equation:**

Vision & values | *Fiduciary duty* | *License to operate*

Competence, ethics, values | *Conflicts-of-interest* | *Trust, Reputation*

Purpose + **Professionalism** + **Assurance** = **Value**

Experiences and outcomes

The Value Creation Equation

Purpose
- *Vision & values*
- *Fiduciary duty*

+

Professionalism
- *Competence, ethics, values*

+

Assurance
- *Fiduciary duty*
- *License to operate*
- *Trust, Reputation*
- *Conflicts-of-interest*

=

Value

Experiences and outcomes

Foundations for the CAIA Ethical Principles

Evaluate the following statements:

- Trustworthiness is always enhanced by a firm's brand.

  This is a false statement – while confidence in a well-known brand can enhance trust, brand issues can also negatively affect trust when stakeholder outcomes are below expectations

- A firm should never engage in a business activity that leads to conflicts of interest.

  This is false statement- a firm should avoid conflicts wherever possible however it is likely there will be unavoidable conflicts which will need to be disclosed.

The CAIA Ethical Principles 1 – 4: Doing The Right Things

Map the following behavior to the *most relevant* Principle:

Behavior
Speak the truth. Pass on important information
Moral courage, integrity, encourage others to act ethically, responsibility to all stakeholders
Strong governance/oversight. Place client's interests before self-interest
Know your client, communicate in a manner that builds trust

Principle
1. Ethical and Professional Behavior
2. Partnership
3. Client First Mindset
4. High Standards of Conduct: Transparency, Integrity, Accountability

The CAIA Ethical Principles 1 – 4: Doing The Right Things

Map the following behavior to the *most relevant* Principle:

Behavior
Speak the truth. Pass on important information
Moral courage, integrity, encourage others to act ethically, responsibility to all stakeholders
Strong governance/oversight. Place client's interests before self-interest
Know your client, communicate in a manner that builds trust

Principle
1. Ethical and Professional Behavior
2. Partnership
3. Client First Mindset
4. High Standards of Conduct: Transparency, Integrity, Accountability

The CAIA Ethical Principles 5 – 8: Doing Things Right

Map the following behavior to the *most relevant* Principle:

Behavior
Establishing adequate ethical framework, appropriate reward systems
Value diversity, work with regulators, mentor and volunteer
Be humble and curious, apply a growth mindset
Comply with laws, act ethically under duress, manage risk, perform proper due diligence,

Principle
5. High Standards of Practice
6. Professional Work
7. Continued Learning
8. Collaboration

The CAIA Ethical Principles 5 – 8: Doing Things Right

Map the following behavior to the *most relevant* Principle:

Behavior
Establishing adequate ethical framework, appropriate reward systems
Value diversity, work with regulators, mentor and volunteer
Be humble and curious, apply a growth mindset
Comply with laws, act ethically under duress, manage risk, perform proper due diligence,

Principle
5. High Standards of Practice
6. Professional Work
7. Continued Learning
8. Collaboration

The CAIA Ethical Principles

Map the following behaviors to the principle that they *most directly* breach:

- A firm appoints an analyst to cover a company where the analyst's spouse is a chief executive.
  - Breach of Principle 3: Client-First Mindset
    - Avoid conflicts, disclose those that cannot be avoided
- An investment manager deliberately engages in complex language with clients to give the impression they are delivering more value than they are.
  - Breach of Principle 2: Partnership
    - Communicate in a manner which builds trust

The CAIA Ethical Principles

Map the following behaviors to the principle that they *most directly* breach:

- Firm executives deploy a business strategy that is likely to be very profitable in the short term but cause instability and for markets to require fiscal and monetary support in the long term.
  - Breach of Principle 1: Ethical and Professional Behavior
    - Show responsibility to all stakeholders
- An employee follows process within their firm that they suspect is very likely unethical or even illegal.
  - Breach of Principle 1: Ethical and Professional Behavior
    - Voice concerns and show moral courage

