


CAIA™ Level II Final Review

TOPIC 1

CAIA Ethical Principles

- 1.1 Professionalism and Fiduciary Responsibilities
- 1.2 Ethics

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Reading 1.1

Reading 1.1 – Professionalism & Fiduciary Responsibility

Investment industry

- Ecosystem
 - 1. Participants
 - 2. Technologies
 - 3. Markets
- Facets of purpose
 - 1. Fundamental purpose – increase societal wealth & well-being.
 - 2. Intrinsic purpose – source & allocate capital.
 - 3. Core purpose – wealth & risk management to end savers.
 - 4. Collateral purpose – produce jobs, rewards, etc.

Investment industry players –

Asset Owners (<i>Principals</i>)	<i>Agents</i> (<i>Value chain</i>)	Wider Stakeholders
Individuals	Asset managers	Governments
Pension funds	Investment banks	Regulators
Endowments & foundations	Index providers	Standard setters
SWFs	Consultants/advisors	Investee entities
Insurance companies	Research providers	Co-investors
Mutual funds	Data providers	Academics
Outsourced CIOs		Civil society
Family offices		

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Qualifying Traits of Asset Owner/Allocator

- Traits –
 1. Work for beneficiaries (or savers or investors) as manager of assets in fiduciary capacity under delegated responsibility.
 2. Work with sponsoring entity.
 3. Work within law & have implicit societal license to operate.
 4. Deliver mission-specific outcomes to beneficiaries & stakeholders.
 5. Use business models that combine governance budget & risk budget.
- Pension funds – largest group of qualifying asset owners.

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Value Creation in the Investment Industry

- Industry's two key activities –
 1. Wealth & risk management (most significant) – build portfolios & manage risk (mostly point-in-time) with focus on relative risk.
 2. Stewardship – engage with management.
- ⇒ Higher value creation score for #1 than for allocating capital.
 - Better score if risk management is on through-time & absolute risk.
- Organizations share client-first mission; contribute in unique ways.
 - Purpose reflects 3 factors: passion, competencies, and success of profit & performance drivers.
- **Sustainability** meets present needs without compromising future generations' needs.
- Financial & broader goals may overlap ⇒ 2 ways to create value –
 1. Financial: investing for sustainability can lead to improved financial outcome.
 2. Impact: value creation that investment strategy generates on real-world issues.

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Value Creation (cont.)

- Sustainability choices based on *social-license principle*: pursue financial goals based on realizing socially-valued goals.
- Value models –
 - Shareholder value model – financial returns are key.
 - Shared value model – maximize shareholder value & contribute to society.
 - Elkington (1994): "*triple bottom line*" – corporations should focus on economic value as well as environmental & social value they add.
 - System-value model – business is within society & society within environment. Value creation should:
 1. Be activities used to create future wealth & well-being (fundamental purpose).
 2. Be judged through stakeholder lenses with subjectivity.
 3. Occur over extended periods, with progress assessed looking back & forward.

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Fiduciary Obligations

- Purpose: adopt high standards of professional practice to protect clients from abuse of power.
- Areas of fiduciary obligations –
 1. Loyalty – beneficiaries' interests first; avoid conflicts of interest.
 2. Prudence and care
 3. Diversification
 4. Impartiality
- Challenges –
 1. No objective interpretation (of obligations)
 2. No static interpretation (not fixed in time)
 3. No globally consistent interpretation
 4. Financial interests first
- Fiduciary duty is codification of professionalism – involves professional mindset & skill set, is source of license to operate, & is evident in commitment to long-term value creation.
- Fiduciary & professional mindset – begins with understanding purpose & alignment to client.

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Fiduciary Obligations (cont.)

