



CFA Institute

2024

# Standards of Practice Handbook

12th Edition



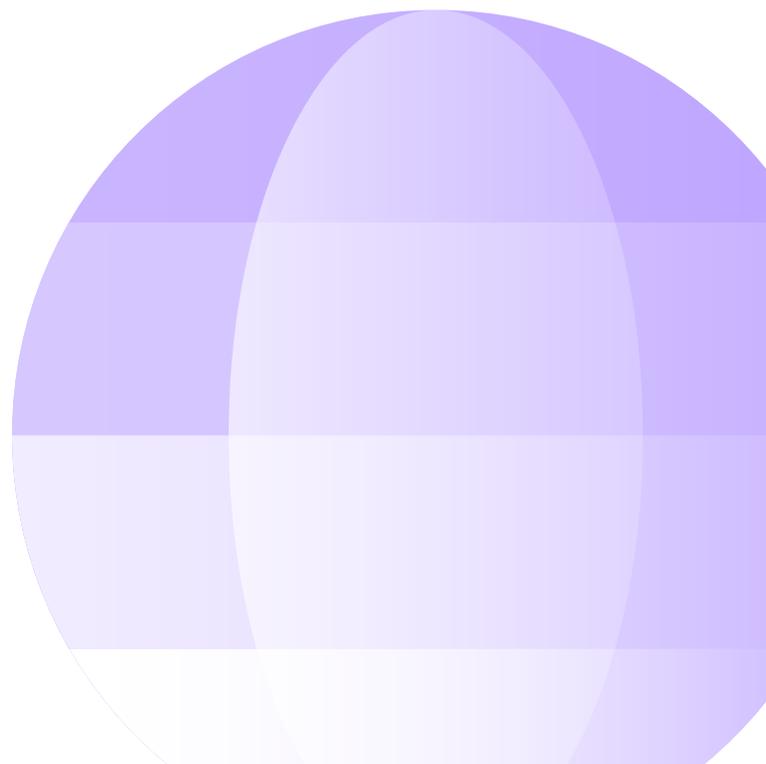
2024

# Standards of Practice Handbook

12th Edition



**CFA Institute**



The guidance and examples contained in the 12th edition of this book are the most recent as of the time of publication. For the most up-to-date guidance and examples, please visit the CFA Institute website at [www.cfainstitute.org/en/ethics-standards/ethics/code-of-ethics-standards-of-conduct-guidance](http://www.cfainstitute.org/en/ethics-standards/ethics/code-of-ethics-standards-of-conduct-guidance).



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**PROFESSIONAL LEARNING QUALIFIED ACTIVITY**

This publication qualifies for 6.25 PL credits under the guidelines of the CFA Institute Professional Learning Program.

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# PREFACE

The *Standards of Practice Handbook (Handbook)* provides guidance to the people who grapple with real ethical dilemmas in the investment profession on a daily basis; the *Handbook* addresses the professional intersection where theory meets practice and where the concept of ethical behavior crosses from the abstract to the concrete. The *Handbook* is written for a diverse global audience of CFA Institute members and investment professionals who are navigating ambiguous ethical situations and seeking to understand the nature of their responsibilities to each other, to existing and potential clients, and to the broader financial markets.

Events in global financial markets test the ethical mettle of financial market participants, including CFA Institute members and candidates. The CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards) taught in the CFA® Program and by which CFA Institute members and candidates must abide set forth timeless ethical principles and professional conduct requirements. Through adherence to the Code and Standards, which serve as the model for ethical behavior in the investment profession globally, each market participant does his or her part to improve the integrity and efficient operations of the global capital markets.

The *Handbook* provides guidance and interpretation for understanding the principles and provisions of the Code and Standards. The Code contains high-level aspirational ethical principles that drive members and candidates to create a positive and reputable investment profession. The Standards contain practical principles of conduct that members and candidates must follow to meet investment industry expectations for ethical behavior. The Code and Standards should be viewed and interpreted as an interwoven tapestry of ethical requirements. Through members' and candidates' adherence to these principles as a whole, the integrity of and trust in the capital markets are improved.

## Evolution of the CFA Institute Code of Ethics and Standards of Professional Conduct

The Code and Standards are regularly reviewed and updated so that they remain effective and continue to represent the highest ethical standards in the global investment industry. CFA Institute strongly believes that revisions of the Code and Standards are undertaken not for cosmetic purposes but to add value by addressing legitimate concerns and improving comprehension. In 2023, the CFA Institute Board of Governors approved revisions to the Code and Standards that are fully described below.

Changes to the Code and Standards have far-reaching implications for the CFA Institute membership, CFA Institute programs, and the investment industry as a whole. CFA Institute members and candidates are *required* to adhere to the Code and Standards. In addition, the Code and Standards are often adopted, in whole or in part, by firms and regulatory authorities.

## ***Standards of Practice Handbook***

The periodic revisions of the *Standards of Practice Handbook* have come in conjunction with updates of the Code and Standards. The material in the *Handbook* represents the foundation of the ethics education efforts of CFA Institute and is the primary resource for guidance in interpreting and implementing the Code and Standards. The *Handbook* seeks to educate members and candidates on how to apply the Code and Standards to their professional lives in a variety of situations and thereby benefit their clients, their employers, and the investing public in general.

Examples in the “Application of the Standard” sections are meant to illustrate how each standard applies to hypothetical but factual situations. The names contained in the examples are fictional and are not meant to refer to any actual person or entity. Unless otherwise stated (e.g., one or more people are specifically identified), individuals in each example are subject to the requirements of the Code and Standards. Because factual circumstances vary so widely and often involve gray areas, the explanatory material and examples are not intended to be all inclusive. Many examples set forth in the application sections involve standards that have legal counterparts. Members and candidates are strongly urged to discuss with their supervisors and legal and compliance departments the content of the Code and Standards and the members’ and candidates’ obligations under the Code and Standards.

CFA Institute recognizes that the presence of any set of ethical standards may create a false sense of security unless the documents are fully understood, enforced, and made a meaningful part of everyday professional activities. The *Handbook* is intended to provide a useful frame of reference that outlines ethical professional conduct for the organization’s members and candidates. The *Handbook* cannot, however, cover every contingency or circumstance, and it does not attempt to do so. The development and interpretation of the Code and Standards are evolving processes; the Code and Standards will be subject to continuing refinement.

## **Summary of the 2023 Changes to the Code and Standards**

In 2023, the CFA Institute Board of Governors revised the Standards of Professional Conduct in three areas. This resulted in the inclusion of one new standard and revisions to two existing standards. The following is a summary of the changes:

1. Within Standard I: Professionalism, the Board approved a new standard, Standard I(E): Competence, to reinforce the principle set forth in the Code of Ethics. Standard I(E) requires members and candidates to act with and maintain the competence necessary to fulfill their professional responsibilities.
2. Within Standard V: Investment Analysis, Recommendations, and Actions, the Board revised Standard V(B): Communication with Clients and Prospective Clients to include a new requirement on disclosures about the nature of the services provided by members and candidates and the costs to the client associated with those services.
3. Within Standard VI: Conflicts of Interest, the Board renamed Standard VI(A) “Avoid or Disclose Conflicts” and revised the standard to require members and candidates to either avoid conflicts of interest or disclose those conflicts. Previously, there was no mention of avoiding conflicts of interest in the standard.

New guidance and examples have been added to the *Handbook* in this twelfth edition to fully explain these new requirements.

## New and Revised Standards of Professional Conduct

### New Competence Standard

#### I. Professionalism

#### E. Competence

Members and Candidates must act with and maintain the competence necessary to fulfill their professional responsibilities.

Given the diverse range of professional services engaged in by members and candidates, the knowledge, skills, and abilities necessary to successfully fulfill their role will vary according to the nature of their professional duties. Over time, a member’s role may expand, requiring new or different knowledge, skills, and abilities. Members and candidates will develop and refine their skills and abilities throughout their professional careers. Requiring members and candidates to act with and maintain appropriate levels of competence will help ensure they provide a high standard of professional service for their clients and employers.

Currently, the Code of Ethics requires members and candidates to “act with integrity, competence, and diligence” and to “maintain and improve their professional competence and strive to improve the competence of other investment professionals.” This new standard is consistent with and directly supports the requirements of the Code of Ethics. Standard I(E) makes these requirements of the Code of Ethics more explicit and emphasizes the need for

members and candidates to continuously maintain or improve the competence required by their professional position.

The skills and abilities necessary for members and candidates to successfully fulfill their role vary according to the nature and complexity of their professional duties. As a result, there will be different criteria for competence for different members. An examination of the facts and circumstances of each member or candidate will dictate their expected conduct under this standard.

Finally, Standard I(E) does not require members and candidates to engage in any specific program of professional development or continuing education. There are a variety of ways members and candidates can demonstrate and maintain competence when engaging in their professional responsibilities.

## **Revised Client Communication Standard with a New Requirement to Disclose the Nature of Services and Costs to the Client**

### **V. Investment Analysis, Recommendations, and Actions**

#### **B. Communication with Clients and Prospective Clients**

##### **Members and Candidates must:**

1. Disclose to clients and prospective clients the nature of the services provided, along with information about the costs to the client associated with those services.

A fundamental goal of the Code and Standards is to protect client interests and allow clients to make fully informed decisions about their investments and financial well-being. Providing clients with information about the nature of the services they can expect from investment professionals and the financial impact they can expect from those services is critical to achieving this goal. The new disclosures required by this revised standard will permit clients to make informed decisions as to whether to engage with the member or candidate and his or her firm.

Standard V(B) Communication with Clients and Prospective Clients also requires members to disclose the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and to promptly disclose any material changes to these processes. The associated financial impact is an important part of the investment process but was not explicitly addressed as part of this disclosure until now. The revision to Standard V(B) to include a new requirement that requires the disclosure of the nature and costs of services fills this gap.

## Revised Standard Relating to Conflicts

### VI. Conflicts of Interest

#### A. Avoid or Disclose Conflicts

Members and Candidates must avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

Standard VI(A) Conflicts of Interest historically required members and candidates to disclose conflicts, but the language of the standard made no mention of avoiding conflicts. Nevertheless, the guidance for Standard VI(A) has long stated that best practice is to avoid conflicts or the appearance of conflicts. Including the option to avoid versus simply disclosing conflicts in the language of the standard emphasizes that members and candidates should avoid conflicts of interest whenever reasonably possible. Although avoiding conflicts altogether is preferred, often in the investment industry it may not be reasonable for members and candidates to avoid a conflict or the perception of a conflict. When it is not reasonable for members and candidates to avoid a conflict, Standard VI(A) continues to require clear and complete disclosure of the conflict.

## CFA Institute Professional Conduct Program

All CFA Institute members and candidates for the CFA and CIPM® designations are required to comply with the Code and Standards. The CFA Institute Board of Governors maintains oversight and responsibility for the Professional Conduct (PC) group, which, in conjunction with the Disciplinary Review Committee (DRC), is responsible for enforcement of the Code and Standards. The PC staff investigates allegations of misconduct by members and candidates. The DRC is a volunteer committee of CFA charterholders who serve on hearing panels to review misconduct allegations and impose sanctions for violations of the Code and Standards. The DRC also partners with PC staff to establish and review professional conduct policies. The CFA Institute Bylaws and Rules of Procedure (Rules of Procedure) form the basic structure for enforcing the Code and Standards.

Professional conduct investigations arise from a number of sources. First, members and candidates must self-disclose on the annual Professional Conduct Statement all matters that question their professional conduct, such as involvement in civil litigation or a criminal investigation or being the subject of a written complaint. Second, written complaints received by PC staff can

bring about an investigation. Third, CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or another public source. Lastly, CFA Institute works with testing centers, conducts analyses of scores and exam materials after exams, and monitors online and social media to detect potential misconduct, including disclosure of confidential exam information.

When an inquiry is initiated, the PC staff conducts an investigation that may include requesting a written explanation from the member or candidate; interviewing the member or candidate, complaining parties, and third parties; and collecting documents and records relevant to the investigation. Upon reviewing the material obtained during the investigation, the PC staff may conclude the inquiry with no disciplinary sanction, issue a cautionary letter, or continue proceedings to discipline the member or candidate. If the PC staff believes a violation of the Code and Standards has occurred, the member or candidate has the opportunity to reject or accept any charges and the proposed sanction.

If the member or candidate does not accept the charges and proposed sanction, the matter is referred to a panel composed of DRC members. DRC panels evaluate materials and presentations from PC staff and from the member or candidate. In contested matters, the DRC panel's task is to determine whether the member or candidate violated the Code and Standards or testing policies and, if so, what sanction should be imposed. DRC panels also review matters where members and candidates agree to PC's proposed charges and sanction to ensure that the findings are reasonable.

Sanctions imposed by CFA Institute may have significant consequences; sanctions include public censure, suspension of membership and use of the CFA designation, and revocation of membership and the right to use the CFA designation. Candidates enrolled in the CFA Program who have violated the Code and Standards or testing policies may be suspended or prohibited from further participation in the CFA Program.

## Adoption of the Code and Standards

The Code and Standards apply to individual members of CFA Institute and candidates for the CFA and CIPM designations. CFA Institute does encourage firms to adopt the Code and Standards, however, as part of their code of ethics. Those who claim compliance should fully understand the requirements of each principle of the Code and Standards.

Once a party—nonmember or firm—ensures its code of ethics meets the principles of the Code and Standards, that party should make the following statement whenever claiming compliance:

[Insert name of party] claims compliance with the CFA Institute Code of Ethics and Standards of Professional Conduct. This claim has not been verified by CFA Institute.

CFA Institute welcomes public acknowledgment, when appropriate, that firms are complying with the CFA Institute Code of Ethics and Standards of Professional Conduct.

CFA Institute has also published the CFA Institute Asset Manager Code, which is designed, in part, to help asset managers comply with regulations mandating codes of ethics for investment advisers. Whereas the Code and Standards are aimed at individual investment professionals who are members of CFA Institute or candidates for CFA Institute designations, the Asset Manager Code applies to firms. The Asset Manager Code provides specific, practical guidelines for asset managers in six areas: loyalty to clients, the investment process, trading, compliance, performance, and disclosure. The Asset Manager Code and the appropriate steps to acknowledge compliance can be found on the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)).

## Acknowledgments

CFA Institute is a not-for-profit organization that is heavily dependent on the expertise and intellectual contributions of member volunteers. Members devote their time because they share a mutual interest in the organization's mission to promote and achieve ethical practices in the investment profession. CFA Institute owes much to the volunteers' abundant generosity and energy in extending ethical integrity.

The CFA Institute Standards of Practice Council (SPC), a group consisting of CFA charterholder volunteers from many different markets, is charged with maintaining and interpreting the Code and Standards and ensuring that they are effective. The SPC draws its membership from a broad spectrum of organizations in the securities field, including brokers, investment advisers, banks, and insurance companies.

The SPC continually evaluates the Code and Standards, as well as the guidance in the *Handbook*, to ensure that they are

- representative of high standards of professional conduct,
- relevant to the changing nature of the investment profession,
- globally applicable, and
- sufficiently comprehensive, practical, and specific.

Over the years, many volunteer members of the SPC have spent countless hours reviewing and discussing revisions to the Code and Standards and updates to the guidance that make up the *Handbook*. CFA Institute would like to thank all the volunteers who generously donated their time and energy to this effort, including the following current and past members of the SPC:

## Current and Past SPC Members

Rik Albrecht, CFA

Jayesh Bhansali, CFA

Ashraf Bava, CFA

Julia Bonafede, CFA

Jean-François Bureau, CFA

Corey Cook, CFA

Sharon Criswell, CFA

Ru Huey Fung, CFA

Chris Hooper, CFA

Geraldine Jimenez, CFA

Asjeet Lamba, CFA

Wonil Lee, CFA

Young Lee, CFA

Godfrey Marozva, CFA

Edouard Senechal, CFA

Vineet Yash, CFA

# ETHICS AND THE INVESTMENT INDUSTRY

Society ultimately benefits from efficient markets where capital can freely flow to the most productive or innovative destination. Well-functioning capital markets efficiently match those needing capital with those seeking to invest their assets in revenue-generating ventures. In order for capital markets to be efficient, investors must be able to trust that the markets are fair and transparent and offer them the opportunity to be rewarded for the risk they choose to take. Laws, regulations, and enforcement play a vital role but are insufficient alone to guarantee fair and transparent markets. The markets depend on an ethical foundation to guide participants' judgment and behavior. CFA Institute maintains and promotes the Code and Standards in order to create a culture of ethics for the ultimate benefit of society.

