

ETHICAL AND PROFESSIONAL STANDARDS CFA LEVEL III WORKSHOP

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ETHICAL AND PROFESSIONAL STANDARDS

- Workshop Breakdown: 90 minutes total
 - Ethics Test-Tips (Slides 3-4): 10-15 minutes
 - Code of Ethics and Professional Standards Highlights (Slides 5-12): 15-20 minutes
 - Detailed Professional Standards (Slides 13-28): 20-25 minutes
 - Asset Manager Code (Slides 29-30): 5-10 minutes
 - Attendee Q&A: 15-20 minutes

ETHICS TEST TIPS

- 10% - 15% of Level III Exam – Arguably most important topic
- Read question and answer choices carefully (e.g. Std II Q needs Std II answer)
- Strategy in answering questions: Suggested approach
 - 1. Code or Professional Standards Question?
 - Most Questions will involve Professional Standards
 - 2. If Standards Question, which one?
 - 3. Identify Parties within the fact pattern to determine Standard
 - For example, Employer (Std IV) or Client (Std III)
 - Priority of Transactions (Client first, then Employer, then CFA)
- Generally, if **DISCLOSE** issues (e.g. conflicts) and **TIMING** of disclosure is adequate, personal action is allowed unless:
 - Breaks the law;
 - Standard specifically prohibits an action; or
 - Standard requires consent (e.g. Std IV Employer)
- Personal ownership of securities = Conflicts question (Std VI & III; Std VI & IV)

ETHICS TEST TIPS (CONTINUED)

- Concepts are straightforward; complexity is with overlapping standards
- Apply the process of elimination and use common sense
- Select BEST answer rather than look for CORRECT answer
 - Answers may have various shades of gray (i.e. correctness)
 - Get into the habit of going through each of the answer choices
- Most questions will have an ethical issue
 - Why? Issues test candidates' understanding of concepts and practices
- Beware of specific answers on exam
 - Standards are more general than regulatory rules (e.g. 3 days to notify...)
- Know the difference between what is required by the Standards and what is good office practice (e.g. Informing clients of additional compensation arrangements when only employer consent is required under Std IV.B)
- Read the fact pattern carefully; a possible Standards violation may be spotted by a single word within the hypothetical (e.g. “none”, “quickly”)
- To prepare for this section, practice as many Ethics questions as possible

DESCRIBE THE STRUCTURE OF THE CFA PROFESSIONAL CONDUCT PROGRAM AND THE PROCESS OF ENFORCEMENT OF THE CODE AND STANDARDS

- CFA Institute Bylaws and Rules of Procedure form basic structure in enforcing the Code and Standards.
- Rules of Procedure are guided by (a) fair process to the member and candidate, and (b) confidentiality of proceedings.
- CFA Institute Board of Governors maintains oversight for Professional Conduct Program (PCP) thru the Disciplinary Review Committee (DRC), which is responsible for enforcement of the Code and Standards
- PCP staff, under the direction of CFA Institute Designated Officer, conducts professional conduct inquiries. **Anyone** can write to PCP with a complaint. 4 major sources of complaints:
 - Self-disclosure in Annual Professional Conduct Statement
 - Written complaints received by PCP staff
 - Awareness thru media or other publications
 - CFA examination proctors who suspect violation of professional conduct during the exam
- PCP staff will conduct own due diligence and determine if violation of Code or Standard.
- The Designated Officer will then review all material and (1) dismiss complaint, (2) issue cautionary letter, or (3) institute proceedings to discipline member.
- Disciplinary actions may be rejected or accepted by member or candidate. If rejected, the matter is referred to a hearing by a panel of CFA Institute members
- Sanctions imposed by CFA Institute have “significant” consequences. For members, this may include condemnation by CFA peers and ramifications for employment. For candidates, this may suspend further participation in the CFA Program. Note: No monetary fines may be assessed!