- Values that support true fiduciary & professional mindset –
 1. Ethical and professional behavior
 2. Partnership – with client.
 3. Client first – know client & understand needs; make decisions to meet needs.
 4. Transparency, integrity, & accountability
 5. Public responsibility and clean license to operate
 - Investment profession's warranty involves certain behaviors –
 - i. Responsibility to society
 - ii. Accepted standards of fair practice
 - iii. Accepted body of knowledge & practice
 - iv. Processes for learning from experience
 - v. Standards for accreditation, codes of discipline, & sanctions, achieved via collective assurance

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Professionalism Skill Set

- Key areas –
 1. Adhere to "best practice" standard
 2. Continue to learn and grow their knowledge base
 3. Diligent, competent, & objective throughout investment process
 4. Judge risks broadly and avoid unnecessary risks
- Based on skills and abilities –

Skills	Technical	Soft	Leadership	T-Shaped
	<ul style="list-style-type: none"> • Solutions • Investment foundations • Finance • IT • Management science 	<ul style="list-style-type: none"> • Innovation • Collaboration • Relationship • Humility • Consultative/selling 	<ul style="list-style-type: none"> • Vision and mission • Ethical culture • Governance stakeholders • Crisis management • Comfortable globally 	<ul style="list-style-type: none"> • Situational fluency • Connects disciplines • Diverse perspectives • Network connections • System understanding
Abilities	Digital	Emotional	Creative	Systematic
	<ul style="list-style-type: none"> • Data science • Statistical intelligence 	<ul style="list-style-type: none"> • Emotional intelligence • Resilience 	<ul style="list-style-type: none"> • Creative intelligence • Idea ownership 	<ul style="list-style-type: none"> • Behavioral understanding • Inter-connections

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Client-First Approach

- In practice, goal is to treat all clients fairly – challenging to operationalize.
- May need to forgo maximizing short-term profits for relationship.
- Areas where "right" choice is not always clear –
 1. Conflicts of interest
 2. Trade-off between benefits & costs for different stakeholders
 3. Insufficient knowledge of client
- Make choice in well-ordered, transparent process with balanced rules & principles.
- Instead of observing client-first behavior, assess culture with questions –
 1. Well-managed capacity and capability to achieve client expectations?
 2. Process & attitude to listen to clients & get feedback?
 3. Attention given to understanding & managing client risks?
 4. Professionals understand professional & ethical practice and its practical application?
 5. How professional prioritizes client, firm, & self and regard for societal interests?
 6. How org. views of fair rewards, and can it show alignment with the principle?
 7. What are levels of trust between organization & clients?
- Client-first principles also require rejecting bad habits (e.g., overclaiming).

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Culture & Industry Professionalism; Trust in Client Relationships

- Role of culture – how people in groups think/ behave. Influenced by leaders.
- Culture contributes to achieving professionalism via 3 main channels/principles –
 1. Aligns values & beliefs, establishes expectations & trust, and reduces uncertainty.
 2. Focuses on factors that matter in all organizational situations.
 3. Captures power of strong communication & engagement in organization and in client interactions.

Trust

- Two-sided: is asset manager worthy of trust & is allocator willing to trust?
- Significance increases with investment's risk & duration.
- Earned by asset managers who build credibility (tangible), communicate (tangible), & exhibit professionalism (tacit).
 - Credibility's 2 parts: end investors need assurance –
 1. Professional is accredited to provide services.
 2. Of value proposition, and validation that asset manager can add value.

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Trust

- Features in investment industry –
 1. Has value to allocator & asset manager (by enabling value creation to develop).
 2. Levels vary by geography & demography, culture, and correlate with market experiences.
 3. Factor during entire life cycle; more significant when interventions needed.
 4. Can be helped by technology, but requires human involvement.
 5. Brand can support trust, but can compromise it if brand promise is not fulfilled.
 6. Information is essential.
 7. Innovation & use of technology can enhance trust.
- Widespread industry failings –
 1. Weakness in value proposition: value does not match fees charged
 2. Misalignments in values of asset management firms with clients
 3. Communication with inadequate accuracy and honesty

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Value Produced by Industry; Fiduciary & Professional Mindset

- Industry can secure more/less value for itself & society.
 - Misaligned industry – in long term => untrusted industry with fewer assets; may not be sustainable.
- Industry not driven by fiduciary culture does not get rewards associated with risk.