## Why Ethics Matters

Ethics can be defined as a set of principles or rules of conduct that provide guidance for our behavior when it affects others. Widely acknowledged fundamental ethical principles include honesty, fairness, diligence, and care and respect for others. Ethical conduct follows those principles and balances self-interest with both the direct and the indirect consequences of that behavior for other people.

Not only does unethical behavior by individuals have serious personal consequences—ranging from job loss and reputational damage to fines and even jail—but unethical conduct from market participants, investment professionals, and those who service investors can damage investor trust and thereby impair the sustainability of the global capital markets as a whole. Unfortunately, there seems to be an unending parade of stories bringing to light accounting frauds and manipulations, Ponzi schemes, insider-trading scandals, and other misdeeds. Not surprisingly, this situation has led to erosion in public confidence in investment professionals. Empirical evidence from numerous surveys documents the low standing of the people and institutions that are entrusted with the economic well-being and retirement security of society in the eyes of the investing public.

Governments and regulators have historically tried to combat misconduct in the industry through regulatory reform, with various levels of success. Global capital markets are highly regulated to protect investors and other market participants. However, compliance with regulation alone is insufficient to fully earn investor trust. Individuals and firms must develop a “culture of integrity” that permeates all levels of operations and promotes the ethical principles of stewardship of investor assets and working in the best interests of clients, above and beyond strict compliance with the law. A strong ethical culture that helps honest, ethical people engage in ethical behavior will foster the trust of investors, lead

to robust global capital markets, and ultimately benefit society. That is why ethics matters.

## Ethics, Society, and the Capital Markets

The CFA Institute mission is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. CFA Institute includes the concept “for the ultimate benefit of society” as part of its mission to underscore that we want to live in a socially, politically, and financially stable society that fosters individual well-being and welfare of the public. A key ingredient for this goal is global capital markets that facilitate the efficient allocation of resources so that the available capital finds its way to places where it most benefits that society. These investments are then used to produce goods and services, to fund innovation and jobs, and to promote improvements in standards of living. Indeed, such a function serves the interests of society. Efficient capital markets, in turn, provide a host of benefits to those providing the investment capital. Investors are provided the opportunity to transfer and transform risk because the capital markets serve as an information exchange, create investment products, provide liquidity, and limit transaction costs.

However, a well-functioning and efficient capital market system is dependent on trust of the participants. If investors believe that capital market participants—investment professionals and firms—cannot be trusted with their financial assets or that the capital markets are unfair such that only insiders can be successful, they will be unlikely to invest or, at the very least, will require a higher risk premium. Decreased investment capital can reduce innovation and job creation and hurt the economy and society as a whole. Reduced trust in capital markets can also result in a less vibrant, if not smaller, investment industry.

Ethics for a global investment industry should be universal and ultimately support trust and integrity above acceptable local or regional customs and culture. Universal ethics for a global industry strongly supports the efficiency, values, and mission of the industry as a whole. Different countries may be at different stages of development in establishing standards of practice, but the end goal must be to achieve rules, regulations, and standards that support and promote fundamental ethical principles on a global basis.

## Capital Market Sustainability and the Actions of One

Individuals and firms also have to look at the indirect impacts of their actions on the broader investment community. The interconnected nature of global finance brings to the fore an added consideration of market sustainability that was, perhaps, less appreciated in years past. In addition to committing to the highest levels of ethical behavior, today’s investment professionals and their employers should consider the long-term health of the market as a whole.

Apparently isolated and unrelated decisions, however innocuous when considered on an individual basis, in aggregate can precipitate a market crisis. In an interconnected global economy and marketplace, each participant should strive to be aware of how his or her actions or the products he or she distributes may have an impact on capital market participants in other regions or countries.

Investment professionals should consider how their investment decision-making processes affect the global financial markets in the broader context of how they apply their ethical and professional obligations. Those in positions of authority have a special responsibility to consider the broader context of market sustainability in their development and approval of corporate policies, particularly those involving risk management and product development. In addition, corporate compensation strategies should not encourage otherwise ethically sound individuals to engage in unethical or questionable conduct for financial gain. Ethics, sustainability, and properly functioning capital markets are components of the same concept of protecting the best interests of all. To always place the interests of clients ahead of both investment professionals' own interests and those of their employer remains a key ethos.

## The Relationship between Ethics and Regulations

Some equate ethical behavior with legal behavior: If you are following the law, you must be acting appropriately. Ethical principles, like laws and regulations, prescribe appropriate constraints on our natural tendency to pursue self-interest that could harm the interests of others. Laws and regulations often attempt to guide people toward ethical behavior, but they do not cover all unethical behavior. Ethical behavior is often distinguished from legal conduct by describing legal behavior as what is required and ethical behavior as conduct that is morally correct. Ethical principles go beyond that which is legally sufficient and encompass what is the right thing to do.

Given many regulators' lack of sufficient resources to enforce well-conceived rules and regulations, relying on a regulatory framework to lead the charge in establishing ethical behavior has its challenges. Therefore, reliance on compliance with laws and regulation alone is insufficient to ensure ethical behavior of investment professionals or to create a truly ethical culture in the industry.

Inevitably, some individuals will succeed at circumventing the regulatory rules for their personal gain. Only the application of strong ethical principles, at both the individual level and the firm level, will limit abuses. Knowing the rules or regulations to apply in a particular situation, although important, may not be sufficient to ensure ethical conduct. Individuals must be able both to recognize areas that are prone to ethical pitfalls and to identify and process those circumstances and influences that can impair ethical judgment.

## Applying an Ethical Framework

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct. When faced with an ethical dilemma, individuals must have a well-developed set of principles; otherwise, their thought processes can lead to, at best, equivocation and indecision and, at worst, fraudulent conduct and destruction of the public trust. Establishing an ethical framework for an internal thought process prior to deciding to act is a crucial step in engaging in ethical conduct.

Most investment professionals are used to making decisions from a business (profit/loss) outlook. But given the importance of ethical behavior in carrying out professional responsibilities, it is critical to also analyze decisions and potential conduct from an ethical perspective. Using a framework for ethical decision making will help investment professionals effectively examine their conduct in the context of conflicting interests common to their professional obligations (e.g., researching and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze their conduct in a way that meets high standards of ethical behavior.

An ethical decision-making framework can come in many forms but should provide investment professionals with a tool for following the principles of the firm's code of ethics. Through analyzing the particular circumstances of each decision, investment professionals are able to determine the best course of action to fulfill their responsibilities in an ethical manner.

## Commitment to Ethics by Firms

A firm's code of ethics risks becoming a largely ignored, dusty compilation if it is not truly integrated into the fabric of the business. The ability to relate an ethical decision-making framework to a firm's code of ethics allows investment professionals to bring the aspirations and principles of the code of ethics to life—transforming it from a compliance exercise to something that is at the heart of a firm's culture.

An investment professional's natural desire to "do the right thing" must be reinforced by building a culture of integrity in the workplace. Development, maintenance, and demonstration of a strong culture of integrity within the firm by senior management may be the single most important factor in promoting ethical behavior among the firm's employees. Adopting a code of ethics that clearly lays out the ethical principles that guide the thought processes and conduct the firm expects from its employees is a critical first step. But a code of ethics, while necessary, is insufficient.

Simply nurturing an inclination to do right is no match for the multitude of daily decisions that investment managers make. We need to exercise ethical decision-making skills to develop the “muscle memory” necessary for fundamentally ethical people to make good decisions despite the reality of conflicts of interest. Just as coaching and practice transform our natural ability to run across a field into the technique and endurance required to run a race, teaching, reinforcing, and practicing ethical decision-making skills prepare us to confront the hard issues effectively. It is good for business, individuals, firms, the industry, and the markets, as well as society as a whole, to engage in the investment management profession in a highly ethical manner.

## Ethical Commitment of CFA Institute

For more than 60 years, CFA Institute members and candidates have been required to abide by the organization’s Code and Standards. Although the investment world has become a far more complex place since the first publication of the *Standards of Practice Handbook*, CFA Institute has committed to revising and updating the Code and Standards to ensure that they remain relevant to the changing nature of the investment profession and representative of the highest standard of professional conduct.

New challenges will continually arise for members and candidates in applying the Code and Standards because many decisions are not unambiguously right or wrong. The dilemma exists because the choice between right and wrong is not always clear. Even well-intentioned investment professionals can find themselves in circumstances that may tempt them to cut corners. Situational influences can overpower the best of intentions.

CFA Institute has made a significant commitment to providing members and candidates with the resources to extend and deepen their understanding of how to appropriately apply the principles of the Code and Standards. Through publications, conferences, webcasts, and podcasts, the ethical challenges of investment professionals are brought to light. Archived issues of many of these items are available on the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)).

By reviewing these resources and discussing them with their peers, market participants can further enhance their abilities to apply an effective ethical decision-making framework. In time, this should promote the trust of clients, investors, and market participants.

Markets function to an important extent on trust. Investment professionals should remain mindful of the long-term health of financial markets and incorporate this concern for the market’s sustainability in their investment decision making. CFA Institute and the Standards of Practice Council hope the *Handbook* will assist and guide investment professionals in meeting the ethical demands of the highly interconnected global capital markets for the ultimate benefit of society.

# CFA INSTITUTE CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

## Preamble

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to continue to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA] designation) and CFA candidates have the personal responsibility to embrace and uphold the provisions of the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

## The Code of Ethics

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and 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.

# Standards of Professional Conduct

## I. PROFESSIONALISM

### A. Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

### B. Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates 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.

### C. Misrepresentation

Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

### D. Misconduct

Members and Candidates 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.

### E. Competence

Members and Candidates must act with and maintain the competence necessary to fulfill their professional responsibilities.

## II. INTEGRITY OF CAPITAL MARKETS

### A. Material Nonpublic Information

Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

### B. Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

### III. DUTIES TO CLIENTS

#### A. Loyalty, Prudence, and Care

Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

#### B. Fair Dealing

Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

#### C. Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:

- a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
- b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
- c. Judge the suitability of investments in the context of the client's total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

#### D. Performance Presentation

When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

#### E. Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,
2. Disclosure is required by law, or

3. The client or prospective client permits disclosure of the information.

#### IV. DUTIES TO EMPLOYERS

##### A. Loyalty

In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

##### B. Additional Compensation Arrangements

Members and Candidates 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.

##### 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.

#### V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

##### A. Diligence and Reasonable Basis

Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

##### B. Communication with Clients and Prospective Clients

Members and Candidates must:

1. Disclose to clients and prospective clients the nature of the services provided, along with information about the costs to the client associated with those services.
2. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
3. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

4. 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.
5. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

**C. Record Retention**

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

## **VI. CONFLICTS OF INTEREST**

**A. Avoid or Disclose Conflicts**

Members and Candidates must avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity and interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

**B. Priority of Transactions**

Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

**C. Referral Fees**

Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

## **VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE**

**A. Conduct as Participants in CFA Institute Programs**

Members and Candidates 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 CFA Institute programs.

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

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

# STANDARD I: PROFESSIONALISM

## Standard I(A) Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

### Guidance

Members and candidates must understand the applicable laws and regulations of the countries and jurisdictions where they engage in professional activities. On the basis of their reasonable and good faith understanding, members and candidates must comply with the laws and regulations that directly govern their professional activities.

As applicable laws, rules, or regulations are updated, members and candidates must remain vigilant in maintaining their knowledge of the requirements for their professional activities. When questions arise, members and candidates should access compliance and legal guidance from their employer or outside compliance or legal resources to assist them in meeting their responsibilities under this standard. This standard does not require members and candidates to become experts, however, in compliance. Additionally, members and candidates are not required to have detailed knowledge of or be experts on all the laws that could potentially govern their activities. However, members and candidates must have knowledge of and comply with laws, rules, and regulations that directly relate to their professional responsibility. For instance, depending on the circumstances, an employee of a firm who has no supervisory responsibility may not need to have detailed knowledge of employment law, while a member or candidate in a management position who oversees one or more divisions with many employees may need to be familiar with employment law as it directly relates to his or her professional responsibilities.

## Relationship between the Code and Standards and Applicable Law

Some members or candidates may live, work, or provide investment services to clients living in a country that has no law or regulation governing a particular action or that has laws or regulations that differ from the requirements of the Code and Standards. When applicable law and the Code and Standards require different conduct, members and candidates must follow the more strict of the applicable law or the Code and Standards.

“Applicable law” is the law that governs the member’s or candidate’s conduct. Which law applies will depend on the particular facts and circumstances of each case. The “more strict” law or regulation is the law or regulation that imposes greater restrictions on the action of the member or candidate or calls for the member or candidate to exert a greater degree of action to protect the interests of clients. For example, applicable laws or regulations may not require members and candidates to disclose referral fees received from or paid to others for the recommendation of investment products or services. Because the Code and Standards impose this obligation, however, members and candidates must disclose the existence of such fees.

Members and candidates must adhere to the following principles:

- Members and candidates must comply with applicable laws or regulations related to their professional activities.
- Members and candidates must not engage in conduct that constitutes a violation of the Code and Standards, even though it may otherwise be legal.
- In the absence of any applicable law or regulation or when the Code and Standards impose a higher degree of responsibility than applicable laws and regulations, members and candidates must adhere to the Code and Standards. Applications of these principles are outlined in **Exhibit 1**.

Complying with applicable laws governing the professional responsibilities of a member or candidate is the minimum threshold of acceptable actions. When members and candidates take actions that exceed the minimum requirements and go above and beyond the law to protect client interests or otherwise act in an ethical manner, they further support the conduct required by Standard I(A).

CFA Institute members are obligated to abide by the CFA Institute Code of Ethics, Standards of Professional Conduct, Rules of Procedure, and Membership Agreement, as well as other applicable rules promulgated by CFA Institute, all as amended periodically. CFA candidates who are not members must also abide by these documents (except for the Membership Agreement), as well as the

Candidate Agreement, the rules and regulations related to the administration of the CFA exams, the Candidate Responsibility Statement, and the Candidate Pledge.

## Participation in or Association with Violations by Others

Members and candidates are responsible for violations in which they *knowingly* participate or assist. Although members and candidates are presumed to have knowledge of all applicable laws, rules, and regulations, CFA Institute acknowledges that members may not recognize violations if they are not aware of all the facts giving rise to the violations. Standard I(A) applies when members and candidates know or should know that their conduct may contribute to a violation of applicable laws, rules, or regulations or the Code and Standards.

If a member or candidate has reasonable grounds to believe that imminent or ongoing activities of their colleagues, employer, or clients are illegal or unethical, the member or candidate must dissociate, or separate, from the activity. In extreme cases, dissociation may require a member or candidate to leave his or her employment. Members and candidates may take the following intermediate steps to dissociate from ethical violations of others when direct discussions with the person or persons committing the violation are unsuccessful. The first step is to attempt to stop the behavior by bringing it to the attention of the employer through a supervisor or the firm's compliance department. If this attempt is unsuccessful, then members and candidates have a responsibility to step away and dissociate from the activity. Dissociation practices will differ on the basis of the member's or candidate's professional role or responsibilities. Dissociation may include removing one's name from written reports or recommendations, asking for a different assignment, or refusing to accept a new client or continue to advise a current client. Inaction combined with continuing association with those involved in illegal or unethical conduct may be construed as participation or assistance in the illegal or unethical conduct.

CFA Institute strongly encourages members and candidates to report potential violations of the Code and Standards committed by fellow members and candidates. Although a failure to report is less likely to be construed as a violation than a failure to dissociate from unethical conduct, the impact of inactivity on the integrity of capital markets can be significant. Although the Code and Standards do not compel members and candidates to report violations to their governmental or regulatory organizations unless such disclosure is mandatory under applicable law (voluntary reporting is often referred to as "whistle-blowing"), such disclosure may be prudent under certain circumstances. Members and candidates should consult their legal and compliance advisers for guidance.