ETHICS AND PROFESSIONAL STANDARDS

- Describe a Framework for Ethical Decision Making
 - Developing, maintaining and demonstrating a strong culture of integrity is the most important factor in promoting ethical behavior
 - Establishing an effective ethical blueprint or framework on how to act is a crucial step to engaging in ethical conduct
 - General ethical decision-making framework:
 - 1. Identify: Important relevant facts, stakeholders and duties owed, ethical principles, conflicts of interest (e.g. duty to client vs. duty to employer)
 - 2. Consider: Situational influences (e.g. behavioral biases), seeking additional guidance, identifying and evaluation alternative actions
 - 3. Decide and Act: Make a decision and act accordingly
 - 4. Reflect: Was outcome what was anticipated? All factors considered?
 - Framework application does not need to be sequential and is often iterative (i.e. repetitive to achieve desired result)

ETHICS AND PROFESSIONAL STANDARDS

- Code vs. Standards: Know the difference

Code = General guide for how members should act (what is obligatory and what is forbidden conduct)

Standards = Benchmark for minimally acceptable behavior by members

KNOW THE 6 COMPONENTS OF THE CODE OF ETHICS: MEMORIZE!

The Code of Ethics

Members of the CFA Institute and candidates for the CFA designation shall:

- Act with integrity, competence, diligence, respect, and in an ethical manner when dealing the public, clients, prospects, 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 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.

Use mnemonic devices as memory aids! Examples: “DICE”, which is Diligence, Integrity, Competence and Ethical; “RIP”, which is Reasonable care, Independent Professional judgment.

EXPLAIN THE ETHICAL RESPONSIBILITIES REQUIRED BY THE CODE AND STANDARDS, INCLUDING THE MULTIPLE SUB-SECTIONS OF EACH STANDARD

The Standards of Professional Conduct

Outline

Standard I: Professionalism

- A. Knowledge of the Law (Slide #13)
- B. Independence and Objectivity (Slide #14)
- C. Misrepresentation (Slides #14-15)
- D. Misconduct (Slide #15)

Standard II: Integrity of Capital Markets

- A. Material Nonpublic Information (Slides #16-17)
- B. Market Manipulation (Slide #17)

THE STANDARDS OF PROFESSIONAL CONDUCT OUTLINE

Standard III: Duties to Clients *

- A. Loyalty, Prudence, and Care (Slide #18)
- B. Fair Dealing (Slide #18)
- C. Suitability (Slide #19)
- D. Performance Presentation (Slide #20)
- E. Preservation of Confidentiality (Slide #20)

Standard IV: Duties to Employers

- A. Loyalty (Slide #21)
- B. Additional Compensation Arrangements (Slide #21)
- C. Responsibilities of Supervisors (Slide #22)

Standard V: Investment Analysis, Recommendations, and Actions

- A. Diligence and Reasonable Basis (Slide #23)
- B. Communication with Clients and Prospective Clients (Slides #23-24)
- C. Record Retention (Slide #24)

THE STANDARDS OF PROFESSIONAL CONDUCT OUTLINE

Standard VI: Conflicts of Interest **

- A. Disclosure of Conflicts (Slide #25)
- B. Priority of Transactions (Slide #25)
- C. Referral Fees (Slide #26)

Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate

- A. Conduct as Participants in the CFA Programs (Slide #27)
- B. Reference to CFA Institute, CFA Designation, and CFA Program (Slide #28)

DEMONSTRATE A THOROUGH KNOWLEDGE OF THE CODE AND STANDARDS TO SPECIFIC SITUATIONS OF PROFESSIONAL INTEGRITY. RECOMMEND PRACTICES AND PROCEDURES DESIGNED TO PREVENT VIOLATIONS OF THE CODE AND STANDARDS. EVALUATE PRACTICES, POLICIES AND CONDUCT RELATIVE TO THE CODE AND STANDARDS

The Standards of Professional Conduct

Use Mnemonic Devices to assist in memorizing standards! Consider “PICE IConR”:

P rofessionalism:	Standard I
I ntegrity of Markets:	Standard II
C lients (Duties to):	Standard III
E mployers (Duties to):	Standard IV
I nterest Analysis:	Standard V
C onflicts of Interest:	Standard VI
R esponsibilities:	Standard VII

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard I: Professionalism (“PICE IConR”):

A. Knowledge of the Law

- Must understand and comply with all applicable laws, rules, and regulations (including CFA Code of Ethics and Standards of Professional Conduct)
- Must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations
- When in doubt on whether an action complies or violates this Standard, should consult supervisor and compliance department

Important Rule of Thumb:

If there is a conflict between laws and regulations, and the Code and Standards, Members and candidates must follow the stricter of: (1) the law, rule or regulation, or (2) the Code and Standards

(Review all 10 examples in Exhibit 1, Text Pages 24-25 in Reading 32)

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard I: Professionalism (“PICE IConR”) – (cont’d)