Greater Industry Benefit

Misaligned Industry	Professional Industry
Good for industry Bad for society	Good for industry Good for society
Absent Industry	Unnecessary Industry
Bad for industry Bad for society	Bad for industry Good for society

Greater Society Benefit

Fiduciary & professional mindset

- Creates value for clients via –
 1. Values & behaviors aligned with fiduciary duty & focus on client interests
 2. Client relationships with trust & empathy; with transparent, accurate, & authentic communication.
 3. Working with holistic model & actions relating to value creation relative to goals
 4. Adopting fair rewards given resources & outcomes involved
 5. Regard for public responsibility and adherence to clean social license
- Adds value since creates virtuous circle of positive forces –
 - Portfolio – benefits from skill & attention.
 - Client – benefits from best performance reinforced by trust in manager.
 - Asset manager – benefits from sustainable, successful client relationship.

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Reading 1.2 – Ethics

Elements of professionalism & fiduciary responsibility

1. Investment industry: ecosystem subset of finance.
2. Industry's purposes: capital allocation, wealth & risk management, & service of society.
3. Participants/players: end saver/principal through multiple agents.
4. Value creation: portfolio construction, stewardship, and sustainability.
5. Why this system exists: path dependency & possible impermanence.
6. Effect of fiduciary duty: binds agents to high standards to protect clients.
7. Fiduciary & professional mindset: value creation for client.
8. Skill set: best practice standards, continuous learning, diligence, competence, & risk management.
9. Role of culture: align values & beliefs, focus on significant things, & engagement.
10. Put client first: treat all clients fairly.
11. Make "right" choice: navigate conflicts of interest, trade off benefits & costs; and address client's insufficient knowledge.
12. Exhibit client-first approach, role of trust, and how above compare to current system.
13. How professional & fiduciary mindset adds value to clients, etc.; and why should foster culture of professionalism.

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Takeaways from Previous Reading; 8 Ethical Principles

Key takeaways

- Understanding professionalism requires understanding investment industry.
- Consider professionalism via organizational purpose & vision; consider goals, motivations, and boundaries.
- Professionalism best codified via balanced use of principles with rules & policies.
- Clarity on organizational purpose & ideals of professionalism improve outcomes.

8 Ethical Principles

Professionalism: Doing the right things

1. Ethical & professional behavior
2. Partnership
3. Client-first mindset
4. High standards of conduct

Professionalism: Doing things right

5. High standards of practice
6. Professional work
7. Continued learning
8. Collaboration

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Principles' Foundational Ideas and Concepts

- **Investment ecosystem** – Better term than "investment industry".
- Purpose & vision – includes fundamental purpose of contributing to society.
- Professionalism and professional conduct – competencies, values, etc.
- Ethics and values
 - **Values** – individual beliefs that.
 - **Ethics** – set of moral principles.
- Regulation
- National & cultural differences
- Importance of trust

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Value Creation Equation; Professionalism in Organizational Value Chain

Purpose	Professionalism	Assurance	Value			
<ul style="list-style-type: none"> • Vision & values <ul style="list-style-type: none"> ➢ Why we exist ➢ How we create value • Fiduciary duty • Stakeholder map <ul style="list-style-type: none"> ➢ Interconnectivity 	+	<ul style="list-style-type: none"> • Values <ul style="list-style-type: none"> ➢ Ethics • Competency <ul style="list-style-type: none"> ➢ Standards ➢ Knowledge & skill • Accountability 	+	<ul style="list-style-type: none"> • Fiduciary duty • License to operate • Trust & reputation • Track record <ul style="list-style-type: none"> ➢ Standards ➢ Credentials 	=	<ul style="list-style-type: none"> • Experiences • Outcomes <ul style="list-style-type: none"> ➢ Influenced via trust & perceptions vs expectations

Purpose, vision, and goals	Professionalism	Strategy <ul style="list-style-type: none"> • System model • Business model • Investment model • People model • Change model 	Outcomes to organization & clients
	Feedback	Feedback	Feedback

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4 Components of *Assurance of Quality*


1. **Fiduciary duty** – helps ensure high standards of care, alignment of interests, & development of trust. Traits –
 - i. **Loyalty**
 - ii. **Prudence and care**
 - iii. **Impartiality**
 - iv. Diversification
2. **License to operate** – aligns interests & trust. Basic tenets –
 - i. Firms have covenant from society to pursue commercial goals.
 - ii. Realizing social goals legitimizes commercial goals.
 - iii. Reflects solidarity of working together.

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4 Components of *Assurance of Quality* (cont.)