Additionally, CFA Institute encourages members, nonmembers, clients, and the investing public to report violations of the Code and Standards by CFA Institute members or CFA candidates by submitting a complaint in writing to the CFA Institute Professional Conduct Program via e-mail ([pcentforcement@cfainstitute.org](mailto:pcentforcement@cfainstitute.org)) or the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)).

## Investment Products and Applicable Laws

Members and candidates involved in creating or maintaining investment services or investment products must be mindful of where these services or products will be sold and their places of origination. Those members or candidates who are responsible for providing the services or creating or providing investment products must understand and comply with applicable laws and regulations in all relevant jurisdictions. Members and candidates must undertake the necessary due diligence when transacting cross-border business to understand the multiple applicable laws and regulations.

Given the complexity that can arise with business transactions in global markets, there may be some uncertainty surrounding which laws or regulations are considered applicable when activities are being conducted in multiple jurisdictions. Members and candidates should seek the appropriate guidance, potentially including the firm's compliance or legal departments and legal counsel outside the organization, to gain a reasonable understanding of their responsibilities and how to take appropriate measures to ensure compliance with applicable law.

## Global Application of the Code and Standards

Members and candidates who practice in multiple jurisdictions may be subject to various laws and regulations. If applicable law is stricter than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, they must adhere to the Code and Standards. Exhibit 1 provides illustrations involving a member who may be subject to the securities laws and regulations of three different types of countries:

NS:	Country with no securities laws or regulations
LS:	Country with <b>less strict</b> securities laws and regulations than the Code and Standards
MS:	Country with <b>more strict</b> securities laws and regulations than the Code and Standards

## Exhibit 1. Application of the Code and Standards

Applicable Law	Duties	Explanation
Member resides in NS country, does business in LS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, the member must adhere to the Code and Standards.
Member resides in NS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the stricter applicable law.
Member resides in LS country, does business in NS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the stricter applicable law.
Member resides in LS country, does business in NS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and there is no local law, the member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; LS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the law of MS country.	Because applicable law of the locality where the business is conducted governs and local law is stricter than the Code and Standards, member must adhere to the stricter applicable law.
Member resides in MS country, does business in LS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the stricter applicable law.
Member resides in MS country, does business in LS country; MS law applies, but it states that law of locality where business is conducted governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the locality where the business is conducted governs and local law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of LS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the Code and Standards.	Because applicable law states that the law of the client's home country governs (which is less strict than the Code and Standards), member must adhere to the Code and Standards.
Member resides in MS country, does business in LS country with a client who is a citizen of MS country; MS law applies, but it states that the law of the client's home country governs.	Member must adhere to the law of MS country.	Because applicable law states that the law of the client's home country governs and the law of the client's home country is stricter than the Code and Standards, the member must adhere to the stricter applicable law.

## Compliance Practices

- *Stay informed:* Members and candidates should establish practices and procedures to remain regularly informed about changes in applicable laws, rules, and regulations. In many instances, the employer's compliance department or legal counsel can provide such information. Also, participation in an internal or external continuing education program is a practical method of staying current.
- *Maintain current resources:* Members and candidates should maintain or encourage their employers to maintain readily accessible current reference copies of applicable statutes, rules, and regulations, as well as important cases.
- *Seek advice:* When in doubt about the appropriate action to take, members and candidates should seek the advice of compliance personnel or legal counsel concerning legal requirements. If a potential violation is being committed by a fellow employee, it may also be prudent for the member or candidate to seek the advice of the firm's compliance department or legal counsel.
- *Dissociate from violations:* When dissociating from an activity that violates the Code and Standards, members and candidates should document the violation.

## Application of the Standard

### Example 1 (Notification of Known Violations)

Allen works for a brokerage firm and is responsible for an underwriting of securities. A senior manager for an issuing company gives Allen information indicating that the financial statements Allen filed with the regulator overstate the issuer's earnings. Allen seeks the advice of the brokerage firm's general counsel, who states that it would be difficult for the regulator to prove that Allen has been involved in any wrongdoing.

*Comment:* Although it is recommended that members and candidates seek the advice of legal counsel, the reliance on such advice does not absolve a member or candidate from the requirement to comply with the law or regulation. Allen should report this situation to his supervisor, seek an independent legal opinion, and determine whether the regulator should be notified of the error.

### Example 2 (Dissociating from a Violation)

Brown's employer, an investment banking firm, is the principal underwriter for an issue of convertible debentures by the Courtney Company. Brown discovers that the Courtney Company concealed severe third-quarter losses in its foreign operations. The preliminary prospectus was already distributed.

*Comment:* Knowing that the preliminary prospectus is misleading, Brown should report his findings to the appropriate supervisory persons in his firm. If the matter is not remedied and Brown's employer does not dissociate from the underwriting, Brown must sever all his connections with the underwriting. Brown should also seek legal advice to determine whether additional reporting or other action should be taken.

### Example 3 (Dissociating from a Violation)

Washington's firm advertises its past performance record by showing the 10-year return of a composite of its client accounts. Washington discovers, however, that the composite omits the performance of accounts that left the firm during the 10-year period, whereas the description of the composite indicates the inclusion of all firm accounts. This omission led to an inflated performance figure. Washington is asked to use promotional material that includes the erroneous performance number when soliciting business for the firm.

*Comment:* Misrepresenting performance is a violation of the Code and Standards. Although she did not calculate the performance herself, Washington will assist in violating Standard I(A) if she were to use the inflated performance number when soliciting clients. She must dissociate herself from the activity. If discussing the misleading number with the person responsible is not an option for correcting the problem, she must bring the situation to the attention of her supervisor or the compliance department at her firm. If her firm is unwilling to recalculate performance, she must refrain from using the misleading promotional material and should notify the firm of her reasons. If the firm insists that she use the material, she should consider whether her obligation to dissociate from the activity requires her to seek other employment.

### Example 4 (Following the Highest Requirements)

Collins is an investment analyst for a major Wall Street brokerage firm. He works in a developing country with a rapidly modernizing economy and a growing capital market. Local securities laws are minimal—in form and content—and include no punitive prohibitions against insider trading.

*Comment:* Collins must abide by the requirements of the Code and Standards, which are stricter than the rules of the developing country. In handling material nonpublic information that comes into his possession, he must follow Standard II(A) Material Nonpublic Information.

### Example 5 (Following the Highest Requirements)

Jameson works for a multinational investment adviser based in the United States. Jameson lives and works as a registered investment adviser in the tiny but wealthy island nation of Karramba. Karramba's securities laws state that no

investment adviser registered and working in that country can participate in initial public offerings (IPOs). Jameson, believing that, as a US citizen working for a US-based company, she should comply only with US law, ignored this Karrambian law. In addition, Jameson believes that as a charterholder, as long as she adheres to the Code and Standards requirement that she disclose her participation in any IPO to her employer and clients when such ownership creates a conflict of interest, she is meeting the highest ethical requirements.

*Comment:* Jameson is in violation of Standard I(A). As a registered investment adviser in Karramba, Jameson is prevented by Karrambian securities law from participating in IPOs regardless of the law of her home country. In addition, because the law of the country where she works is stricter than the Code and Standards, she must follow the stricter requirements of the local law rather than the requirements of the Code and Standards.

### Example 6 (Failure to Maintain Knowledge of the Law)

White communicates with clients and potential clients through social media. She posts investment information, including performance reports and investment opinions and recommendations, along with brief announcements and opinions (e.g., “Prospects for future growth of XYZ company look good! #makingmoney4U”). Prior to White’s use of social media, the local regulator issued new requirements and guidance governing online electronic communication. White’s communications conflict with the recent regulatory announcements.

*Comment:* White is in violation of Standard I(A) because her communications do not comply with the existing applicable regulation governing use of social media. White must be aware of the evolving legal requirements pertaining to areas of the financial services industry that apply to her. She should seek guidance from appropriate, knowledgeable, and reliable sources, such as her firm’s compliance department, external service providers, or outside counsel, unless she diligently follows legal and regulatory trends affecting her professional responsibilities. Having appropriate knowledge of the laws directly applicable to her professional activities is also required by Standard I(E) Competence.

### Example 7 (Knowledge of Applicable Law)

Scherzer is a portfolio manager for National Investment Advisors (NIA). He, along with many other NIA personnel, assists in preparing for the firm’s annual audit of financial reports required by local regulations. While gathering and preparing material to assist Strasberg, the firm’s chief financial officer (CFO), and her audit team in fulfilling the firm’s annual regulatory reporting requirements, Scherzer neglects to properly collect and disclose certain information required by the regulations.

*Comment:* Although Scherzer occasionally assists with the firm's financial audit, his primary professional responsibilities relate to portfolio management of client accounts. As such, Standard I(A) does not require Scherzer to have detailed knowledge of the financial audit regulations applicable to his firm. Strasberg, as the CFO and the person responsible for the internal audit team, would be required by Standard I(A) to understand and comply with the audit regulations. Scherzer can rely on Strasberg to understand what information is required by the regulations and give him advice on how to properly gather and disclose that information.

## Standard I(B) Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates 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.

### Guidance

Standard I(B) states the responsibility of CFA Institute members and candidates to maintain independence and objectivity so that their clients will have the benefit of their work and opinions unaffected by any potential conflict of interest or other circumstance adversely affecting their judgment. Every member and candidate should endeavor to avoid situations that could cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action.

Members and candidates are personally responsible for maintaining independence and objectivity when preparing research reports, making investment recommendations, and taking investment action on behalf of clients. Recommendations must convey the member's or candidate's true opinions, free of bias from internal or external pressures, and be stated in clear and unambiguous language.

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of benefits. Corporations may seek expanded research coverage, issuers and underwriters may wish to promote new securities offerings, brokers may want to increase commission business, and independent rating agencies may be influenced by the company requesting the rating. Benefits may include gifts, invitations to lavish functions, tickets, favors, or job referrals. Modest gifts and entertainment are acceptable, but special care must be taken by members and candidates to resist subtle and not-so-subtle pressures to act in conflict with the interests of their clients. Members and candidates must reject any offer of gifts or entertainment that could reasonably be expected to threaten their independence and objectivity.

Receiving a gift, benefit, or consideration from a *client* can be distinguished from gifts given by entities seeking to influence a member or candidate to the detriment of other clients. In a client relationship, the client has already entered some type of compensation arrangement with the member, candidate, or his or her firm. A gift from a client could be considered supplementary compensation rather than an attempt to influence a member or candidate to favor the gift-giving client to the detriment of other clients. Prior to accepting

“bonuses” or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients. If notification is not possible prior to acceptance, members and candidates must disclose to their employer benefits previously accepted from clients. Disclosure allows the employer to make an independent determination about the extent to which the gift may affect the member’s or candidate’s independence and objectivity.

## Investment Banking Relationships

Members and candidates may also come under pressure from their own firms to, for example, issue favorable research reports or recommendations for certain companies with potential or continuing business relationships with the firm. Members and candidates acting in a sales or marketing capacity must be especially mindful of their objectivity in promoting appropriate investments for their clients.

In some firms, research analysts frequently work closely with their investment banking colleagues to help evaluate prospective investment banking clients. Although collaboration between research analysts and investment banking colleagues may benefit the firm and enhance market efficiency (e.g., by allowing firms to assess risks more accurately and make better pricing assumptions), it requires firms to carefully balance the conflicts of interest inherent in the collaboration. Having analysts work with investment bankers is appropriate only when the conflicts are adequately and effectively managed. Any such conflict that is not avoided must be disclosed; see Standard VI(A) Avoid or Disclose Conflicts.

## Performance Measurement and Attribution

Members and candidates working in a firm’s investment performance measurement department may also be presented with situations that challenge their independence and objectivity. As performance analysts, their analyses may reveal instances where managers may appear to have strayed from their mandate. Additionally, the performance analyst may receive requests to alter the construction of composite benchmarks owing to negative results for a selected account or fund. The member or candidate must not allow internal or external influences to affect their independence and objectivity as they faithfully complete their performance calculation and analysis-related responsibilities.

## Public Companies

Analysts may be pressured to issue favorable reports and recommendations by the companies they follow. Left unmanaged, pressures that threaten independence place research analysts in a difficult position and may jeopardize their ability to act independently and objectively. One of the ways that research analysts have coped with these pressures is to use subtle and ambiguous language in their recommendations or to temper the tone of their research reports. Such subtleties, however, are lost on some investors who reasonably

expect research reports and recommendations to be straightforward and transparent and to communicate clearly an analyst's views based on unbiased analysis and independent judgment.

In making an investment recommendation, the analyst is responsible for anticipating, interpreting, and assessing a company's prospects and stock price performance in a factual manner. Due diligence in financial research and analysis involves gathering information from a wide variety of sources, including public disclosure documents (such as proxy statements, annual reports, and other regulatory filings), company management and investor relations personnel, suppliers, customers, competitors, and other relevant sources. Research analysts may justifiably fear that companies will limit their ability to conduct thorough research by denying analysts who have "negative" views direct access to company managers and/or barring them from conference calls and other communication venues. This concern may make it difficult for them to conduct the comprehensive research needed to make objective recommendations. Members and candidates should work with issuers they cover to make clear their responsibility to produce independent and objective research. For further information and guidance, members and candidates should refer to the CFA Institute publication "Best Practice Guidelines Governing Analyst/Corporate Issuer Relations."<sup>1</sup>

## Credit Rating Agency Opinions

Credit rating agencies provide a service by grading the fixed-income products offered by companies. Members and candidates employed at rating agencies should ensure that procedures and processes at the agencies prevent undue influences from a sponsoring company during the analysis. Members and candidates must abide by their agencies' and the industry's standards of conduct regarding the analytical process and the distribution of their reports.

The work of credit rating agencies also raises concerns similar to those inherent in investment banking relationships. Analysts may face pressure to issue ratings at a specific level because of other services the agency offers companies—namely, advising on the development of structured products. The rating agencies need to develop the necessary firewalls and protections to allow the independent operations of their different business lines.

When using information provided by credit rating agencies, members and candidates should be mindful of the potential conflicts of interest. And because of the potential conflicts, members and candidates may need to independently validate the rating granted.

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<sup>1</sup>CFA Institute, "Best Practice Guidelines Governing Analyst/Corporate Issuer Relations," position paper (February 2005). [www.cfainstitute.org/en/advocacy/policy-positions/best-practice-guidelines-governing-analyst](http://www.cfainstitute.org/en/advocacy/policy-positions/best-practice-guidelines-governing-analyst).

## Influence during the Manager Selection

Members and candidates may find themselves on either side of the manager selection process. An individual may be on the hiring side as a representative of a pension organization or an investment committee member of an endowment or a charitable organization. Other members and candidates may be representing their organizations in attempts to earn new investment allocation mandates. The responsibility of members and candidates to maintain their independence and objectivity extends to the hiring or firing of those who provide business services beyond investment management.

When serving in a hiring capacity, members and candidates must not solicit gifts, contributions, or other compensation that affects their independence and objectivity or that reasonably could be expected to influence their decision-making process. Solicitations do not have to benefit members and candidates personally to conflict with Standard I(B). Requesting contributions to a favorite charity or political organization may also be perceived as an attempt to influence the decision-making process. When working to earn a new investment allocation, members and candidates must not offer gifts, contributions, or other compensation to influence the decision of the hiring representative. Offering these items with the intent to impair the independence and objectivity of another person would not comply with Standard I(B). Such prohibited actions may include offering donations to a charitable organization or political candidate referred by the hiring representative.

A clear example of improperly influencing hiring representatives was displayed in the “pay-to-play” scandal involving government-sponsored pension funds in the United States. Managers looking to gain lucrative allocations from the large funds made requested donations to the political campaigns of individuals directly responsible for the hiring decisions. This scandal and similar events have led to new laws requiring additional reporting concerning political contributions and bans on hiring—or hiring delay requirements for—managers who made campaign contributions to representatives associated with the decision-making process.

## Issuer-Paid Research

Many companies, seeking to increase visibility both in the financial markets and with potential investors, have hired analysts to produce research reports analyzing their companies. These reports bridge the gap created by the lack of sell-side coverage and can be an effective method of communicating with investors.