B. Independence and Objectivity:

- Must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities.
- Must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another’s independence and objectivity.
- Modest gifts and entertainment are acceptable but special care must be exercised to resist subtle or not-so-subtle pressures to act in conflict or impair independence.
- Special care should be exercised in accepting gifts from a client as this may be considered supplemental compensation, which is covered under Standard IV.B, Disclosure of Additional Compensation Arrangements

C. Misrepresentation:

- Must not knowingly make any untrue statement or omit information relating to investment analysis, recommendations, actions, or other professional activities. “Knowingly” means known or should have known.
- Do not make any statements, orally or in writing, that misrepresent:
 - Services that member or his/her firm is capable of performing;
 - Member’s qualifications or the qualifications of his/her firm;
 - Member’s academic or professional credentials

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard I: Professionalism (“PICE IConR”) – (continued)

C. Misrepresentation (cont’d)

- Prohibition against Plagiarism: Do not copy or use, in substantially the same form as the original, material prepared by another without acknowledging and identifying the name of the author, publisher, or source of such material.
 - Without acknowledgment, can use factual information published by recognized financial and statistical reporting services.

D. Misconduct (the “Catch-All” Standard)

- Must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.
- Standard I.D extends beyond technical compliance with laws and regulations and addresses personal integrity with respect to business and professional activities.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard II: Integrity of Capital Markets (“PICE IConR”)

A. Material Non-Public Information:

- If possess material nonpublic information, do not act or cause others to act in that security:
 - (1) if such act would breach a duty;
 - (2) if no breach of duty exists, the information was misappropriated (illegally obtained);
 - (3) if the information relates to a tender offer.
- “Material” information is any disclosure that would (1) likely affect price significantly, or (2) a reasonable investor would consider important in determining whether to trade in that security.
 - Material information includes earnings, mergers, acquisitions, tender offers, joint ventures, innovative products, new licenses, changes in management, bankruptcies, significant legal disputes (see Page 85 of Text Readings for more examples)
- Make reasonable efforts to achieve public dissemination of material nonpublic information if such information is disclosed in breach of a duty.
- Prohibition is on tipping another who then trades or personal trading while in possession
- Mosaic theory - No violation of the law when combining public information with non-material nonpublic information to gain a significant insight.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard II: Integrity of Capital Markets (“PICE IConR”) – (cont’d)

A. Material Non-Public Information: (continued)

- Compliance procedures should be adopted to prevent the misuse of material nonpublic information
- Information barrier (“fire wall”) is most likely approach to prevent communication of material nonpublic information. Such a “fire wall” restricts the flow of confidential information to those who need the information to perform their jobs effectively.

B. Market Manipulation

- Must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.
- Includes information-based manipulation, which is the dissemination of false rumors or misleading information to induce trading by others (e.g. “pump and dump” trading)
- Also includes transaction-based manipulation where transactions artificially affect prices or volume to give the impression of activity or price movement of a financial instrument
- Damages the interests of investors by disrupting the functioning of financial markets and erodes investor confidence.
- No violation of this Standard with legitimate trading strategies or transactions completed for tax purposes. Intent of the action is critical in determining whether a violation of the Standard exists.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard III: Duties to Clients (“PICE IConR”) *

A. Loyalty, Prudence, and Care

- Must act with reasonable care/exercise prudent judgment (portfolio context).
- Must act for the benefit of clients and place clients’ interests their own interests. *
 - Client interests are paramount, even above employer (see Standard IV.A) *
- Must act in accordance with the fiduciary duty imposed by the stricter of: (1) applicable laws or regulations, or (2) Code and Standards (see Standard I.A).
- Duty of loyalty includes voting proxies in an informed and responsible manner.
- Also includes “soft dollar” arrangements, where an investment manager directs trades to brokers in exchange for research services.
 - Must seek best price and execution at all times relative to the services received.