3. **Trust model**
 - Vital features –
 - i. 2-sided: from end investor & provider.
 - ii. Value to end investor & provider.
 - iii. Grows slowly; can quickly erode.
 - iv. Importance grows as risk & duration increase.
 - v. For end investor, value relates to perceptions of outcome vs. expectations.
 - "Trust capital" (i.e., size & robustness) affected by fact that trust –
 - i. Key in entire savings life cycle.
 - ii. Enhanced by reputation.
 - iii. Depends on quantity & quality of communication.
 - iv. Helped by technology; needs personal touch.
 - v. Can enhance brand; can diminish if promise unfulfilled.
 - vi. Levels vary by geography & demography, & correlate with market experiences.

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4 Components of *Assurance of Quality* (cont.)

4. *Conflict-of-interest model*

- Examples –
 - i. Financial incentives
 - ii. Commitments to other clients or areas of responsibility
 - iii. Personal relationships or interests that may be incentives
 - iv. Gifts
- Patterns – some conflicts:
 - i. Are avoidable; some unavoidable.
 - ii. May be managed.
 - iii. May affect clients in positive & negative ways.
 - iv. May be subjective or abstract.
- Effects mitigated by transparency, integrity, and responsible practices; and by governance & culture.

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Principles 1, 2, & 3

Principle 1: Ethical and Professional Behavior

1. Act ethically
2. Act professionally with integrity and respect
3. Be concerned for well-being
4. Voice concerns
5. Take personal responsibility
6. Show responsibility to stakeholders
7. Encourage others to act ethically
8. Act with *moral courage*

Principle 3: Client-first mindset


1. Client-first mindset
2. Support governance & culture
3. Manage conflicts within multiple products
4. Avoid conflicts of interest

Principle 2: Partnership

1. Know your client
2. Communicate timely and accurately
3. Embrace opportunities for co-creation & collaboration
4. Operate with alignment of interests
5. Seek alignment of values

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Principles 4 & 5

Principle 4: High standards of conduct: transparency, integrity, & accountability

1. Be transparent and set goals
2. Disclose errors
3. Disclose costs
4. Act with *integrity*
5. Take accountability
6. Support & promote ethical cultural values


Principle 5: High standards of practice

1. Define standards of practice
2. Define competencies & body of knowledge
3. Seek professional accreditation
4. Operate in ethical framework
5. Work in appropriate reward system
6. Be adaptable & responsive

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Principles 6, 7, & 8

Principle 6: Professional work

1. Comply with applicable local laws
2. Show professional work
3. Ensure appropriate risk assumptions & models
4. Operate in ethical judgment framework
5. Ensure sufficient documentation
6. Behave with diligence & professionalism under stress

Principle 7: Continued learning

1. Humility & curiosity as attitudes
2. Continuous education
3. Growth mindset principles
4. Understand impact of technology
5. Undertake adjacent learning

Principle 8: Collaboration

1. Value to diversity, teamwork, & collaboration
2. Use peer review of work
3. Seek peer review in ethics code
4. Support investment ecosystem
5. Support professional community

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Ethical Misconduct at MF Global

- Large European sovereign debt investments. ~\$1.6b shortfall in customer accounts.
- What went wrong?
 1. Failed to uphold fiduciary duties & engage in ethical conduct.
 2. Lack of risk management, with large investment & risk exposure.
 3. CEO ignored CRO's warnings and replaced him; asked board to raise risk exposure.
 4. Illegally used customer funds to maintain liquidity.
- Ethical violations -
 1. Princ. 3 (Client-First Mindset) – weak governance & CEO's excessive risk-taking.
 2. Princ. 1 (Ethical & Prof. Behav.) by employees – did not voice concerns or take responsibility for losses.
 3. Princ. 4 (High Standards of Conduct) – failed to disclose losses, be accountable, & act with integrity.
 4. Princ. 6 (Prof. Work) – did not segregate customer accounts.
- In review – CEO:
 - Excessive risk-taking.
 - Removed CRO & pressured board to support high-risk trades.
 - Authorized illegal use of customer funds to cover losses.
 - Promoted improper culture, replaced employees, & conducted illegal transactions.

