

Ethics

Ching 1: Ethics & Trust in Invest Profession

Attr. of invest firm to gain trust

↳ Transparent & open business practices

↳ Takes responsible actions to address an issue

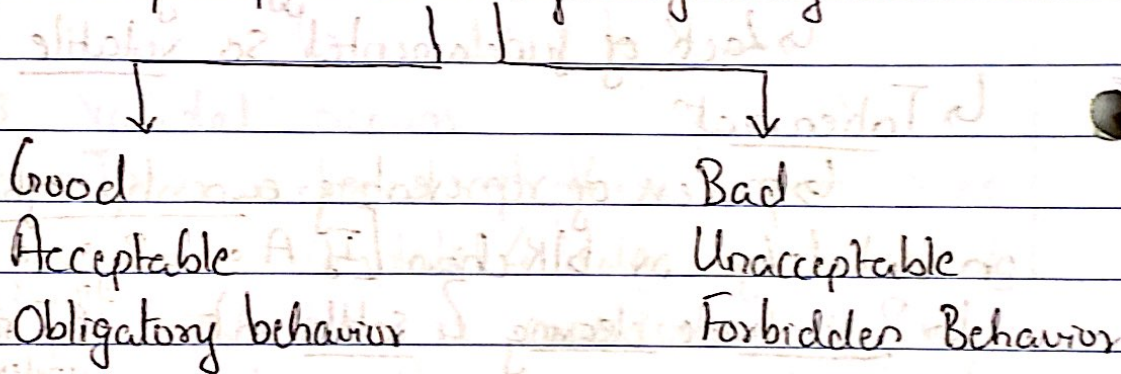
↳ Has ethical business practices

- Ethical behavior goes beyond law

* Ethics

- Study of moral principles

Ethical principles are beliefs regarding what is



- Can be described as study of good & bad behavior or study of making good choices as opposed to bad choices

- Ethical conduct

↳ Behavior consistent w/ ethical principles & balances self interest w/ both both direct & indirect consequences of behavior on others

• Stakeholders *
↳ Groups of individuals impacted by our decisions

• Standards of conduct
↳ Serve as benchmarks for minimally acceptable behavior of community members & can help clarify code of ethics.

• Laws & regulations
↳ Country specific
↳ Rule based (Narrow)

• Code of ethics & code of conduct ← Principle based

* Ethics & Professionalism
Job → Vocation → Profession

• Profession is:
↳ based on specialized knowledge & skills
↳ based on service to others
↳ practiced by members who share & agree to *
adhere to common code of ethics.

• Profess. use their specialized knowledge & skills to serve clients

* Challenges to Ethical conduct

• Challenges

↳ People believe they are more ethical than they actually are (Overconfid. bias)

↳ Decision makers fail to recognize / underestimate the effect of situational influence

• Situational influence

↳ External factors that shape our decision making, thinking & behavior

↳ Eg. Money & prestige, Loyalty to employer, Compliance culture

↳ Can motivate individuals to act in short term self interest w/o recog. long term risk / conseq. of their actions

• Failure to recognize challenges can lead to unethical behavior

* Importance of ethical conduct in invest industry

Investors

Invest ind

Borrowers

1999 program provided a source of a trust.

So in order for the diag. to work efficiently, invest. ind. must be able to build trust which is possible by following ethical conduct

Ethical conduct → Trust → Eff. flow of funds
Broader participat^m
Overall benefit to eco.

Seemingly isolated actions have far reaching consequences

Invest. ind. has specialised knowledge & better access to informatⁿ so ↑ responsibility

They have intangible nature of products (services)