The CAIA Ethical Principles

Map the following behaviors to the principle that they *most directly* breach:

- An analyst insists on working independently to others in the research team and resists peer review before publishing work on confidentiality grounds.
  - Breach of Principle 8: Collaboration
    - Utilize peer review in work and in ethics code
- An analyst regularly states that they have mastered a particular style of investing and can not improve the level of service they provide to clients.
  - Breach of Principle 7: Continued Learning
    - Be humble and curious, apply a growth mindset

The CAIA Ethical Principles

Map the following behaviors to the principle that they *most directly* breach:

- A firm does not have an effective compliance function fit for modern financial markets.
  - Breach of Principle 5: High Standards of Practice
    - Operate under an ethical framework which evolves with markets
- An investment firm is regularly fined by regulators.
  - Breach of Principle 6: Professional Work
    - Comply with applicable laws, rules and regulations

The CAIA Ethical Principles

Map the following behaviors to the principle that they *most directly* breach:

- A firm has ineffective governance and oversight of investment management decisions.
  - Breach of Principle 3: Client-First Mindset
    - Support strong governance and culture
- An investment manager aggressively hides costs within an opaque network of private fund structures.
  - Breach of Principle 4: High Standards of Conduct
    - Disclose costs (Transparency, Integrity and Accountability)

The CAIA Ethical Principles: Case Studies

Briefly **describe** one breach of the CAIA Ethical Principles from each of the following case studies:

- MF Global
- Archegos Capital Management
- Bear Stearns' Hedge Funds
- NY State Pension
- CalPERS

The CAIA Ethical Principles: Case Studies

MF Global

- Unlawfully used client funds to cover margin calls for losses on proprietary positions, eventually filing for bankruptcy with shortfalls in client funds
- Key **breaches** of ethical principles:
  - Lack of adequate risk governance (P3: Client-First Mindset)
  - Employees not voicing concerns (P1: Ethical and Professional Behavior)
  - Failure in transparency and accountability (P4: High Standards of Conduct)
  - Not adhering to CFTC segregation rules (P6: Professional Work)

The CAIA Ethical Principles: Case Studies

Archegos Capital Management

- Took highly levered positions in derivatives whilst concealing overall exposure to counterparties. Eventual losses to counterparties estimated to be $10 billion.
- **Breaches** of ethical principles:
  - Manipulation of stock market prices (P1: Ethical and Professional Behaviour)
  - Lack of transparency in exposure with counterparties (P4: High Standards of Conduct)
  - Lack of ethical framework (P5: High Standards of Practice)
  - Lack of effective risk management (P6: Professional Work)

The CAIA Ethical Principles: Case Studies

Bear Stearns Hedge Funds

- Two structured credit hedge funds collapsed, with clients suffering losses whilst portfolio managers concealed losses and redeemed their own personal investments (whilst lying about adding assets to the fund)
- **Breaches** of ethical principles:
  - Misleading clients about prospects for the funds (P1: Ethical and Professional Behavior)
  - Transferring assets out of the fund ahead of clients (P3: Client-First Mindset)
  - Failing to disclose extent of issue to clients (P4: High Standards of Conduct)

The CAIA Ethical Principles: Case Studies

NY State Common Retirement Fund

- New York State comptroller and adviser guilty of receiving gifts and donations from financial firms to which they had allocated capital
- **Breaches** of ethical principles:
  - Disregard for pension plan participants (P1: Ethical and Professional Behavior)
  - Placing their own interest above plan participants (P3: Client-First Mindset)
  - Lack of effective investment decision making (P6: Professional Work)

© Kaplan, Inc.

The CAIA Ethical Principles: Case Studies

CalPERS

- CEO took bribes from adviser in return for allocations to adviser’s funds whilst falsifying documents claiming to show approval for investment decisions
- **Breaches** of ethical principles:
  - Taking bribes (P1: Ethical and Professional Behavior)
  - Lack of adequate governance (P3: Client-First Mindset)
  - Inappropriate reward system (P5: High Standards of Practice)