B. Fair Dealing:

- Deal fairly and objectively with all clients with respect to investment analysis, investment recommendations, investment action, and other professional activities.
- Issues of fairness often involve: *
 - Amount and timing of disclosure to clients, and/or
 - Allocation and timing of trades on behalf of clients.
- Standard does not mandate “equal” treatment, but requires an effort to be fair and impartial

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard III: Duties to Clients (“PICE IConR”) - (con’t)

C. Suitability

- When in an advisory relationship with a client:
 - Make reasonable inquiry into a client’s financial situation, investment experience, risk and return objectives, and financial restraints prior to making any investment recommendations. Update information regularly, at least annually.
 - Determine that an investment is suitable to client’s financial situation; and is consistent with client’s written objectives (including risk tolerance), mandates, and constraints prior to the making investment recommendations or taking investment action.
 - Judge the suitability within the context of client’s total portfolio.
- When responsible for managing a portfolio with a specific mandate, strategy, or style, must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard III: Duties to Clients (“PICE IConR”) - (continued)

D. Performance Presentation

- Must make every reasonable effort to assure that performance information is fair, accurate, and complete.
 - Must avoid misstating past or reasonably expected performance, or misleading clients about Member or candidate’s investment record, whether performance presentation or performance measurement.
 - Applying GIPS is best method to ensure compliance under this standard.
 - Must maintain data and records substantiating the performance presented.

E. Preservation of Confidentiality:

- Preserve the confidentiality of information communicated by current, former and prospective clients unless:
 - Information concerns illegal activities by the client;
 - Disclosure is required by law; or
 - Client or prospective client permits the disclosure of the information.
- Confidentiality requirement is invoked when information is conveyed to Member or candidate because of his or her special ability, or because of a special or confidential relationship.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard IV: Duties to Employers (“PICE IconR”)

A. Loyalty

- Must act for benefit of employer and not deprive employer of the advantage of skills and abilities, divulge confidential information, or cause harm (unless employer actions involve illegal activity that is required to be disclosed).
 - Must notify with sufficient disclosure and receive consent from employer if undertake competing “independent practice” for compensation. Independent practice does not include preparations to begin such a practice. *
 - When leaving an employer, must continue to act in employer’s best interest and without conflict until resignation becomes effective. Can’t misappropriate trade secrets, misuse confidential information, solicit employer clients before resignation, and misappropriate client lists.
 - Duty of loyalty applies to employees, not to independent contractors.
 - Employment status depends on level of control by hiring company

B Additional Compensation Arrangements:

- Must not accept gifts, benefits, compensation, or consideration that competes with, or might reasonably be expected to create a conflict of interest with their employer’s interest unless they obtain written consent from all parties involved.
 - Includes direct and indirect compensation
 - Includes other benefits received from third parties
 - “Written consent” includes any form of communication that can be documented (e.g. email)

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard IV: Duties to Employers (“PICE IconR”) – (cont’d)

C. Responsibilities of Supervisors:

- Members and candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards. Note that this standard says “anyone”, not just CFA charterholders, members, or candidates.
 - Applies not only when there is direct supervisory responsibility but also when there is an ability to influence the conduct of others.
 - Can delegate supervisory duties but can’t escape the applicability of this Standard.
- Safe Harbor: If reasonable procedures are adopted and steps are taken to institute an effective compliance program before a violation occurs, then Member may not be in violation of this Standard if the he/she is unable to detect problems that occur despite these efforts.
 - If compliance program inadequate, or procedures are adequate but not followed, this safe harbor provision may not apply
 - Adequacy of procedures is determined by industry standards.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard V: Investment Analysis, Recommendations, and Actions ("PICE IConR")

A. Diligence and Reasonable Basis:

- Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
 - Bottom line: Must do your homework!
- Have a reasonable and adequate basis, supported by appropriate research and investigation, for such investment analysis, recommendation or action.
 - If Member or candidate relies on secondary research (performed by someone else within the firm) or third-party research (performed by someone outside of the firm), reasonable and diligent efforts must be employed to determine that such research is sound.
 - If Member or candidate participates in a group research report that he/she does not agree with or share the same conclusions as the group, he/she does not have to dissociate his/her name from the report, but should document his/her differences with the team.

B. Communication with Clients and Prospective Clients

- Disclose to clients and prospects the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios. Promptly disclose any changes that might materially affect those processes.
 - This is important to ensure suitability of investment to a client or prospect

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard V: Investment Analysis, Recommendations, and Actions ("PICE IConR") – (continued)

B. Communication with Clients and Prospective Clients – (cont'd)

- Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
- Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
 - Communications include those of any means, including email, telephone conversation, media broadcasts, and in-person meetings
- Distinguish between facts and opinions in the presentation of investment analysis and recommendations.
 - Must separate past results from future predictions or estimates.
 - Identify the limitations of such investment analysis

C. Record Retention *

- Must develop and maintain appropriate records to support investment analysis, recommendations, actions, and other investment-related communications with clients and prospective clients.
 - Records belong to the employer, not to the Member or candidate
 - If there are no regulations or laws with respect to record retention, CFA Institute recommends maintaining data for 7 years

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard VI: Conflicts of Interests (“PICE IConR”)

A. Disclosure of Conflicts *

- Must make full and fair disclosure of all matters that could reasonably impair independence and objectivity, or interfere with respective duties to their clients prospects, and employer.
 - Frequent conflict of interest situations involve:
 - Ownership of stocks analyzed or recommended, *
 - Cross-Departmental issues within the same company;*
 - Outside Board service
- Must ensure that such disclosures are prominent, delivered in plain language, and communicate relevant information effectively.