* Ethical vs Legal Standards

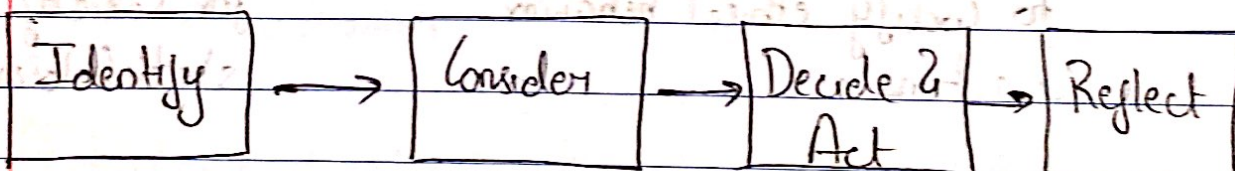
Laws (regulation) attempt to regulate ethical behavior → Better outcomes for society or specific stakeholders

Acting in accordance with laws & acting ethically are not necessarily the same

- Trust in fin. services is below avg. among ppl
- Most imp factor in promoting ethical decision making among prof is strong culture of integrity by ^{senior} mgmt
- A new law might address an existing ethical problem but create an opportunity for other ^{un}ethical behavior.
- Law can be interpreted differently & can vary across jurisdictions.
- Ethical conduct encourages us to:
 - ↳ Go beyond what is legally required
 - ↳ Consider the impact on stakeholders
 - ↳ Make good choices even in absence of law

* Ethical Decision Making Frameworks

- Considers alternative actions & unintended consequences
- Develop ethical framework which guides investment managers thought process
 - ↳ Examine choices from multiple perspective
 - ↳ Justify actions to stakeholders



- Relevant facts
- Stakeholders owed
- Ethical princ
- Conflict of int
- Situatⁿ influences
- Actⁿ guidance
- Alternative actions

Reading 2: Code & Standards

* CFA Institute Professional Conduct Program

- CFA members & candidates req. to comply
- Professional Conduct Prog. (PCP) in conjunctⁿ w/ Disciplinary Review Committee (DRC) is responsible for enforcing Code & Stds.

• DRC

- ↳ Volunteer committee
- ↳ Reviews conduct
- ↳ Partner w/ PCP staff to establish & review professional conduct policies

- CFA Inst. bylaws + Rules of Proced. for Professional Conduct = Basic structure for enforcing code & stds

Inquiry

- ↳ Can be prompted by:
 - ① Self-disclosure
 - ② Written complaints
 - ③ Evidence of misconduct
 - ④ Report by CFA exam proctor
- ↳ CFAI monitor social media post exams to detect disclosure

Investigatⁿ

- ↳ If PCP believes that violatⁿ has occurred, the member or candidate has the opportunity to accept or reject charges

- | | |
|---|--|
| Member/cand. does not accept | Member/candidate <u>accepts</u> |
| • Matter referred to DRC to review materials from PCP staff & member. | • Sanctions include: Susp. of CFA design., revocat ⁿ etc. |
| • Panels task to determine if violat ⁿ actually occurred or not & if so what are the actions | <u>DO NOT INCLUDE MONETARY FINES</u> |

* Code of Ethics

- Members of CFAI & candidates must:
 - ↳ Act w/ integrity, diligence, respect & in an ethical manner w/ public clients, prospective clients, employers, employees & other ppl in global cap mkt.
 - ↳ Place integrity of invest prof & int. of clients above personal int.
 - ↳ Use reasonable care & exercise independent prof. judgement when conducting, making, taking invest dec, analy. etc
 - ↳ Practice & encourage others to practice ethical behavior
 - ↳ Promote integrity & viability of global cap. mkt for benefit of society
 - ↳ Maintain & improve professional competence & strive to maintain & improve comp. of other ppl.

2 primary principles of CFA Inst. Rules of Proc. for Proceedings Related to Prof. Conduct are confidentiality & fair process to members

* Standards of Professional Conduct

Professionalism

(A) Knowledge of Law
↳ Whenever conflict b/w applicable law & code and stats, follow the stricter one

↳ If you are part of grp who is violating, either try to stop it or disassociate

(B) Independence & Objectivity

↳ Must not accept any gift that compromises your indep. & objectivity

(C) Misrepresentation

(D) Misconduct

Integrity of Capital Markets

(A) Material non-public information
↳ Not using this to make invest decisions

(B) Market Manipulation

Duties to Clients

(A) Loyalty, Prudence & Care

↳ You have loyalty to clients & must act w/ reasonable care & exercise prudent judgement

↳ Client int > employer & your int

(B) Fair Dealing

(C) Suitability

↳ Make inquiry into clients invest experience, risk & return obj. before making any invest. reco. & update this info regularly

↳ Must determine the invest is suitable for clients fin. situat & consistent w/ clients obj.