Issuer-paid research conducted by independent analysts, however, is fraught with potential conflicts. Depending on how the research is written and distributed, investors may be misled into believing that the research is from an independent source when, in reality, it has been paid for by the subject company.

Members and candidates must adhere to strict standards of conduct that govern how the research is to be conducted and what disclosures must be made in the report. Analysts must engage in thorough, independent, and unbiased analysis and must fully disclose potential conflicts of interest, including the nature of their compensation. Otherwise, analysts risk misleading investors. Analysts must exercise diligence, independence, and thoroughness in conducting their research in an objective manner. Analysts must distinguish between fact and opinion in their reports. Conclusions must have a reasonable and adequate basis and must be supported by appropriate research.

Independent analysts must also strictly limit the type of compensation that they accept for conducting issuer-paid research. Otherwise, the content and conclusions of the reports could reasonably be expected to be determined or affected by compensation from the sponsoring companies. Compensation that might influence the research report could be direct, such as payment based on the conclusions of the report, or indirect, such as stock warrants or other equity instruments that could increase in value on the basis of positive coverage in the report. In such instances, the independent analyst has an incentive to avoid including negative information or making negative conclusions. Best practice is for independent analysts, prior to writing their reports, to negotiate only a flat fee for their work that is not linked to their conclusions or recommendations and to disclose that they are being compensated by the issuer for writing the report.

## Travel Funding

The benefits related to accepting paid travel extend beyond the cost savings to members or candidates and their firms, such as the chance to talk exclusively with the executives of a company or learning more about the investment options provided by an investment organization. Acceptance also comes with potential concerns; for example, members and candidates may be influenced by these discussions when flying on a corporate or chartered jet or attending sponsored conferences where many expenses, including airfare and lodging, are covered. To avoid compromising their independence and objectivity, best practice dictates that members and candidates always use commercial transportation at their expense or at the expense of their firm rather than accept paid travel arrangements from an outside company. If commercial transportation is unavailable, members and candidates may accept modestly arranged travel to participate in appropriate information-gathering events, such as a property tour.

## Compliance Practices

Members and candidates should adhere to the following practices to avoid violations of Standard I(B):

- *Comply with firm policies:* Members and candidates must comply with firm policies for protecting the integrity of research and the unbiased opinions of analysts. Such policies could include a restricted list of companies with whom the employer has an investment banking or other relationship, if the

firm is unwilling to permit dissemination of adverse opinions about these companies.

- *Restrict special cost arrangements:* When attending meetings at an issuer's headquarters, members and candidates should pay for commercial transportation and hotel charges. No corporate issuer should reimburse members or candidates for air transportation.
- *Limit gifts:* Even if a member's or candidate's employer does not have a policy on accepting gifts, members and candidates must limit the acceptance of gratuities and/or gifts to token items. Standard I(B) does not preclude customary, ordinary business-related entertainment as long as its purpose is not to influence or reward members or candidates.

## Application of the Standard

### Example 1 (Travel Expenses)

Taylor, a mining analyst with Bronson Brokers, is invited by Precision Metals to join a group of his peers in a tour of mining facilities in several western US states. The company arranges for chartered group flights from site to site and for modest accommodations in Spartan Motels, the only chain with accommodations near the mines, for three nights. Taylor allows Precision Metals to pick up his tab, as do the other analysts, with one exception—Adams, an employee of a large trust company who insists on following his company's policy and paying for his hotel room himself.

*Comment:* The policy of the company where Adams works complies closely with Standard I(B) by avoiding even the appearance of a conflict of interest, but Taylor and the other analysts did not necessarily violate Standard I(B). In general, when allowing companies to pay for travel and/or accommodations in these circumstances, members and candidates must use their judgment. They must be on guard that such arrangements do not impinge on a member's or candidate's independence and objectivity. In this example, the trip was strictly for business and Taylor was not accepting irrelevant or lavish hospitality. The itinerary required chartered flights, for which analysts were not expected to pay. The accommodations were modest. In the final analysis, members and candidates must consider both whether they can remain objective and whether their integrity might be perceived by their clients to have been compromised.

### Example 2 (Research Independence)

Dillon, an analyst in the corporate finance department of an investment services firm, is making a presentation to a potential new business client that includes the promise that her firm will provide full research coverage of the potential client.

*Comment:* Dillon may agree to provide research coverage, but she must not commit her firm's research department to providing a favorable recommendation. The firm's recommendation (favorable, neutral, or unfavorable) must be based on an independent and objective investigation and analysis of the company and its securities.

### Example 3 (Research Independence and Intrafirm Pressure)

Fritz is an equity analyst at Hilton Brokerage who covers the mining industry. He has concluded that the stock of Metals & Mining is overpriced at its current level, but he is concerned that a negative research report will hurt the good relationship between Metals & Mining and the investment banking division of his firm. In fact, a senior manager of Hilton Brokerage just sent him a copy of a proposal his firm made to Metals & Mining to underwrite a debt offering. Fritz needs to produce a report right away and is concerned about issuing a less-than-favorable rating.

*Comment:* Fritz's analysis of Metals & Mining must be objective and based solely on consideration of company fundamentals. Any pressure from other divisions of his firm is inappropriate. This conflict could have been eliminated if, in anticipation of the offering, Hilton Brokerage had placed Metals & Mining on a restricted list.

### Example 4 (Research Independence and Issuer Relationship Pressure)

Fritz is an equity analyst at Hilton Brokerage who covers the mining industry. Fritz has concluded that Metals & Mining stock is overvalued at its current level, but he is concerned that a negative research report might jeopardize a close rapport that he has nurtured over the years with Metals & Mining's CEO, chief financial officer, and investment relations officer. Fritz is concerned that a negative report might also result in management retaliation—for instance, cutting him off from participating in conference calls when a quarterly earnings release is made, denying him the ability to ask questions on such calls, and/or denying him access to top management for arranging group meetings between Hilton Brokerage clients and top Metals & Mining managers.

*Comment:* Fritz's analysis must be objective and based solely on consideration of company fundamentals. Any pressure from Metals & Mining is inappropriate. To support the integrity of his conclusions, Fritz should fully document his work, including how his investment recommendation is based on relative valuation.

### Example 5 (Research Independence and Sales Pressure)

In her role supporting the sales effort of a corporate bond department, Warner offers credit guidance to fixed-income investors. Her compensation is closely linked to the performance of the corporate bond department. Near the quarter's

end, Warner's firm has a large inventory position in the bonds of Milton, Ltd., and has been unable to sell the bonds because of Milton's recent announcement of an operating problem. Salespeople have asked her to contact large clients to push the bonds.

*Comment:* Unethical sales practices create significant potential violations of the Code and Standards. Warner's opinion of the Milton bonds must not be affected by internal pressure or compensation. In this case, Warner must refuse to push the Milton bonds unless she is able to justify that the market price has already adjusted for the operating problem.

### Example 6 (Research Independence and Prior Coverage)

Jorund, a securities analyst following airline stocks, is a rising star at her firm. Her boss has been carrying a "buy" recommendation on International Airlines and asks Jorund to take over coverage of the airline. He tells Jorund that under no circumstances should the prevailing buy recommendation be changed.

*Comment:* Jorund must be independent and objective in her analysis of International Airlines. If she believes that her boss's instructions have compromised her, she has two options: She can tell her boss that she cannot cover the company under these constraints, or she can take over coverage of the company, reach her own independent conclusions, and if they conflict with her boss's opinion, share the conclusions with her boss or other supervisors in the firm so that they can make appropriate recommendations. Jorund must issue only recommendations that reflect her independent and objective opinion.

### Example 7 (Gifts and Entertainment from Related Parties)

Grant directs a large amount of his commission business to a New York-based brokerage house. In appreciation for all the business, the brokerage house gives Grant two tickets to the World Cup in South Africa, two nights at a nearby resort, several meals, and transportation via limousine to the game.

*Comment:* Grant violated Standard I(B) because accepting these substantial gifts may impede his independence and objectivity. Members and candidates must not solicit or accept gifts, contributions, or other compensation that affects their independence and objectivity or that reasonably could be expected to influence their decision-making process. Best practice is to avoid situations that might cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action. By accepting the trip, Grant created a conflict of interest and opened himself up to the accusation that he may give the broker favored treatment in return. At a minimum, Grant must disclose this conflict to his employer and clients.

## Example 8 (Gifts and Entertainment from Clients)

Green manages the portfolio of Knowlden, a client of Tisbury Investments. Green achieves an annual return for Knowlden that is consistently better than that of the benchmark she and the client previously agreed to. As a reward, Knowlden offers Green two tickets to Wimbledon and the use of Knowlden's flat in London for a week. Green discloses this gift to her supervisor at Tisbury.

*Comment:* Green is in compliance with Standard I(B) because she disclosed the gift from one of her clients. Members and candidates may accept bonuses or gifts from clients as long as they disclose them to their employer because gifts in a client relationship are deemed less likely to affect a member's or candidate's objectivity and independence than gifts in other situations. Disclosure is required, however, so that supervisors can monitor such situations to guard against employees favoring a gift-giving client to the detriment of other fee-paying clients (such as by allocating a greater proportion of IPO stock to the gift-giving client's portfolio).

## Example 9 (Travel Expenses from External Managers)

Wayne is the investment manager of the Franklin City Employee Pension Plan. He recently completed a successful search for a firm to manage the foreign equity allocation of the plan's diversified portfolio. He followed the plan's standard procedure of seeking presentations from a number of qualified firms and recommended that his board select Penguin Advisers because of its experience, well-defined investment strategy, and performance record. The firm claims compliance with the Global Investment Performance Standards (GIPS®) and has been verified. Following the selection of Penguin, a reporter from the *Franklin City Record* calls to ask whether there was any connection between this action and the fact that Penguin Advisers was one of the sponsors of an "investment fact-finding trip to Asia" that Wayne made earlier in the year. The trip was one of several conducted by the Pension Investment Academy, which had arranged the itinerary of meetings with economic, government, and corporate officials in major cities in several Asian countries. The Pension Investment Academy obtains support for the cost of these trips from a number of investment managers, including Penguin Advisers; the Academy then pays the travel expenses of the various pension plan managers on the trip and provides all meals and accommodations. The president of Penguin Advisers was also one of the travelers on the trip.

*Comment:* Although Wayne can probably put to good use the knowledge he gained from the trip when selecting external portfolio managers and in other areas of managing the pension plan, his recommendation of Penguin Advisers may be tainted by the possible conflict incurred when he participated in the international trip partly paid for by Penguin Advisers and when he was in the daily company of the

president of Penguin Advisers. To avoid violating Standard I(B), Wayne's basic expenses for travel and accommodations should have been paid by his employer or the pension plan; contact with the president of Penguin Advisers should have been limited to informational or educational events only; and the trip, the organizer, and the sponsor should have been made a matter of public record.

### Example 10 (Research Independence and Compensation Arrangements)

Herrero recently left his job as a research analyst for a large investment adviser. While looking for a new position, he was hired as a contractor by an investor relations firm to write a research report on one of its clients, a small educational software company. The investor relations firm hopes to generate investor interest in the technology company. The firm will pay Herrero a flat fee plus a bonus if any new investors buy stock in the company as a result of Herrero's report.

*Comment:* If Herrero accepts this payment arrangement, he will be in violation of Standard I(B) because the compensation arrangement can reasonably be expected to compromise his independence and objectivity. Herrero will receive a bonus for attracting investors, which provides an incentive to draft a positive report regardless of the facts and to ignore or play down any negative information about the company. Herrero should accept only a flat fee that is not tied to the conclusions or recommendations of the report. Issuer-paid research that is objective and unbiased is acceptable under certain circumstances as long as the analyst takes steps to maintain his or her objectivity and includes in the report proper disclosures regarding potential conflicts of interest.

### Example 11 (Influencing Manager Selection Decisions)

Mandel is a senior portfolio manager for ZZYY Capital Management who oversees a team of investment professionals who manage labor union pension funds. A few years ago, ZZYY sought to win a competitive asset manager search to manage a significant allocation of the pension fund of the United Doughnut and Pretzel Bakers Union (UDPBU). UDPBU's investment board is chaired by Gomez, a recognized key decision maker and long-time leader of the union. To improve ZZYY's chances of winning the competition, Mandel made significant monetary contributions to Gomez's union reelection campaign fund. Even after ZZYY was hired as a primary manager of the pension fund, Mandel believed that his firm's position was not secure. Mandel continued to contribute to Gomez's reelection campaign fund and lavishly entertained the union leader and his family at top restaurants on a regular basis. All of Mandel's outlays were routinely handled as marketing expenses reimbursed by ZZYY's expense accounts and were disclosed to his senior management as being instrumental in maintaining a strong close relationship with an important client.

*Comment:* Mandel not only offered but actually gave monetary gifts, benefits, and other considerations that reasonably could be expected to compromise Gomez's objectivity. Therefore, Mandel was in violation of Standard I(B).

### Example 12 (Fund Manager Relationships)

Scott is a performance analyst who is responsible for analyzing the performance of external managers for her firm. While completing her quarterly analysis, Scott notices a change in one manager's reported composite construction. The change concealed the bad performance of a particularly large account by placing that account into a new residual composite. This change allowed the manager to remain at the top of the list of manager performance. Scott knows her firm has a large allocation to this manager, and the fund's manager is a close personal friend of the CEO. She needs to deliver her final report but is concerned about pointing out the composite change.

*Comment:* Scott would be in violation of Standard I(B) if she did not disclose the change in her final report. The analysis of managers' performance must not be influenced by personal relationships or the size of the allocation to the outside managers. By not including the change, Scott would not be providing an independent analysis of the performance metrics for her firm.

### Example 13 (Intrafirm Pressure)

Stein is head of performance measurement for her firm. During the last quarter, many members of the organization's research department were removed because of the poor quality of their recommendations. The subpar research caused one larger account holder to experience significant underperformance, which resulted in the client withdrawing his money after the end of the quarter. The head of sales requests that Stein remove this account from the firm's performance composite because the performance decline can be attributed to the departed research team and not the client's adviser.

*Comment:* Pressure from other internal departments can create situations that cause a member or candidate to violate the Code and Standards. Stein must maintain her independence and objectivity and refuse to exclude specific accounts from the firm's performance composites to which they belong. As long as the client invested under a strategy similar to that of the defined composite, it cannot be excluded because of the poor stock selections that led to the underperformance and asset withdrawal.

## Standard I(C) Misrepresentation

Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

### Guidance

Trust is the foundation of the investment profession. Investors must be able to rely on the statements and information provided to them by those with whom the investors have trusted their financial well-being. Honest communication is critical for capital markets to work efficiently. Investment professionals who make false or misleading statements not only harm investors but also reduce the level of investor confidence in the investment profession and threaten the integrity of capital markets as a whole.

Members and candidates must not misrepresent any aspect of their professional activities or investment practice, including, but not limited to, their qualifications or credentials, the qualifications or services provided by their firm, their performance record and the record of their firm, and the characteristics of an investment. Any misrepresentation made by a member or candidate relating to the member's or candidate's professional activities is a breach of this standard.

When communicating information about their professional activities, members and candidates must provide information and make disclosures that are accurate, timely, complete, and in plain language. The term "plain language" means language that is clear and concise, uses common words, and is not dominated by technical or obscure wording or jargon. Accurate language is truthful, free from error, and precise and is not incomplete, vague, or misleading. Timely communication means the statements are made or given with sufficient notice to allow those receiving the material to act on the information. Complete communications contain all facts and elements necessary and customary to convey the information.

A misrepresentation is any untrue statement or omission of a fact or any statement that is otherwise false or misleading. A member or candidate must not knowingly omit or misrepresent information or give a false impression about their professional activities in any communication, whether in written, electronic, or verbal form. In this context, "knowingly" means that the member or candidate either knows or should have known that the misrepresentation was being made or that omitted information could alter the investment decision-making process.

Written materials include but are not limited to research reports, underwriting documents, company financial reports, advertising material, market letters, newspaper articles, and books. Electronic communications include emails, texts, and information posted on the internet. Members and candidates should regularly monitor materials posted on websites and social media to ensure the information complies with this standard.