B. Priority of Transactions *

- Transactions for clients and employers shall have priority over transactions of which a Member or candidate is the beneficial owner (i.e. ownership thru spouse or family members).
 - Member or candidate may profit from personal investments if (1) client is not disadvantaged by the trade, (2) no personal benefits from trades undertaken for client, and (3) regulatory requirements are not violated.
 - Must give clients and employer a reasonable opportunity to act on recommendations before taking any action that personally benefits Member or candidate, either directly or indirectly (No “front-running” client trades!)

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard VI: Conflicts of Interests (“PICE IConR”) – (continued)

C. Referral Fees

- Must disclose to employers, clients and prospects, as appropriate, any compensation, consideration or benefit received by or paid to others for the recommendation of products or services.
 - This disclosure allows client and employer to evaluate (1) any impartiality shown in any recommendation of services and (2) the full cost of the services.
- Disclosure should include nature of the consideration (e.g. cash, soft dollars) and the estimated dollar value of the consideration.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate - (“PICE IConR”)

A. Conduct as Participants in the CFA Institute Programs

- Must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA Institute programs.
 - No cheating on the CFA exam!
 - Must adhere to rules of the CFA Program
 - No providing confidential Program information to candidates or the public
 - No disregarding or circumventing security measures established for the CFA examination
 - No improper use of CFA designation in any form of communication
 - No improper use of an association with CFA Institute to further personal or professional goals
 - No misrepresentation of information on the Professional Conduct Statement or the CFA Institute Professional Development Program
 - Members and candidates are free to disagree and express their disagreement with CFA Institute on policies, procedures or any advocacy positions.

THE STANDARDS OF PROFESSIONAL CONDUCT

Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate - (“PICE IConR”) – (continued)

B. Reference to CFA Institute, CFA Designation, and CFA Program

- Must not misrepresent or exaggerate the meaning or implications of:
 - Membership in CFA Institute
 - Holding the CFA designation, or
 - Candidacy in the CFA Program
- Statements must not over-promise the competency of an individual or over-promise future investment results (also see Standard I.C, Misrepresentation)
- To be considered a “CFA Institute member”, must submit annual Professional Conduct Statement and pay applicable CFA Institute membership dues
- In using CFA designation, only individuals meeting all requirements may claim to be a CFA charterholder.
 - No partial CFA designation exists and no misleading statements are allowed.
- Important to review “improper”/“proper” references to the CFA Designation in Exhibit 3 on Text Reading 32, page 172 and Application of the Standard examples on pages 173-174.

ASSET MANAGER CODE OF PROFESSIONAL CONDUCT

- 6 General Principles:
 - Act in a professional and ethical manner at all times (Code)
 - Act for the benefit of clients (Std III.a)
 - Act with independence and objectivity (Std I.b)
 - Act with skill, competence, and diligence (Code)
 - Communicate with clients in a timely and accurate manner (Std V.b)
 - Uphold the applicable rules governing capital markets (Std I.a)
- Asset Manager Code of Professional Conduct:
 - 6 components (Code of Ethics & Professional Standards embedded in each)
 - Loyalty to Clients
 - Investment Process and Actions
 - Trading
 - Risk Management, Compliance and Support
 - Performance and Valuation
 - Disclosures

ASSET MANAGER CODE OF PROFESSIONAL CONDUCT

- Comparison to Code of Ethics and Standards of Professional Conduct
 - AMC addresses conduct by a firm (via senior management, board of directors, and oversight bodies) rather than individuals
 - Adopting AMC and claiming compliance is voluntary
 - Significant overlap of AMC General Principles and Code of Conduct with the Code of Ethics and Professional Standards
- Sets forth minimum ethical standards for providing asset management services for clients
- If one masters the Code of Ethics and Standards of Professional Conduct, AMC questions should be relatively easy
- Don't expect significant testing on AMC