↳ Must judge invest w/ context of clients portfolio

(D) Performance Presentat

↳ No cheating in reporting this

(E) Preservat of Confidentiality

↳ Disclose iff

↳ Illegal act by client

↳ Rep. by law

↳ Client allows.

Duties to Employer

(A) Loyalty (MUST DO)

(B) Additional Compensation Arrangements (gifts etc) (MUST NOT DO)

(C) Responsibilities of Supervisor

↳ Anyone under your supervisory must comply w/ code of conduct

Invest analysis, recommendation & actions

(A) Diligence & Reasonable Basis

(B) Communicatⁿ w/ clients & prospective clients

↳ Disclose to clients basic format & principles of the invest. process & changes that might impact the processes

↳ Disclose limitatⁿ & risks w/ the process

↳ Use judgement to identify imp. factors

↳ Must distinguish fact & opinion

(C) Record Retention

Conflicts of interest (Disclose)

(A) Priority of Transact

(B) Disclosure of conflicts

(C) Referral fees

Responsibilities as CFAI member / candidate

(A) Conduct as participants in CFAI Program

(B) Reference to CFAI, CFA designatⁿ & CFA Program

- Board of governors: resp for maintaining oversight & resp. for PCP
- PCP & Disp. Review Com work in conjunction & resp for enforcement of Code of Standards
- To claim compliance w/ CFA Inst. Code of Ethics, no need to notify CFA or take permission. Public acknowledgement works

Reading 3 Guidance for Standards

III Duties to Clients

(A) Loyalty, Prudence & Care

- Must act for client's benefit
- Guidance
 - ↳ Understand appⁿ of loyalty, prudence & care
 - ↳ Shd be loyal while giving advice to client
 - ↳ Identifying actual invest client
 - ↳ Loyal to the mandate
 - ↳ Developing client's portfolio
 - ↳ Follow guidelines given by client
 - ↳ Evaluate must wrt its impact on portfolio
 - ↳ Soft commission Policies
 - ↳ If client hires you & you hire broker to get research study, you have to make sure that the study is beneficial to the client & the overall cost to hire a broker is minimum
 - ↳ Proxy Voting policies
 - ↳ Your policies abt voting must be clearly communicated to the client

consistent w/ stated objectives

• Guidance

↳ Developing IPS

↳ Understanding client's risk profile

↳ Updating IPS

↳ Need for diversification

↳ Addressing unsolicited trading req.

↳ Managing to an index

• Recommended Policies

↳ IPS

↳ Regular updates

↳ Suitability test policies.

① Performance Presentation

• Ensure communication is fair, accurate & complete

• Guidance

↳ Provide credible perf. info to clients

↳ Avoid misstating perf

↳ If presentatⁿ is brief, make avail. to clients &

on request, details supporting info

• Recommended Procedures for Compliance

↳ Apply GIPS Stels

↳ Comply w/o applying GIPS

↳ Consider Knowledge of audience

↳ Present wt. return as comp. to single return

↳ Include terminated accts as in perf. history

↳ include disclosure that fully explain perf. results being reported

↳ maintain data & records

(E) Preservation of Confidentiality

• Members must keep info confidential unless

↳ Info concerns illegal activities on party of client

↳ Disclosure req by law

↳ Client permits disclosure

• Guidance

↳ Status of clients

↳ Compliance w/ laws

↳ Electronic info

↳ Prof. Conduct Investigated by CFAI

- Recommended Procedures

- ↳ Avoid disclosing any info received from a client except to authorized fellow employees who are working for client

(V)

Invest analysis, recommendatⁿ & actions

(A)

Diligence & Reasonable Basis

- Members & Candidates must

- ↳ Exercise diligence, indep. & thoroughness in analyzing investment etc

- ↳ Have reasonable & adequate basis, supported by appr. research & investⁿ, for any invest analysis, rev. or act

- Guidelines

- ↳ Defining diligence & reasonable basis

- ↳ Relevant info must be understood before making any invest action

- ↳ Have reasonable basis before rev

- ↳ Using secondary or Third-party research

- ↳ Make sure info from 3rd party is sound, relevant & is updated.