## Use of Third-Party Information

Members and candidates rely on models to identify new investment opportunities, develop investment vehicles, and produce investment recommendations and ratings. Although not every model can test for every factor or outcome, members and candidates must ensure that their analyses incorporate a broad range of assumptions—from very positive scenarios to extremely negative scenarios. The omission from the analysis of potentially negative outcomes or of levels of risk outside the norm may misrepresent the true economic value of the investment.

Members and candidates must exercise care and diligence when incorporating third-party information into their own work. Misrepresentations that result from using materials produced by outside parties become the responsibility of members and candidates when they incorporate that material into or make it part of their work. When providing information to clients from third parties, members and candidates share a responsibility for the accuracy of the marketing and distribution materials that pertain to the third party's capabilities, services, and products.

Members and candidates must disclose their intended use of external third parties and must not represent the work of others as their own. Although the level of involvement of external third parties may change over time, appropriate disclosures by members and candidates are important to avoiding misrepresentations.

## Investment Performance

Most investments contain some element of risk that makes their return inherently unpredictable. Standard I(C) prohibits members and candidates from stating or implying that clients will obtain or achieve a rate of return that was generated in the past. Guaranteeing either a particular rate of return or preservation of investment capital (e.g., "I can guarantee that you will earn 8% on equities this year" or "I can guarantee that you will not lose money on this investment") is also misleading to investors and a violation of this standard. Standard I(C) does not prohibit members and candidates from providing clients with information on investment products that have guarantees built into the structure of the product itself or for which an institution has agreed to cover any losses.

The performance benchmark selection process is another area where misrepresentations may occur. Members and candidates may misrepresent the success of their performance record through presenting benchmarks that are not comparable to their strategies. Further, clients can be misled if the benchmark's results are not reported on a basis comparable to that of the fund's or client's results. Best practice is selecting the most appropriate available benchmark from a universe of available options. The transparent presentation of appropriate performance benchmarks is an important aspect in providing clients with information that is useful in making investment decisions.

However, Standard I(C) does not require that a benchmark always be provided in order to comply. Some investment strategies may not lend themselves to displaying an appropriate benchmark because of the complexity or diversity of the investments included. Furthermore, some investment strategies may use reference indexes that do not reflect the opportunity set of the invested assets—for example, a hedge fund comparing its performance with a “cash plus” basis. When such a benchmark is used, members and candidates must make reasonable efforts to ensure that they disclose the reasons behind the use of this reference index to avoid misrepresentations of their performance. Members and candidates should discuss with clients on a continuous basis the appropriate benchmark to be used for performance evaluations and any related fee calculations.

Reporting misrepresentations may also occur when valuations for illiquid or nontraded securities are available from more than one source. When different options are available, members and candidates may be tempted to switch providers to obtain higher security valuations. The process of shopping for values may misrepresent a security's worth, lead to misinformed decisions to sell or hold an investment, and result in overcharging clients for advisory fees.

Members and candidates must take reasonable steps to provide accurate and reliable security pricing information to clients on a consistent basis. Changing pricing providers must not be based solely on the justification that the new provider reports a higher current value of a security. Consistency in the valuation process will improve the value of the security pricing information. Clients will likely have additional confidence that they were able to make an informed decision about continuing to hold these securities in their portfolios.

## Social Media

Members and candidates must ensure that all communications on social media regarding their professional activities adhere to the requirements of the Code and Standards. The perceived anonymity granted through these platforms may entice individuals to misrepresent their qualifications or abilities or those of their employer. Actions undertaken through social media that knowingly misrepresent investment recommendations or professional activities are violations of Standard I(C).

## Omissions

The omission of a fact or outcome can be misleading, especially in the use of models and technical analysis processes. Members and candidates may rely on such models and processes to look for new investment opportunities, to develop investment vehicles, and to produce investment recommendations and ratings. When inputs are knowingly omitted, the resulting outcomes may provide misleading information to those who rely on information for making investment decisions. Additionally, the outcomes from models must not be presented as fact, because they represent the expected results based on the inputs and analysis process incorporated.

Omissions in the performance measurement and attribution process can also misrepresent a manager's performance and skill. Members and candidates must not misrepresent performance history by engaging in practices that distort past investment performance (e.g., cherry-picking the highest-performing accounts and presenting them as representative of a strategy).

## Plagiarism

Standard I(C) also prohibits plagiarism in the preparation of material for distribution to employers, associates, clients, prospects, or the general public. Plagiarism is defined as copying or using in substantially the same form materials prepared by others without acknowledging the source of the material or identifying the author and publisher of such material. Members and candidates must not copy (or represent as their own) original ideas or material without permission and must acknowledge and identify the source of ideas or material that is not their own.

The investment profession uses a myriad of financial, economic, and statistical data in the investment decision-making process. Through various publications and presentations, the investment professional is constantly exposed to the work of others and to the temptation to use that work without proper acknowledgment.

Misrepresentation through plagiarism in investment management can take various forms. The simplest and most flagrant example is to take a research report or study done by another firm or person, change the names, and release the material as one's own original analysis. This action is a clear violation of Standard I(C). Other practices include (1) using excerpts from articles or reports prepared by others either verbatim or with only slight changes in wording without acknowledgment, (2) citing specific quotations as attributable to "leading analysts" and "investment experts" without naming the specific references, (3) presenting statistical estimates of forecasts prepared by others and identifying the sources but without including the qualifying statements or caveats that may have been used, (4) using charts and graphs without stating their sources, and (5) copying proprietary spreadsheets or algorithms without seeking the cooperation or authorization of their creators.

In the case of distributing third-party, outsourced research, members and candidates may use and distribute these reports as long as they do not represent themselves as the authors of such reports. Indeed, the member or candidate may add value for the client by sifting through research and repackaging it for clients. In such cases, clients should be fully informed that they are paying for the ability of the member or candidate to find the best research from a wide variety of sources. Members and candidates must not misrepresent their abilities, the extent of their expertise, or the extent of their work in a way that would mislead their clients or prospective clients. Members and candidates should disclose whether the research being presented to clients comes from another source, from either within or outside the member's or candidate's firm. Such disclosure allows clients to understand who has the expertise behind the report or whether the work is being done by the analyst, other members of the firm, or an outside party.

The preparation of research reports based on multiple sources of information without acknowledging the sources is a violation of this standard. Examples of information from such sources include ideas, statistical compilations, and forecasts combined to give the appearance of original work. Although there is no monopoly on ideas, members and candidates must give credit where it is clearly due. Sources must be revealed to bring the responsibility directly back to the author of the report or the firm involved.

In some situations, however, members or candidates may use research conducted or models developed by others within the same firm without committing a violation. The most common example relates to the situation in which one (or more) of the original analysts is no longer with the firm. Research and models developed while employed by a firm are the property of the firm. The firm retains the right to continue using the work completed after a member or candidate has left the organization. The firm may issue future reports without providing attribution to the prior analysts. A member or candidate must not, however, reissue a previously released report solely under his or her name.

## Compliance Practices

### Description of Qualifications and Services

Members and candidates can prevent unintentional misrepresentations of the qualifications or services they or their firms provide if each member and candidate understands the limit of the firm's or individual's capabilities and the need to be accurate and complete in presentations. Whether or not their employer provides guidance, members and candidates must make certain that they understand the services the firm performs and its qualifications and disclose that information without misrepresentation. Each member and candidate should prepare a summary of his or her own qualifications and experience and a list of the services the member or candidate is capable of performing.

## Monitor Online Content

Members and candidates should regularly monitor materials and content posted online or through social media to ensure that they contain current information. Members and candidates who publish content through websites should also ensure that all reasonable precautions have been taken to protect the website's integrity, confidentiality, and security and that the website does not misrepresent any information and provides full disclosure.

## Avoiding Plagiarism

To avoid plagiarism in preparing research reports or conclusions of analysis, members and candidates should take the following steps:

- *Maintain copies:* Keep copies of all research reports, articles containing research ideas, material with new statistical methodologies, and other materials that were relied on in preparing the research report.
- *Attribute quotations:* Attribute to their sources any direct quotations, including projections, tables, statistics, model/product ideas, and new methodologies prepared by persons other than recognized financial and statistical reporting services or similar sources.
- *Attribute summaries:* Attribute to their sources any paraphrases or summaries of material prepared by others.

## Application of The Standard

### Example 1 (Representing the Firm's Abilities)

Rogers is a partner at Rogers and Black, a small firm offering investment advisory services. She assures a prospective client who inherited a portfolio worth US\$1 million that "we can perform all the financial and investment services you need." Rogers and Black is well equipped to provide investment advice but, in fact, cannot provide a full array of financial and investment services, such as tax planning.

*Comment:* Rogers violated Standard I(C) by orally misrepresenting the services her firm can perform for the prospective client. Using vague, imprecise, and general language such as "all the financial and investment services you need" oversells and misrepresents the services she and her firm can provide. She must limit herself to describing the range of investment advisory services Rogers and Black can provide and offer to help the client obtain elsewhere the financial and investment services that her firm cannot provide.

## Example 2 (Disclosure of Issuer-Paid Research)

McGuire is an issuer-paid analyst hired by publicly traded companies to electronically promote their stocks. McGuire creates a website that promotes his research efforts as a seemingly independent analyst. McGuire posts a profile and a strong buy recommendation for each company on the website, indicating that the stock is expected to increase in value. He does not disclose the contractual relationships with the companies he covers on his website, in the research reports he issues, or in the statements he makes about the companies in internet chatrooms.

*Comment:* McGuire violated Standard I(C) because the internet site is misleading to potential investors. Even if the recommendations are valid and supported with thorough research, his omissions regarding the true relationship between himself and the companies he covers constitute a misrepresentation. McGuire also violated Standard VI(A) Avoid or Disclose Conflicts, by not disclosing the existence of an arrangement with the companies from which he receives compensation in exchange for his services.

## Example 3 (Correction of Unintentional Errors)

Yao is responsible for the creation and distribution of the marketing materials for his firm, which claims compliance with the GIPS standards. Yao creates and distributes a presentation of performance for the firm's Asian Equity Composite that states the composite has ¥350 billion in assets. In fact, the composite has only ¥35 billion in assets, and the higher figure on the presentation is a result of a typographical error. Nevertheless, the erroneous material is distributed to a number of clients before Yao catches the mistake.

*Comment:* Once the error is discovered, Yao must take steps to cease distribution of the incorrect material and correct the error by informing those who have received the erroneous information. Because Yao did not knowingly make the misrepresentation, however, he did not violate Standard I(C). Since his firm claims compliance with the GIPS standards, he must also comply with the GIPS standards requirements addressing the treatment of material errors.

## Example 4 (Not Correcting Known Errors)

Muhammad is the president of an investment management firm. The promotional material for the firm, created by the firm's marketing department, incorrectly claims that Muhammad has an advanced degree in finance from a prestigious business school in addition to the CFA designation. Although Muhammad attended the school for a short period of time, he did not receive a degree. Over the years, Muhammad and others in the firm have distributed this material to numerous prospective clients and consultants.

*Comment:* Even though Muhammad may not have been directly responsible for the misrepresentation of his credentials in the firm's promotional material, he should have known of the misrepresentation because he used this material numerous times over an extended period, and therefore, he violated Standard I(C). Once Muhammad became aware of the errors in the promotional material, he should have corrected the information. Best practice would be for Muhammad to provide correct information to any recipients of the erroneous material.

### Example 5 (Plagiarism)

Grant, a research analyst for a Canadian brokerage firm, has specialized in the Canadian mining industry for the past 10 years. She recently read an extensive research report on Jefferson Mining, Ltd., by Barton, an analyst at a different firm. Barton provided extensive statistics on the mineral reserves, production capacity, selling rates, and marketing factors affecting Jefferson's operations. He also noted that initial drilling results on a new ore body, which had not been made public, might show the existence of mineral zones that could increase the life of Jefferson's main mines, but Barton cited no specific data as to the initial drilling results. Grant called an officer of Jefferson, who gave her the initial drilling results over the telephone. The data indicated that the expected life of the main mines would be tripled. Grant added these statistics to Barton's report and circulated it as her own report within her firm.

*Comment:* Grant plagiarized Barton's report by reproducing large parts of it in her own report without acknowledgment and, therefore, violated Standard I(C).

### Example 6 (Misrepresentation of Information)

When Marks sells mortgage-backed derivatives called "interest-only strips" (IOs) to public pension plan clients, she describes them as "guaranteed by the US government." Purchasers of the IOs are entitled only to the interest stream generated by the mortgages, however, not the notional principal itself. One particular municipality's investment policies and local law require that securities purchased by its public pension plans be guaranteed by the US government. Although the underlying mortgages are guaranteed, neither the investor's investment nor the interest stream on the IOs is guaranteed. When interest rates decline, causing an increase in prepayment of mortgages, interest payments to the IOs' investors decline, and these investors lose a portion of their investment.

*Comment:* Marks violated Standard I(C) by misrepresenting the terms and character of the investment.

## Example 7 (Potential Information Misrepresentation)

Abdrabbo manages the investments of several high-net-worth individuals in the United States who are approaching retirement. Abdrabbo advises these individuals that a portion of their investments should be moved from equity to bank-sponsored certificates of deposit and money market accounts so that the principal will be “guaranteed” up to a certain amount. The interest is not guaranteed.

*Comment:* Although there is risk that the institution offering the certificates of deposit and money market accounts could go bankrupt, in the United States, these accounts are insured by the US government through the Federal Deposit Insurance Corporation. Therefore, using the term “guaranteed” in this context is appropriate if the amount is within the government-insured limit. Abdrabbo must explain these facts to the clients.

## Example 8 (Plagiarism)

Swanson is a senior analyst in the investment research department of Ballard and Company. Apex Corporation has asked Ballard to assist in acquiring the majority ownership of stock in the Campbell Company, a financial consulting firm, and to prepare a report recommending that stockholders of Campbell agree to the acquisition. Another investment firm, Davis and Company, had already prepared a report for Apex analyzing both Apex and Campbell and recommending an exchange ratio. Apex has given the Davis report to Ballard officers, who have passed it on to Swanson. Swanson reviews the Davis report and other available material on Apex and Campbell. From his analysis, he concludes that the common stocks of Campbell and Apex represent good value at their current prices; he believes, however, that the Davis report does not consider all the factors a Campbell stockholder would need to know to make a decision. Swanson reports his conclusions to the partner in charge, who tells him to “use the Davis report, change a few words, sign your name, and get it out.”

*Comment:* If Swanson does as requested, he will violate Standard I(C). He could refer to those portions of the Davis report that he agrees with if he identifies Davis as the source; he could then add his own analysis and conclusions to the report before signing and distributing it.

## Example 9 (Plagiarism)

Browning, a quantitative analyst for Double Alpha, Inc., is excited after returning from a seminar. In that seminar, Jorrelly, a well-publicized quantitative analyst at a national brokerage firm, discussed one of his new models in great detail, and Browning is intrigued by the new concepts. He proceeds to test the model,

making some minor changes but retaining the concepts, until he produces some very positive results. Browning quickly announces to his supervisors at Double Alpha that he has discovered a new model and that clients and prospective clients should be informed of this positive finding as ongoing proof of Double Alpha's continuing innovation and ability to add value.

*Comment:* Although Browning tested Jorrely's model on his own and even slightly modified it, he must still acknowledge the original source of the idea. Browning can certainly take credit for the final, practical results; he can also support his conclusions with his own test. The credit for the innovative thinking, however, must be given to Jorrely.

### Example 10 (Plagiarism)

Zubia would like to include in his firm's marketing materials some "plain-language" descriptions of various concepts, such as the price-to-earnings (P/E) multiple and why standard deviation is used as a measure of risk. The descriptions come from other sources, but Zubia wishes to use them without reference to the original authors.

*Comment:* Copying verbatim any material without acknowledgment, including plain-language descriptions of the P/E multiple and standard deviation, violates Standard I(C). Even though these concepts are general, best practice would be for Zubia to describe them in his own words or cite the sources from which the descriptions are quoted. Members and candidates would be violating Standard I(C) if they either were responsible for creating marketing materials without attribution or knowingly used plagiarized materials.

### Example 11 (Plagiarism)

Through a mainstream media outlet, Schneider learns about a study that she would like to cite in her research. She questions whether she should cite both the mainstream intermediary source and the author of the study itself when using that information.