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Ethical Misconduct at Archegos Capital Management

- Family office; founded by Hwang. Used high leverage & derivatives. Several counterparties; concealed total exposure. Lied about positions; inflated portfolio.
- What went wrong? – High leverage by not disclosing to counterparties. Sizeable holdings; manipulated prices. Lacked governance & independent risk management.
- Ethical violations –
 1. Princ. 1 (Ethical & Prof. Behavior) & Princ. 4 (High Standards of Conduct)
 2. Princ. 5 (High Standards of Practice) & Princ. 6 (Prof. Work)
- In review
 - Highly-leveraged positions with several banks & deceived counterparties. Large positions; some likely resulted in manipulated inflated prices.
 - Collapse triggered by ViacomCBS's 2021 20% 1-day decline, and inability to meet margin calls and forced unwindings.
 - Counterparties lost ~\$10b.
 - 2024: Hwang sentenced to 18 years for fraud & market manipulation.

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Ethical Misconduct at Bear Stearns

- 2 HFs: High-Grade Structured Credit (HGSC) and HGSC Enhanced Leveraged. Invested in MBSs & CDOs. Lost > \$2b due to collapse of subprime markets, and liquidity issues and excessive leverage.
- What went wrong?
 - Portfolio managers downplayed losses. Investors unaware of true risk.
 - June 2007: HFs lost nearly all capital; unable to meet margin calls, etc.
- Ethical violations -
 1. Princ. 1 (Ethical & Prof. Behavior) – withheld info. & withdrew personal assets while soliciting new money.
 2. Princ. 3 (Client-First Mindset) & Princ. 4 (High Standards of Conduct)
- In review
 - Excessive subprime exposure; did not disclose size (~60%) to clients.
 - As performance fell, managers withdrew personal capital while soliciting new capital.
 - Due to excessive leverage & illiquidity, could not meet redemption requests & margin calls. 2007: HFs collapsed.

Ethical Misconduct at NYS Common Retirement Fund (CRF)

- Pay-to-play: firms & intermediaries paid kickbacks, etc. for investment allocations.
 - Hevesi (Comptroller, CRF's trustee) in pay-to-play with placement agents; accepted gifts, etc. Morris (political adviser) also involved.
- After this, NYS banned use of placement agents & lobbyists by NYSCRF; increased disclosure requirements and created independent oversight process.
 - SEC limited political contributions by investors working with public pensions.
- What went wrong? – Concentrated power. Lack of oversight, checks & balances, etc.
- Ethical failures –
 1. H & M and others violated Princ. 1 (Ethical and Prof. Behavior) – unethical conduct, lack of integrity, and disregard for stakeholders.
 2. H & M violated Princ. 3 (Client-First Mindset) – their interests above CRF's.
 3. H & M violated Princ. 6 (Prof. Work) – no objective decision-making.
- In review
 - Hevesi abused position with pay-to-play; got gifts to direct pension assets.
 - CRF's weak governance concentrated power & lacked oversight.
 - Political contributions not adequately limited.
 - 2010: Hevesi & others sentenced (for felony corruption & securities fraud).

Ethical Misconduct at CalPERS

- Bribery... Buenrostro (CEO) bribed by Villalobos to influence CalPERS's investments for Villa.'s clients. Buen. falsified disclosure letters; later worked for Villa.
- Afterwards, CalPERS's governance reformed – e.g., better transparency & oversight, stricter regulations & disclosure for use of placement agents, and limits on gifts.
- What went wrong? – Buen. gave Villa. CalPERS's confidential info., and accepted benefits in exchange for influencing decision-making. Later was hired by Villa.
- Ethical violations by Buenrostro –
 1. Princ. 1 (Ethical and Prof. Behavior) – took bribes.
 2. Princ. 3 (Client-First Mindset) – created conflict of interest & weak governance.
 3. Princ. 5 (High Standards of Practice) – did not operate in ethical framework or appropriate rewards system.
- In review
 - Buen. falsified documents & accepted bribes to sway CalPERS's investments.
 - Buen. later joined Villa.'s placement agency; continued to influence CalPERS.
 - 2014: Buen. sentenced for corruption. Villa. died by suicide before trial.
 - CalPERS made many governance policy changes.