↳ Using quantitatively Oriented Research

↳ In complicated securities when using models to get risk & σ , make sure you know the assumption, data & formula that has gone in the model

↳ Developing quantitatively oriented techniques

↳ While creating models, be extra diligent & make sure models are effective

↳ Selecting External Advisers & Subadvisers

↳ Before engaging w/ them, review their published return reports, quality, compliance system

↳ Group Research & Decision Making

↳ If you don't agree w/ group decision but the group decision is made w/ diligence & reasonable basis then you can have your name on it

Recommended Procedures for Compliance

↳ Establish policy that research report must have reasonable & adequate basis

↳ Written guidance

↳ Criteria for assessing quality of research

↳ Detailed, written guidance for testing computer based models

↳ Measurable criteria for outside providers

↳ Criteria for evaluating external advisors.

(B) Communicate w/ clients & prospective clients

Members must

↳ Disclose to clients basic principles, format & changes made

↳ Disclose significant limitations & risk associated w/ invest. process

↳ Use reasonable judgment in identifying imp. factors & communicating w/ clients.

↳ Distinguish bt fact & opinion

Guidance

↳ Informing Clients of Invest Process

↳ Diff. forms of communication

↳ Identify risk & limitations

↳ Report presentation (Outlining assumptions while coming up w/ recommendations)

↳ District bt facts & opinion in reports

• Recommended Procedures for Guidance

↳ Depends heavily on case-to-case basis.

(C) Record Retention

- Develop & maintain records to support invest. analyses etc w/ clients

• Guidance

↳ New Media Records

↳ Records that you collect are property of the firm

↳ Local requirements regarding data to be retained

- Recommended Procedures for Compliance

↳ Responsibility to maintain records generally falls w/ firm rather than individuals

↳ Archive research notes & other docs that support invest. related comm.

VI. Conflicts of Interest

(A) Disclosure of Conflicts

- Make full & fair disclosure of all matters that could be expected to impair independence & objectivity.

- Ensure such disclosures are prominent, delivered in plain language

- Guidance

- ↳ Disclosure to employers

- ↳ Disclosure to clients

- ↳ Cross-departmental conflicts

- ↳ Conflicts w/ stock ownership

- ↳ Conflicts as a Director

- Recommended Procedures for Compliance

- ↳ Disclose special compensatⁿ arrangements w/ employer that might conflict w/ client interest, such as bonuses based on short term perf., commission, incentives

- ↳ If firm does not permit such rep. then document the rep. & disassociate from activity

ⓑ Priority of Transactions

- First transactⁿ for clients & employees must have priority over first transacⁿ in which member is beneficial owner

Guidance

- ↳ Avoiding Potential Conflicts
- ↳ Personal trading secondary to trading for clients
- ↳ Standards for nonpublic info.
- ↳ Impact on all acts w/ beneficial ownership

Recommended Procedure for Compliance

- ↳ Limited participation in equity IPO
- ↳ Restrictions on private placements
- ↳ Establish blackout/restricted periods
- ↳ Reporting requirements

↳ Disclosure of holdings in which employee has beneficial interest

↳ Providing duplicate confirmatⁿ of transactⁿ

↳ Pre-clearance procedures

↳ Disclosure of policies

(C) Referral Fees

- Disclose to employer, clients any compensation, consideration or benefit received from or paid to others for reco. of goods & serv.