*Comment:* In all instances, a member or candidate must cite the actual source of the information. Best practice for Schneider would be to obtain the information directly from the author and review it before citing it in a report. In that case, Schneider would not need to report how she found out about the information. For example, suppose Schneider read in the *Financial Times* about a study issued by CFA Institute; best practice for Schneider would be to obtain a copy of the study from CFA Institute, review it, and then cite it in her report. If she does not use any interpretation of the report from the *Financial Times* and the newspaper does not add value to the report itself, the newspaper is merely a conduit to the original information and does not need to be cited.

If she does not obtain the report and review the information, Schneider runs the risk of relying on second-hand information that may misstate facts. If, for example, the *Financial Times* erroneously reported some information from the original CFA Institute study and Schneider copied that erroneous information, she would be including misinformation in her research. To avoid a potential violation of Standard I(C), Schneider must obtain the complete study from its original author and cite only that author or use the information provided by the intermediary and cite both sources.

### Example 12 (Misrepresentation of Information)

Ostrowski runs a two-person investment management firm. His firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged by smaller firms for those firms' clients. Ostrowski's firm distributes these reports to clients as its own work.

*Comment:* Ostrowski may rely on third-party research that has a reasonable and adequate basis, but he must not imply that he is the author of such research. If he does, Ostrowski is misrepresenting the extent of his work in a way that misleads the firm's clients or prospective clients.

### Example 13 (Misrepresentation of Information)

Stafford is part of a team at Appleton Investment Management responsible for managing a pool of assets for Open Air Bank, which distributes structured securities to offshore clients. He becomes aware that Open Air is promoting the structured securities as a much less risky investment than the investment management policy followed by himself and the team to manage the original pool of assets. Also, Open Air has procured an independent rating for the pool that significantly overstates the quality of the investments. Stafford communicates his concerns to his supervisor, who responds that Open Air owns the product and is responsible for all marketing and distribution. Stafford's supervisor goes on to say that the product is outside the US regulatory regime that Appleton follows and that all risks of the product are disclosed at the bottom of page 184 of the prospectus.

*Comment:* As a member of the investment team, Stafford is qualified to recognize the degree of accuracy of the materials that characterize the portfolio, and he is correct to be concerned about Appleton's responsibility for a misrepresentation of the risks. Stafford must continue to pursue the issue of Open Air's inaccurate promotion with Appleton's compliance personnel and management. Stafford cannot be part of promoting, recommending, or distributing information about securities that he considers misleading without potentially violating Standard I(C).

### Example 14 (Misrepresenting Composite Construction)

Palmer is head of performance for an investment manager. When asked to provide performance numbers to databases, he avoids disclosing that the firm excludes from composites accounts that have underperformed their benchmark. The composite returns reported to the databases, although accurate for the accounts that have not underperformed their benchmark, do not present a true representation of the investment manager's track record.

*Comment:* "Cherry-picking" accounts to include in either published reports or information provided to databases or other external parties conflicts with Standard I(C). Selecting only the best-performing accounts to include in a track record materially misrepresents the firm's composite results. Palmer should work with his firm to strengthen its reporting practices concerning composite construction to avoid misrepresenting the firm's track record or the quality of the information being provided.

### Example 15 (Presenting Out-of-Date Information)

Finch is a sales director at a commercial bank, where he directs the bank's client advisers in the sale of third-party mutual funds. Each quarter, he holds a division-wide training session where he provides fact sheets on investment funds the bank is allowed to offer to clients. These fact sheets, which can be redistributed to clients, are created by the mutual fund firms and contain information about the funds, including investment strategy and target distribution rates.

Finch knows that some of the fact sheets are out of date; for example, one long-only fund approved the use of significant leverage last quarter as a method to enhance returns. He continues to provide the sheets to the sales team without updates because the bank has no control over the marketing material released by the mutual fund firms.

*Comment:* Finch is violating Standard I(C) by providing information that misrepresents aspects of the funds. By not providing the sales team and, ultimately, the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets. Finch must instruct the sales team to clarify the deficiencies in the fact sheets with clients and ensure they have the most recent fund documents before accepting orders for investing in any fund.

### Example 16 (Overstating ESG Claims)

Lowery manages the Majesty Fund, which was established in 2018 and has become one of the leading Asian environmental, social, and governance (ESG) funds. The fund's mandate is to seek sustainable wealth creation. Lowery uses ESG scores provided by third-party rating organizations to assess potential

investments for the fund. The fund declares in promotional material and client agreements that it engages in proactive engagement and proxy voting for companies owned by the fund to create sustainable growth. However, Lowery has done neither of these activities. As a result, the fund has never published its detailed engagement reports that include its engagement strategy and its outcomes. Moreover, there has been no clear communication by the fund regarding its proxy voting and its consequences.

*Comment:* A firm that describes one of its funds as considering ESG factors must clearly describe what that means and not overstate the sustainability, social impact, or governance credentials of the fund. By stating that the fund would conduct proactive engagement with management and proxy voting for companies owned by the fund in order to create sustainable growth and failing to do so, Lowery misrepresented the fund and failed to meet Standard I(C).

### Example 17 (Misleading Description of Services)

For many years, Stafford was a partner at Lionsgate LLP, a large, full-service accounting firm that provides audit and other services, primarily in the area of investment performance. She leaves Lionsgate, with a junior associate, to form her own firm, Angelwood Analytics. Angelwood's website, social media, and print marketing heavily emphasize Stafford's expertise and experience and state that Stafford will be personally involved in all client work. Angelwood's clients are small at first, but eventually Stafford attracts several large clients. To service these larger clients, she transitions to an oversight role and hires new staff to work with her longtime clients. Business becomes so successful that Stafford resorts to hiring third-party contractors that eventually provide support for over 50% of Angelwood's work. The staff she uses are qualified, industry practice allows use of third-party contractors for the work, and Angelwood's client agreement states that staffing decisions for each client are discretionary for the firm.

*Comment:* Stafford violated Standard I(C) since her communications were not accurate and complete given the circumstances. Stafford, through her firm, did not accurately describe how her firm was staffed to perform the services that she promoted. While stating that clients could expect her knowledge and expertise, Stafford increasingly relied on junior employees and third-party staffers. While this was acceptable, she did not give a complete picture of how Angelwood will be providing investment services for clients when promoting the firm.

### Example 18 (Inaccurate, Dated Performance History)

For the past two decades, Huggins has managed an investment advisory firm catering to retail clients and high-net-worth individuals. Overall, the investment performance history of the firm for the past five years has been satisfactory, but since the onset of the global pandemic, performance has dropped appreciably.

On the firm's website, Huggins provides the five-year performance history of the fund as a way to convince potential clients to hire his firm for advisory services. He does not update the information on the website to clarify that the performance history since the beginning of the pandemic has been less than stellar, even though that information is available.

*Comment:* Huggins violated Standard I(C) by not providing accurate and timely information as part of his marketing to potential clients.

### Example 19 (Insufficient, Omitted Information)

Hamilton is a research analyst for a private equity fund focused on impact investing in the ESG space. Hamilton creates several research reports to distribute to potential investors that generally demonstrate and describe the process the fund goes through when choosing ESG investments. The reports for potential investors are not as detailed as the research reports provided to investors once they commit to investing in the fund. After committing US\$50 million to the fund, one investor, a charitable foundation, receives the more detailed reports. The chief investment officer of the foundation is unhappy that the private equity fund seems overweighted in developing technology and therefore represents a riskier investment than was indicated by the more general information initially provided by Hamilton.

*Comment:* The information provided by members and candidates when meeting their responsibilities under Standard I(C) must be appropriate for the circumstances. In some circumstances, it may be appropriate to limit the information provided to potential investors, who are not yet clients, while providing more detailed disclosures and information about the investment process to those who have already entered into a client relationship. However, limiting information cannot rise to the level of misrepresenting the nature or risks of the investment. In this case, Hamilton appears to have provided only limited information about the extent to which the fund is invested in developing technology and therefore violated Standard I(C) by improperly misrepresenting the true level of risk of the investment.

### Example 20 (Misleading Description of Service, Misrepresenting Knowledge)

The sovereign wealth fund of a developing country is seeking an investment manager to manage a portion of the fund's assets. The fund's directors want to take advantage of the efficiencies, innovation, and increased profitability they believe are available through the use of artificial intelligence (AI) tools in the investment process. As such, they include several questions on the use of artificial intelligence on the request for proposal (RFP) sent out to potential managers. Al-Wazir, CEO of AWZ Investment Advisers, is intent on being competitive in the fund's manager search, even though his firm is just beginning

to explore AI to enhance investment performance. Wanting to provide a seemingly thorough and knowledgeable answer, he uses ChatGPT to complete the portion of the RFP asking for a narrative of how each responding manager incorporates AI in its investment process.

*Comment:* Al-Wazir violated Standard I(C) by misrepresenting his firm's capabilities relating to AI in its investment process and using ChatGPT to respond to the RFP to hide his superficial knowledge of the topic and seem more knowledgeable than he is.

## Standard I(D) Misconduct

Members and Candidates 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.

### Guidance

Standard I(D) addresses *all* professional conduct that reflects poorly on the reputation, integrity, or competence of members and candidates. Any act that involves lying, cheating, stealing, or other dishonest conduct is a violation of this standard if the offense reflects adversely on a member's or candidate's professional activities. Although CFA Institute discourages any sort of unethical behavior by members and candidates, the Code and Standards are applicable to conduct or activities related to a member's or candidate's professional responsibilities—the obligations and duties members and candidates must fulfill as part of their work.

The terms “professional activities” and “professional conduct” appear in the Code and Standards. For the purposes of the Code and Standards, engaging in “professional activities” is synonymous with “professional conduct.” A professional activity is any activity or conduct that relates to financial analysis, investment management, security analysis, stewardship, or other similar professional endeavors and either (1) involves activity or conduct in the workplace or academia or participation in the investment profession or security markets or (2) explicitly or implicitly encompasses the use of the CFA charter or CIPM designation, membership in CFA Institute or CFA Institute local societies, or candidacy for a designation sponsored by CFA Institute.

Whether an action or incident is related to an individual's professional activities or professional conduct depends on the specific facts and circumstances. Examples of conduct by members and candidates that are considered professional activities under this standard include—*but are not limited to*—the following:

- Interactions with colleagues, employees, or clients in the workplace or academia or when participating in the investment profession
- Activities in which a member or candidate represents to others that he or she is a CFA charterholder, a candidate for a designation sponsored by CFA Institute, or a CFA Institute member
- Conduct while working as an unpaid officer, representative, or volunteer with CFA Institute or a local society

- Conduct while attending or participating in a CFA Institute, local society, or industry-related meeting, course, conference, or event
- Writing about investments or the markets in articles, books, reports, message boards, or blogs outside the workplace or academia
- Communicating with a government agency, regulator, or other professional organization regarding information within the scope of the member's or candidate's professional responsibilities related to the investment profession

Conduct that damages trustworthiness or competence includes behavior that, although not illegal, negatively affects a member's or candidate's ability to perform his or her responsibilities. For example, abusing alcohol during business hours might constitute a violation of this standard because it could have a detrimental effect on the member's or candidate's ability to fulfill his or her professional responsibilities. Personal bankruptcy may not reflect on the integrity or trustworthiness of the person declaring bankruptcy, but if the circumstances of the bankruptcy involve fraudulent or deceitful business conduct, the bankruptcy may be a violation of this standard.

Individuals may attempt to abuse the CFA Institute Professional Conduct Program by actively seeking CFA Institute enforcement of the Code and Standards and, in particular, Standard I(D) as a method of settling personal, political, or other disputes unrelated to professional ethics. CFA Institute is aware of this issue, and appropriate disciplinary policies, procedures, and enforcement mechanisms are in place to address misuse of the Code and Standards and the Professional Conduct Program in this way.

## Compliance Practices

In addition to ensuring that their own behavior is consistent with Standard I(D), to prevent general misconduct, members and candidates should encourage their firms to adopt a code of ethics to which every employee must subscribe and to make clear that any personal behavior that reflects poorly on the individual involved, the institution as a whole, or the investment industry will not be tolerated.

## Application of the Standard

### Example 1 (Professionalism and Competence)

Sasserman is a trust investment officer at a bank in a small, affluent town. He enjoys lunching every day with friends at the country club, where his clients have observed him having numerous drinks. Back at work after lunch, he clearly is intoxicated while making investment decisions. His colleagues make a point of handling any business with Sasserman in the morning because they distrust his judgment after lunch.

*Comment:* Sasserma’s excessive drinking at lunch and subsequent intoxication at work constitute a violation of Standard I(D) because this conduct has raised questions about his professionalism and competence. His behavior reflects poorly on him, his employer, and the investment industry.

### Example 2 (Fraud and Deceit)

Hoffman, a security analyst at ATZ Brothers, Inc., a large brokerage house, submits reimbursement forms over a two-year period to ATZ’s self-funded health insurance program for more than two dozen bills, most of which have been altered to increase the amount due. An investigation by the firm’s director of employee benefits uncovers the inappropriate conduct. ATZ subsequently terminates Hoffman’s employment and notifies CFA Institute.

*Comment:* Hoffman violated Standard I(D) because he engaged in intentional conduct involving fraud and deceit in the workplace that adversely reflected on his integrity.

### Example 3 (Fraud and Deceit)

Brink, an analyst covering the automotive industry, is CEO of a very successful boutique investment research firm. Because she is a prominent member of the community and a CFA charterholder with years of experience in the investment industry, several local charities ask Brink to sit on their board, and she does so as a volunteer. The board of one of the charitable institutions for which Brink serves on the board decides to buy five new vans to deliver hot lunches to low-income elderly people. Brink offers to handle purchasing agreements. To pay a long-standing debt to a friend who operates an automobile dealership—and to compensate herself for her trouble—she agrees to a price 20% higher than normal and splits the surcharge with her friend.

*Comment:* Brink’s volunteer work for the board of the charitable organization is a professional activity for the purposes of this standard since she serves on the board because of her status as an experienced investment analyst and CFA charterholder. Brink engaged in misconduct involving dishonesty, fraud, and misrepresentation and violated Standard I(D).

### Example 4 (Personal Actions and Integrity)

Garcia manages a mutual fund dedicated to socially responsible investing. She is also an environmental activist. As a result of her participation in nonviolent protests, Garcia has been arrested on numerous occasions for trespassing on the property of a large petrochemical plant that is accused of damaging the environment.

*Comment:* Generally, Standard I(D) is not meant to cover legal transgressions resulting from acts of civil disobedience in support of personal beliefs, because such conduct does not reflect poorly on the member's or candidate's professional reputation, integrity, or competence.

### Example 5 (Misconduct as a CFA Institute Society Volunteer)

O'Hara volunteers at his local society as an instructor at the society's CFA exam review course for local candidates in the CFA Program. O'Hara engages in inappropriate behavior with several female candidates that includes making suggestive remarks, unwanted touching, and repeatedly asking candidates out on dates despite being rebuffed by them.

*Comment:* O'Hara is in violation of Standard I(D) by engaging in sexual harassment that reflects poorly on his professional reputation and integrity. Although the actions do not take place in the workplace, O'Hara's actions are professional conduct within the meaning of the Code and Standards because the conduct takes place as part of his work with the local society and encompasses the use of his charter and membership in the organization.

### Example 6 (Identification as a CFA Charterholder)

Nehjer recently retired from a successful career as an economist for an investment adviser to live at her country estate. She maintains active CFA Institute membership with the organization and the local society. A multinational firm has announced its intention to open a large casino within 5 km of her estate. Local officials are balancing the positive economic impact of the casino with the negative effects it will have on the character of the community. Nehjer and her neighbors strenuously object to the casino. She publishes an open letter stating that studies have shown that the positive economic impact of gambling venues is widely overblown. She cites a number of statistics in her letter that she fabricated or altered to help make her point. She signs her name to the letter, indicating that she has a PhD and is a CFA charterholder.

*Comment:* By engaging in fraud, dishonesty, and deceit in using fabricated and altered statistics in an effort to support her opinion on the casino issue, Nehjer engaged in misconduct and violated Standard I(D). Although she is retired, her actions in this case are professional conduct within the meaning of the standard because she identified herself as a CFA charterholder and explicitly used her charter in an attempt to give her analysis and opinions more credibility.