- Guidance

- ↳ Advise client before entry into any formal agreement
- ↳ Disclose nature of consideration or benefit

- Recommended Procedure for Compliance

- ↳ Encourage your employer to develop procedures related to referral fees
- ↳ Employers should tell inst. prog. to keep the clients informed of referral fee & provide updates on amt & nature of compensatⁿ received, to firm

VII Responsibilities as a CFA Institute member or CFA Candidate

(A) Conduct as participants in CFAI Prog.

- Not engage in conduct that compromises the reputatⁿ or integrity of CFA Inst. or CFA designatⁿ or integrity, validity or security of CFAI Prog.

- Guidance

- ↳ Confidential Program Informatⁿ
- ↳ Additional CFA Program Restrictⁿ
- ↳ Expressing an Opinion.

● ✖✖

③ Reference to CFA Inst. Designatⁿ & Prog. ✖

- Must not misrepresent or exaggerate meaning or implicatⁿ of membership in CFA Inst., holding CFA desig.

Guidance

↳ Complete CFAI Membership requirements

↳ Follow the rules for using CFA Designatⁿ

↳ Referring to Candidacy in CFA Pgm.

Passed level 1 CFA → OK

I am level 1 CFA → NOT OK

↳ Proper usage of CFA Marks. (Always use as adjective & not as a noun)

< Exhibit 3 & 4 from curriculum >

• If there were some charges against you but eventually they were dropped, still you should report this mention this in the annual conduct stat

- If you know that a comp doesn't have proper procedure in place, you shd not undertake a positⁿ @ the firm before they implement policies. You can join as consultant & help them implement

Reading 4: Introduction to GIPS

* Why were the GIPS Standards Created?

- To make it easier to compare diff. invest mgmt firms.
- W/o standard, different firms would select the method which would make them look good.
- Common misleading practices
 - ↳ Representative accts
 - ↳ Survivorship Bias
 - ↳ Varying Time Periods
- GIPS std are
 - ↳ Practitioner-driven set of ethical principles that establish standardized industry-wide approach in calculating performance calc.
 - ↳ Ensure fair resp repr. & full disclosure of invest. perf.
 - ↳ Helps to avoid misrepr. of perf.
 - ↳ Communicate relevant info.

* Who can claim compliance?

- Only invest mngt firm that ACTUALLY manage assets can claim

- Complying w/ GIPS stds is voluntary

- Compliance is firm wide process that cannot be achieved on single product or composite *

- Only 2 optⁿ w/ regard to compliance w/ GIPS stds

 - ↳ Fully comply w/ all req & claim through use of GIPS compliance statement

 - ↳ Not comply w/ all req & not claim compliance w/ any GIPS stds.

* Who benefits from compliance?

- Invest mngmt firms can

 - ↳ Assure prospective clients that historical "back record" is complete & fairly presented.

 - ↳ Participate in competitive bids

 - ↳ Strengthen firm's internal controls over perf. related process & procedures

- Investors have
 - ↳ Greater level of confidence in integrity of prog. presentat. of GIPS compliant firm
 - ↳ Do not eliminate the need for m-depth diligence on part of inv.
 - ↳ Enhances credibility of most mgt firms that have chosen to undertake this resp.

* Composites

- It is an aggregat. of one or more portfolios managed acc. to similar inst. mandate, strategy etc.
- Must include all fee paying, actual, discretionary portfolios managed in accordance w/ the same inst. mandate, strategy
- Determinat. of which portfolios to include in the composite must be done according to pre-established criteria & not after the fact
- Performance numbers are based on composites.

* Verification

- Firms that claim compliance are responsible for their claim & maintaining that compliance
- Once a firm claims compliance w/ GIPS, they may voluntarily hire an independent 3rd party to perform verification (verification is wrt the entire firm).
- Verification tests
 - ↳ Whether invest firm has ^{complied} complied w/ all composite construct req. of GIPS standards
 - ↳ Whether firm's policies are designed to calculate & present performance in compliance w/ GIPS standards.
- 3rd party verification brings additional credibility to firm's claim of compliance.
- Verification report doesn't confirm specific composite presentations are accurate
- Verification of compliance w/ GIPS REQUIRES independent 3rd party to carry out verification

* Structure of GIPS standards

0. Fundamentals of Compliance
1. Input Data
2. Calculation Methodology
3. Composite Construction
4. Disclosure
5. Presentation & Reporting
6. Real Estate
7. Private Equity
8. Wrap Fee / Separately managed assets portfolio.