## Example 7 (Writing about Investments Outside the Workplace or Academia)

Mewis is an analyst for an investment advisory firm and a candidate for the CFA designation. She has a strong interest in environmental protection and combatting climate change. She starts a blog in which she provides analysis of investment opportunities and makes stock picks for companies based on her evaluation of their environmental, social, and governance (ESG) factors. Her work with her employer is unrelated to ESG analysis, and her employer gives permission for her to create the blog if her ESG-related work is done on her own time and she does not identify herself as an analyst for the firm. In one of her blog posts, Mewis severely criticizes JKL company for causing substantial harm to the environment in its manufacturing process and having incompetent management. She posts on her blog that the company is likely soon to be the subject of regulatory action and private litigation that will greatly affect JKL's profitability. Mewis has no knowledge that any of this is true but seeks to damage the company because of a personal dispute with her ex-husband, the CEO of the company.

*Comment:* Mewis violated Standard I(D) by engaging in dishonesty, fraud, and deceit and in conduct that reflects adversely on her professional reputation and integrity. Although her actions are not related to her employment with the investment adviser, her conduct relates to the candidate's involvement in the investment profession and security markets.

## Example 8 (Actions Unrelated to Professional Conduct)

Tan is a candidate for the CFA designation and a junior analyst working in the downtown office of his employer, QRS Advisers. Because parking is extremely limited, most QRS employees commute to the company offices using public transportation. Tan wants the convenience of driving his own personal vehicle to work. He submits false documentation to government officials indicating that he has health issues that make him eligible for a disabled person parking permit. The government issues his permit, and he regularly drives to work and parks at one of the "disabled person only" spots near his office.

*Comment:* While Tan's actions involve dishonesty, fraud, deceit, and lying to government officials, his actions do not fall within the definition of professional conduct for the purposes of application of the Code and Standards. His conduct is, at most, tangential to his employment and does not implicate his participation in the CFA Program or any other affiliation with CFA Institute. As a result, while his conduct is deplorable, it is not "professional" conduct to which the Code and Standards apply.

## Example 9 (Actions Unrelated to Professional Conduct)

Mondelo is a well-known security analyst, as well as a devoted follower of a national politician running for high public office. Prior to the election, Mondelo volunteers extensively for this politician. After election day, the opponent of Mondelo's candidate is declared the winner. The candidate whom Mondelo supports claims that widespread election fraud took place and urges his followers to demonstrate against the election at the nation's capital on the day his opponent is to be sworn into office. Thousands of followers, including Mondelo, follow the candidate's direction and join the protest. A large number of demonstrators engage in violence and vandalism of government offices. During their investigation of the criminal activity, law enforcement officials interview Mondelo. He denies engaging in violence or vandalism. However, security cameras and the cell phone videos of other protesters that are posted on social media capture Mondelo fighting with police, setting fire to vehicles, and yelling racial slurs at supporters of the newly elected candidate. Mondelo's subsequent arrest makes national news because of his prominence in the investment industry, and he is fired from his job.

*Comment:* Mondelo's violent actions during the protest and lying to government investigators about his actions involve dishonesty and deceit and call into question his integrity and character. However, although he is fired from his job, the activity is not related to his employment or his participation in the investment profession and is unrelated to his charter or any affiliation with CFA Institute. As a result, his activities related to this event do not amount to professional conduct within the meaning of the Code and Standards and are, therefore, not covered by Standard I(D).

Should Mondelo be convicted of a crime that is punishable by more than one year in prison for any actions, including those that arise out of his conduct at the election protest, he could be summarily suspended from CFA Institute under the Rules of Procedure for Conduct Related to the Profession (as amended and restated 1 January 2022).

## Standard I(E) Competence

Members and Candidates must act with and maintain the competence necessary to fulfill their professional responsibilities.

### Guidance

Standard I(E) requires members and candidates to act with and maintain appropriate knowledge, skills, and diligence when they carry out their professional responsibilities so that they provide a high standard of professional service for their clients and employers. The Code of Ethics requires members and candidates to “act with integrity, competence, and diligence” and to “maintain and improve their professional competence and strive to improve the competence of other investment professionals.” Standard I(E) directly supports these requirements of the Code of Ethics.

Given the diverse range of professional services members and candidates engage in, the knowledge, skills, and abilities necessary to successfully fulfill their roles will vary according to the nature of their professional duties. Determining what conduct specifically constitutes competence will differ for each role and will depend on the facts and circumstances applicable to each member or candidate.

While the specific conduct that leads to competence may be different for each member or candidate, the underlying principle of competence is straightforward. To be competent in your role and meet your duties under this standard means having sufficient knowledge, skills, and abilities suitable for a professional to work in that specific role with success. These attributes govern the expertise, experience, and accomplishments that professionals need to perform at the highest level.

- Knowledge is the body of information applied directly to the performance of a function and how effectively it is applied.
- Skills are capabilities to perform a role-specific act or function to complete specific tasks and achieve professional goals.
- Abilities are capabilities and attitudes that support behaviors that result in observable outcomes.

While competence allows members and candidates the opportunity to undertake an activity successfully, lack of competence cannot necessarily be determined by an unsuccessful or a negative outcome. Many competent investment professionals have experienced failure or loss in their professional

lives. For example, a competent investment manager may not always make profitable investment decisions. A competent securities analyst may not accurately predict the future prospects of an investment, despite diligent and thorough analysis.

Competence is not limited to an examination of the education level of a member or candidate. A highly educated investment consultant may not have the experience to undertake consulting activities in an unfamiliar area of practice. An accounting professional supremely competent in providing financial statement audits may not be competent in assessing compliance with performance presentation standards, such as the GIPS standards. Or an investment consultant hired to conduct a search for an investment manager focused on sustainable investing may not have the skills needed to competently evaluate managers with that focus.

Over time, the professional responsibilities of members and candidates may change or expand, requiring new or different knowledge, skills, and abilities. Members and candidates will develop and refine their skills and abilities as their careers progress. Standard I(E) imposes the duty to not simply achieve but also maintain competence, emphasizing the need for members to continuously maintain or improve the competence required of their professional position. Although Standard I(E) contemplates ongoing professional development to maintain proficiency and competence, this standard does not mandate participation in a particular continuing education program or professional development plan. Members and candidates can attain and maintain the competence needed to fulfill their professional responsibilities in a variety of ways.

## Compliance Practices

To achieve and maintain competence, members and candidates should consider the following activities:

- Regularly engaging in a professional development or continuing education program
- Studying for or earning professional certifications or designations
- Attending conferences, seminars, or webinars
- Regularly participating in training offered by their employer
- Diligently engaging in informal continuing education or self-study, such as through outside reading of subject matter articles, treatises, and publications
- Participating in expert groups or organizations
- Becoming proficient with any new skill or knowledge, as necessary, when their professional responsibilities change

## Application of the Standard

### Example 1 (Maintaining Competence)

Lee runs a geopolitical consulting firm where she analyzes international political, social, and economic issues and developments to produce research reports for her clients, many of which are investment management firms. Lee has been closely monitoring news regarding a new multinational trade deal that has the potential to significantly boost commercial activity among countries in a certain region of the world. As soon as the trade deal was officially ratified and announced, she quickly downloaded a copy of the agreement and read it to understand its terms and impact. She also consulted with experts in the field to obtain their opinions on the impacts of the trade deal and confirm her understanding of its terms and implications.

*Comment:* Lee satisfied the requirement of Standard I(E). Lee was able to write a knowledgeable and informative research report for her clients by keeping abreast of developments in her field through news reports, consulting with experts, and studying the trade deal itself to ensure that her knowledge was up to date.

### Example 2 (Improving Competence)

Choe is the director of research at a large sell-side firm. Several of Choe's clients asked her to incorporate environmental, social, and governance (ESG) ratings into the research reports the firm produces. Until now, the firm's research reports have been based only on traditional quantitative metrics. Choe hires an experienced ESG analyst for her team, and she requires all research analysts, including herself, to attend ESG-focused seminars and obtain an ESG investment specialist certificate. In due time, Choe and her team begin to incorporate ESG considerations into their research reports.

*Comment:* Choe extended her competence in her field by educating herself on new considerations relevant to her industry and by hiring someone with ESG expertise to fill a knowledge and skills gap before she and her team incorporated ESG considerations into the firm's research reports. As such, Choe satisfied the requirement of Standard I(E).

### Example 3 (Change in Role)

Glusker is a regulatory attorney for a hedge fund who sought to transition to a sales role after impressing senior management with his strong business acumen. There is a licensing requirement involving an examination that an individual must first pass before being qualified to serve in a sales function. Among other things, the examination covers technical rules and regulations designed to ensure fairness when dealing with clients and prospects. Glusker was not familiar with these rules and regulations because he was never asked

to provide guidance on them as a regulatory attorney. Glusker did not learn the material or study for the examination and instead relied on his industry knowledge to receive a passing score.

*Comment:* Glusker failed to satisfy the requirement of Standard I(E). He did receive a passing score on a licensing examination, but passing the examination, by itself, is not adequate to demonstrate competency. Glusker's failure to learn the applicable rules and regulations relating to fairness when dealing with clients and prospects means that he does not possess the required knowledge to serve in his new role, despite passing the licensing examination.

#### Example 4 (Supervisory Responsibility)

Evans is one member of a five-person team of analysts at a boutique research firm providing independent research to buy-side firms. Evans primarily covers the energy and transportation sectors. Evans's boss leaves the firm to return to academia. Firm management promotes Evans to director of research and hires two junior analysts to replace her. Evans now has supervisory responsibility for four analysts and is responsible for all research produced by the firm. Prior to her promotion date, Evans spends a great deal of time and effort getting up to speed on the research projects of the firm that she was not involved in. Although she has never directly managed others in the past, Evans does not spend any time becoming familiar with effectively managing employees, leading teams, or compliance requirements relating to subordinates.

*Comment:* Evans violated Standard I(E). Her new position demands competence in other skills, abilities, and knowledge beyond those needed for her previous position. Evans must ensure she extends her competence to cover all responsibilities of her new role. She also must now obtain the skills and knowledge needed for fulfilling her supervisory responsibility of the other analysts. This could include attending conferences or taking professional development courses on management, earning compliance credentials, and internal training on supervisory responsibility.

#### Example 5 (Choosing Investments)

Mifune is a financial planner for over 150 retail investors. Based on the investment objectives, financial circumstances, and risk tolerance of 40 of his clients, he suggests they purchase life insurance products from Vouchsafe Insurance Company. Mifune researched Vouchsafe and recommended it because it has a high credit rating, strong financials, and a decade-long history of providing affordable, safe insurance products. Within 18 months, as the result of previously unknown financial impropriety and fraud by the company's chief financial officer, Vouchsafe goes bankrupt and the insurance contracts for thousands of policyholders become worthless. Mifune's clients claim that he was incompetent in recommending the Vouchsafe policies.

*Comment:* Assuming that Mifune's research of Vouchsafe was thorough and appropriate, his failure to uncover the fraudulent practices of the company he recommended, which had misled the investment industry as a whole, does not, by itself, indicate that Mifune is an incompetent financial planner or violated Standard I(E).

### Example 6 (Understanding New Investment Products)

Halsey is a portfolio manager for a number of high-net-worth individuals. Several of his clients are impressed by the significant gains in a short time frame that they believe can be achieved by investing in cryptocurrency. They urge Halsey to include cryptocurrency products as part of their portfolios. Although Halsey is generally aware of cryptocurrency and has read several articles about the cryptocurrency investment trend in reputable newspapers, Halsey is unfamiliar with the nature of the asset or the difference between the many cryptocurrency products. Not wanting to seem out of touch with current developments in the market, lose clients, or miss out on a hot market trend by delaying an investment decision until he completes research into the asset, Halsey purchases a cryptocurrency product that has been heavily promoted through social media and online advertising for several of his clients.

*Comment:* Given his limited knowledge, Halsey is not competent to invest in cryptocurrency for his clients. By hastily investing in cryptocurrency products without understanding the nature of the investment or the suitability of the investment for his clients, Halsey violated Standard I(E).

# STANDARD II: INTEGRITY OF CAPITAL MARKETS

## Standard II(A) Material Nonpublic Information

Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

### Guidance

Trading or inducing others to trade on material nonpublic information erodes confidence in capital markets, institutions, and investment professionals by supporting the idea that those with inside information and special access can take unfair advantage of the general investing public. Although trading on inside information may lead to short-term profits, in the long run, individuals and the profession as a whole suffer from such trading. These actions have caused and will continue to cause investors to avoid capital markets because the markets are perceived to be “rigged” in favor of the knowledgeable insider. When the investing public avoids capital markets, the markets and capital allocation become less efficient and less supportive of strong and vibrant economies. Standard II(A) promotes and allows for a high level of confidence in market integrity, which is one of the foundations of the investment profession.

The prohibition on using this information goes beyond the direct buying and selling of individual securities or bonds. Members and candidates must not use material nonpublic information to influence their investment actions related to derivatives, mutual funds, or other alternative investments. *Any* trading based on material nonpublic information constitutes a violation of Standard II(A).

### What Is “Material” Information?

Information is “material” if its disclosure is likely to have an impact on the price of a security or if reasonable investors would want to know the information before making an investment decision. In other words, information is material if it would significantly alter the total mix of information currently available about a security in such a way that the price of the security would be affected.

The specificity of the information, the extent of its difference from public information, its nature, and its reliability are key factors in determining whether a particular piece of information fits the definition of material. For example,

material information may include, but is not limited to, information on the following:

- earnings;
- mergers, acquisitions, tender offers, or joint ventures;
- changes in assets or asset quality;
- innovative products, processes, or discoveries (e.g., new product trials or research efforts);
- new licenses, patents, registered trademarks, or regulatory approval/rejection of a product;
- developments regarding customers or suppliers (e.g., the acquisition or loss of a contract);
- changes in management;
- change in auditor notification or the fact that the issuer may no longer rely on an auditor's report or qualified opinion;
- events regarding the issuer's securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits, changes in dividends, changes to the rights of security holders, and public or private sales of additional securities);
- bankruptcies;
- significant legal disputes;
- government reports of economic trends (employment, housing starts, currency information, etc.);
- orders for large trades before they are executed; and
- new or changing equity or debt ratings issued by a third party (e.g., sell-side recommendations and credit ratings).

In addition to the substance and specificity of the information, the source or relative reliability of the information also determines materiality. The less reliable a source, the less likely the information provided would be considered material. For example, factual information from a corporate insider regarding a significant new contract for a company is likely to be material, whereas an assumption based on speculation by a competitor about the same contract is likely to be less reliable and, therefore, not material. Additionally, information about trials of a new drug, product, or service under development from qualified personnel involved in the trials is likely to be material, whereas educated conjecture by subject experts not connected to the trials is unlikely to be material.

Also, the more ambiguous the effect of the information on price, the less material that information is considered. If it is unclear whether and to what

extent the information will affect the price of a security, the information may not be considered material. The passage of time may also render information that was once important immaterial.

## What Constitutes “Nonpublic” Information?

Information is “nonpublic” until it has been disseminated or is available to the marketplace in general (as opposed to a select group of investors). “Disseminated” can be defined as “made known.” For example, a company report of profits that is posted on the internet and distributed widely through a press release or accompanied by a filing has been effectively disseminated to the marketplace. Members and candidates must have a reasonable expectation that people have received the information before it can be considered public. It is not necessary, however, to wait for the slowest method of delivery. Once the information is disseminated to the market, it is public information that is no longer covered by this standard.

Members and candidates must be particularly aware of information that is selectively disclosed by corporations to a small group of investors, analysts, or other market participants. Information that is made available to analysts remains nonpublic until it is made available to investors in general. Corporations that disclose information on a limited basis create the potential for insider-trading violations.

Issues of selective disclosure may arise when a corporate insider provides material information to analysts in a briefing or conference call before that information is released to the public. Analysts must be aware that a disclosure made to a room full of analysts does not necessarily make the disclosed information “public.” Analysts should also be alert to the possibility that they are selectively receiving material nonpublic information when a company provides them with guidance or interpretation of such publicly available information as financial statements or regulatory filings.