These provisions are categorised into requirements & recommendations

Company complying w/ GIPS MUST give PROSPECTIVE CLIENTS the presentation once every year. RECOMMENDED BUT NOT REQ. to give it to EXISTING.

GIPS benefits 2 grps: Invest mngmt firm & prospective clients

Official document - 2012/10/10

Reading 5: The GIPS Standard

* Goals of GIPS Executive Committee

- Establish best practices for calculating & presenting invest. performance
- Obtain worldwide acceptance of single std for calculatⁿ based on principle of a fair representⁿ & full disclosure
- Promote use of accurate & consistent invest perf. data

- Significance
- Encourage fair global competition
 - Foster notion of self regulatⁿ on global business

* Key Features of GIPS Standard

- Ethical stds for invest perf presentatⁿ
- Firms must adhere recommenda^t to achieve best practices in calc & presentatⁿ of perf.
- Requires to include all fee paying, discretionary, actual

Official governing version → English

Portfolios in at least one composite to prevent cherry-picking

GIPS still rely on integrity & requires firms to adhere to certain calculation methodologies & make specific disclosures along w/ firms perf.

< FROM CURRICULUM >

GIPS compliance can be claimed only by invest firm or subsidiaries

The firm claiming comp. is responsible for claiming & maintaining comp. 3rd party independent firm not responsible

GIPS
to
date

Portfolio valuation must use act for all interest earning inst

Ethics

- Even though you work for your business during non-office hours, you shd inform the employer abt the compensatⁿ

If you are fired & you don't tell this to your new employer even though he doesn't ask you; that is a violatⁿ of misconduct & loyalty (Duties to Emp).

- Consider you work @ a firm investing in domestic securities. You & your colleagues plan to start a fund investing in intl securities (not inside the firm) but you don't inform the supervisor. You violated Disclosure of conflicts & not additional compensatⁿ arrangements as you have not yet started earning from this.

1. If you hear a rumor & if you have 2 optⁿs: 1. Confirm the rumor & publish the report 2. Tell the comp to

make the removed info public. (Choose optⁿ 2)

- You If you overhear a conversatⁿ like conv. of board of memb - saying they (will) fire few ppl, you can use this info IF discussed changes are unlikely to affect investors perceptⁿ of the bank
- If the questⁿ says 'quick & simple analysis' consider it was done w/ diligence

- If you receive a referral fee but you don't accept it, then no need to mention it to the clients.
- While doing research on the company, always check for company's compliance & internal proc. policies so that you do not violate diligence & reasonable basis.

• Standard of conduct → Minimal acceptable std

- If ^{your} a company tells you to use vendor X but you want to use Y cos. you have concluded diligence check on Y & u think are suspicious abt X's validity then u should use Y.

- If you have clients & you also write articles for non-clients, then after your analysis for the comp, the news should first reach your clients & then non-clients (free) & NOT SIMULTANEOUSLY

- If you want to select external adviser, make sure you review adherence to strategy

If you hire a broker & broker has completed due diligence, it is req for you to complete due dilig. on the broker as well else its violatⁿ of V(A) Due dil. & basis

- Only if your outside business conflicts w/ current → you need to seek permission else you can just inform

- If your boss tells you to convince someone of something cos he is under press, & you think that what ur boss recommends is not suitable for client then ignore the request

- If you provide diff. type of services to well established accts & diff. serv. to newer accts even though its a company policy, you are violating Stds of Prof. Conduct

- A regulator who requires fm. adv to merely consider the suitability of prod when making recommendatⁿ would be setting legal std
Rep. regulators to act as fiduciaries → legal & ethical stds

- If under ur supervision, someone violates the stds. After which you put in place procedures exceeding ind. stds to avoid future violatⁿ, you still have violated the std as you shd have put in place procedures b4 the violatⁿ occurred