A member or candidate may use insider information provided legitimately by the source company for the specific purpose of conducting due diligence according to the business agreement between the parties for such activities as mergers, loan underwriting, credit ratings, and offering engagements. In such instances, the investment professional would not be considered in violation of Standard II(A) by using the material information. However, the use of insider information provided by the source company for other purposes, especially to trade or entice others to trade the securities of the firm, is a violation of this standard.

## Mosaic Theory

A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for

investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the “mosaic theory,” financial analysts are free to act on this collection, or mosaic, of information without risking violation.

The practice of financial analysis depends on the free flow of information. For the fair and efficient operation of the capital markets, analysts and investors must have the greatest amount of information possible to facilitate making well-informed investment decisions about how and where to invest capital. Accurate, timely, and intelligible communication is essential if analysts and investors are to obtain the data needed to make informed decisions about how and where to invest capital. These disclosures must go beyond the information mandated by the reporting requirements of the securities laws and should include specific business information about items used to guide a company’s future growth, such as new products, capital projects, and the competitive environment. Analysts seek and use such information to compare investment alternatives.

Much of the information used by analysts comes directly from companies. Analysts often receive such information through contacts with corporate insiders, especially investor relations staff and financial officers. Information may be disseminated in the form of press releases, through oral presentations by company executives in analysts’ meetings or conference calls, or during analysts’ visits to company premises. In seeking to develop the most accurate and complete picture of a company, analysts reach beyond contacts with companies themselves and collect information from other sources, such as customers, contractors, suppliers, and the companies’ competitors.

Analysts formulate opinions and insights that are not obvious to the general investing public about the attractiveness of particular securities. In the course of their work, analysts actively seek out corporate information not generally known to the market for the express purpose of analyzing that information, forming an opinion on its significance, and informing their clients, who can be expected to trade based on the recommendation. Analysts’ initiatives to discover and analyze information and communicate their findings to their clients significantly enhance market efficiency, thus benefiting all investors. Accordingly, violations of Standard II(A) will *not* result when a perceptive analyst reaches a conclusion about a corporate action or event through an analysis of public information and items of nonmaterial nonpublic information.

Investment professionals should note, however, that although analysts are free to use mosaic information in their research reports, they should save and document all their research. Evidence of the analyst’s knowledge of public and nonmaterial nonpublic information about a corporation strengthens the assertion that the analyst reached his or her conclusions solely through appropriate methods rather than through using material nonpublic information.

## Social Media

The continuous advancement in technology allows members, candidates, and the industry at large to exchange information with increasing speed and efficiency. Members and candidates may use social media platforms to communicate with clients or investors without conflicting with this standard. If the information reaches all clients or is available to the investing public, the use of social media is comparable to other forms of communication.

However, it is important for investment professionals to understand the implications of using information from the internet and social media platforms because all such information may not actually be considered public. Some social media platforms require membership in specific groups to access the published content. Members and candidates participating in groups with membership limitations should verify that material information obtained from these sources can also be accessed from a source that would be considered available to the public before using that information.

## Using Industry Experts

Members and candidates may engage with outside experts for insights into the complexities of some industries. Businesses have formed to connect analysts and investors with individuals who have specialized knowledge of their industry (e.g., technology or pharmaceuticals). These networks offer investors the opportunity to reach beyond their usual business circles to speak with experts regarding economic conditions, industry trends, and technical issues relating to specific products and services.

Members and candidates may provide compensation to individuals for their insights without violating this standard. However, members and candidates are ultimately responsible for ensuring that they are not requesting or acting on confidential information received from external experts, which may violate security regulations and would violate this standard.

Firms connecting experts with members or candidates often require both parties to sign agreements concerning the disclosure of material nonpublic information. Even with the protections from such compliance practices, if an expert provides material nonpublic information, members and candidates are prohibited from taking investment actions using this information until the information becomes publicly known to the market.

## Investment Research Reports

When a particularly well-known or respected analyst issues a report or makes changes to his or her recommendation, that information alone may influence the market and thus may be considered material. The analyst is not a company insider, however, and does not have access to inside information. Presumably, the analyst created the report from information available to the public

(mosaic theory) and by using his or her expertise to interpret the information. The analyst's hard work, paid for by the client, generated the conclusions.

Simply because the public in general would find the conclusions material does not require that the analyst make his or her work public. Investors who are not clients of the analyst can either do the work themselves or become clients of the analyst to gain access to the analyst's expertise.

## Compliance Practices

### Achieve Public Dissemination

If a member or candidate obtains material nonpublic information, the member or candidate should make reasonable efforts to achieve public dissemination of the information. These efforts usually entail encouraging the issuing company to make the information public. If public dissemination is not possible, the member or candidate must communicate the information only to the designated supervisory and compliance personnel within the member's or candidate's firm and must not take investment action or alter current investment recommendations based on the information. Moreover, members and candidates must not knowingly engage in any conduct that may induce company insiders to privately disclose material nonpublic information.

### Adopt Compliance Procedures

Members and candidates must comply with all compliance procedures adopted by their employer to prevent the misuse of material nonpublic information. Such procedures might address such areas as the review of employee and proprietary trading, the review of investment recommendations, the supervision of interdepartmental communications in multiservice firms, and informing compliance personnel of suspected inappropriate use of material nonpublic information.

### Issue Press Releases

Members and candidates should encourage companies they follow to issue press releases prior to analyst meetings and conference calls and to script those meetings and calls to decrease the chance that further information will be disclosed. If material nonpublic information is disclosed for the first time in an analyst meeting or call, members and candidates should encourage the company to promptly issue a press release or otherwise make the information publicly available.

### Comply with Firewall Restrictions and Procedures

Members and candidates must adhere to any firewall restrictions adopted by their firm.

An information barrier commonly referred to as a “firewall” is the most widely used approach for preventing the communication of material nonpublic information within firms. It restricts the flow of confidential information to those who need to know the information to perform their jobs effectively. Elements of such a system include, but are not limited to, the following:

- substantial control of relevant interdepartmental communications, preferably through a clearance area within the firm in either the compliance or legal department;
- review of employee trading through the maintenance of “watch,” “restricted,” and “rumor” lists;
- documentation of the procedures designed to limit the flow of information between departments and of the actions taken to enforce those procedures; and
- heightened review or restriction of proprietary trading while a firm is in possession of material nonpublic information.

There should be no overlap of personnel between the investment banking and corporate finance areas of a brokerage firm and the sales and research departments or between a bank’s commercial lending department and its trust and research departments. For a firewall to be effective in a multiservice firm, an employee should be on only one side of the firewall at any time. Inside knowledge may not be limited to information about a specific offering or the current financial condition of a company. Analysts may be exposed to much information about the company, including new product developments or future budget projections that clearly constitute inside knowledge and thus preclude the analyst from returning to his or her research function. For example, an analyst who follows a particular company may provide limited assistance to the investment bankers under carefully controlled circumstances when the firm’s investment banking department is involved in a deal with the company. That analyst must then be treated as though he or she were an investment banker; the analyst must remain on the investment banking side of the wall until any information he or she learns is publicly disclosed. In short, the analyst cannot use any information learned in the course of the project for research purposes and cannot share that information with colleagues in the research department.

A primary objective of an effective firewall procedure is to establish a reporting system in which authorized people review and approve communications between departments. If an employee behind a firewall believes that he or she needs to share confidential information with someone on the other side of the firewall, the employee should consult a designated compliance officer to determine whether sharing the information is necessary and how much information should be shared. If the sharing is necessary, the compliance officer should coordinate the process of “looking over the wall” so that the necessary information will be shared and the integrity of the procedure will be maintained.

## Comply with Personal Trading Limitations

Members and candidates must comply with their employers' restrictions or prohibitions on personal trading by employees. Such practices may include firm monitoring of personal trading, mandating periodic reports of personal transactions, and implementing a restricted list and watch list of companies.

## Application of the Standard

### Example 1 (Acting on Nonpublic Information)

Barnes, the president and controlling shareholder of the SmartTown clothing chain, decides to accept a tender offer and sell the family business at a price almost double the market price of its shares. He describes this decision to his sister (SmartTown's treasurer), who conveys it to her daughter (who owns no stock in the family company at present), who tells her husband, Staple. Staple, however, tells his stockbroker, Halsey, who immediately buys SmartTown stock for himself.

*Comment:* The information regarding the pending sale is both material and nonpublic. Staple violated Standard II(A) by communicating the inside information to his broker. Halsey also violated the standard by buying the shares on the basis of material nonpublic information.

### Example 2 (Controlling Nonpublic Information)

Peter, an analyst with Scotland and Pierce Incorporated, is assisting his firm with a secondary offering for Bright Ideas Lamp Company. Peter participates, via video conference call, in a meeting with Scotland and Pierce investment banking employees and Bright Ideas' CEO. Peter is advised that the company's earnings projections for the next year have significantly dropped. Throughout the video conference call, several Scotland and Pierce salespeople and portfolio managers walk in and out of Peter's office, where the call is taking place. As a result, they are aware of the drop in projected earnings for Bright Ideas. Before the call is concluded, firm personnel trade the stock of Bright Ideas Lamp Company on behalf of the firm's clients and the firm's proprietary account.

*Comment:* Peter violated Standard II(A) because he failed to prevent the transfer and misuse of material nonpublic information to others in his firm. Peter's firm should have adopted information barriers to prevent the communication of nonpublic information between departments of the firm. Firm personnel who are members or candidates and who traded on the information also violated Standard II(A) by trading on inside information.

### Example 3 (Selective Disclosure of Material Information)

Levenson is an analyst based in Taipei who covers the Taiwanese market for her firm, which is based in Singapore. She is invited, together with the other 10 largest shareholders of a manufacturing company, to meet the finance director of that company. During the meeting, the finance director states that the company expects its workforce to strike next Friday, which will cripple productivity and distribution. Can Levenson use this information as a basis to change her rating on the company from “buy” to “sell”?

*Comment:* Levenson must first determine whether the material information is public. According to Standard II(A), if the company has not made this information public (a small group forum does not qualify as a method of public dissemination), she must not use the information.

### Example 4 (Determining Materiality)

Fechtman is trying to decide whether to hold or sell shares of an oil-and-gas exploration company that she owns in several of the funds she manages. Although the company has underperformed the index for some time already, the trends in the industry sector signal that companies of this type might become takeover targets. While she is considering her decision, her doctor, who casually follows the markets, mentions that she thinks that the company in question will soon be bought out by a large multinational conglomerate and that it would be a good idea to buy the stock right now. After talking to various investment professionals and checking their opinions on the company, as well as checking industry trends, Fechtman decides the next day to accumulate more stock in the oil-and-gas exploration company.

*Comment:* Although information on an expected takeover bid may be generally material and nonpublic, in this case, the source of information is unreliable, so the information cannot be considered material. Therefore, Fechtman is not prohibited from trading the stock based on this information.

### Example 5 (Applying the Mosaic Theory)

Teja is a buy-side analyst covering the furniture industry. Looking for an attractive company to recommend to clients, he analyzes several furniture makers by studying their financial reports and visiting their operations. He also talks to some designers and retailers to find out which furniture styles are trendy and popular. Although none of the companies that he analyzes are clear buy recommendations, he discovers that one of them, Swan Furniture Company (SFC), may be in financial trouble. SFC’s extravagant new designs have been introduced at substantial cost. Even though these designs initially attracted attention, the public is now buying more conservative furniture from

other makers. Based on this information and on a profit-and-loss analysis, Teja believes that SFC's next-quarter earnings will drop substantially. He issues a sell recommendation for SFC. Immediately after receiving that recommendation, investment managers start reducing the SFC stock in their portfolios.

*Comment:* While company information on quarterly earnings data is material and nonpublic, Teja based his conclusion about the earnings drop on public information and pieces of nonmaterial nonpublic information (such as opinions of designers and retailers). Therefore, trading based on Teja's correct conclusion is not prohibited by Standard II(A).

### Example 6 (Applying the Mosaic Theory)

Clement is a senior financial analyst who specializes in the European automobile sector at Rivoli Capital. Because he has been repeatedly nominated by many leading industry magazines and newsletters as a "best analyst" for the automobile industry, he is widely regarded as an authority on the sector. After speaking with representatives of Turgot Chariots—a European auto manufacturer with sales primarily in the Asia-Pacific (APAC) region—and after conducting interviews with salespeople, labor leaders, his firm's APAC currency analysts, and banking officials, Clement analyzed Turgot Chariots. He concluded that (1) its newly introduced model will probably not meet sales expectations, (2) its corporate restructuring strategy may face serious opposition from unions, (3) the depreciation of the South Korean won should lead to pressure on margins for the industry in general and Turgot's market segment in particular, and (4) banks could take a tougher-than-expected stance in the upcoming round of credit renegotiations with the company. For these reasons, he changes his conclusion about the company from "market outperform" to "market underperform." Clement retains the support material used to reach his conclusion in case questions later arise.

*Comment:* To reach a conclusion about the value of the company, Clement pieced together a number of nonmaterial or public bits of information that affect Turgot Chariots. Therefore, under the mosaic theory, Clement did not violate Standard II(A) in drafting the report.

### Example 7 (Analyst Recommendations as Material Nonpublic Information)

The next day, Clement prepares to be interviewed on a global financial news television program where he will discuss publicly for the first time his changed recommendation on Turgot Chariots. While preparing for the program, he mentions to the show's producers and Zito, the journalist who will be interviewing him, the information he will discuss. Just prior to going on the air, Zito sells her holdings in Turgot Chariots. She also phones her father with the information because she knows that he and other family members have investments in Turgot Chariots.

*Comment:* When Zito receives advance notice of Clement's change of opinion, she knows it will have a material impact on the stock price, even if she is not aware of Clement's underlying reasoning. She is not a client of Clement but obtains early access to the material nonpublic information prior to publication. Her trades are based on material nonpublic information; thus, she violated Standard II(A). Zito further violated the standard by relaying the information to her father. It would not matter if he or any other family member traded; the act of providing the information violated Standard II(A).

### Example 8 (Acting on Nonpublic Information)

Kellogg is a retired investment professional who manages his own portfolio. He owns shares in National Savings, a large local bank. A close friend, Mayfield, is a senior executive at National. National has seen its stock price drop considerably, and the news and outlook for the bank have not been positive in recent months. In a conversation about the economy and the banking industry, Mayfield relays the information that National will surprise the investment community in a few days when it announces excellent earnings for the quarter. Kellogg is pleasantly surprised by this information, and thinking that Mayfield, as a senior executive, knows the law and would not disclose inside information, he doubles his position in the bank. Subsequently, National announces that it had good operating earnings but had to set aside reserves for anticipated significant losses on its loan portfolio. The combined news causes the stock to go down 60%.

*Comment:* Even though Kellogg believes that Mayfield would not break the law by disclosing inside information, Kellogg violated Standard II(A) by purchasing additional shares of National. The fact that he lost money on the purchase does not absolve Kellogg for trading on material nonpublic information. It is the member's or candidate's responsibility to make sure, before executing investment actions, that comments about earnings are not material nonpublic information.

### Example 9 (Materiality Determination)

Nadler, a trader for a mutual fund, gets a text message from another firm's trader, whom he has known for years. The message indicates that the trader believes a particular software company is going to report strong earnings when the firm publicly announces in two days. Nadler has a buy order from a portfolio manager within his firm to purchase several hundred thousand shares of the stock. Nadler is aggressive in placing the portfolio manager's order and completes the purchases by the following morning, a day ahead of the firm's planned earnings announcement.

*Comment:* There are often rumors and whisper numbers before a release of any kind. The text message from the other trader would most likely be considered market noise. Unless Nadler knew that the trader

had an ongoing business relationship with the public firm, he had no reason to suspect he was receiving material nonpublic information that would prevent him from completing the trading request of the portfolio manager.

### Example 10 (Using an Expert Network)

McCoy is the senior drug analyst at a mutual fund. Her firm hires a service that connects her to experts in the treatment of cancer. Through various phone conversations, McCoy enhances her understanding of the latest therapies for successful treatment. This information is critical to McCoy for making informed recommendations of the companies producing these drugs.

*Comment:* McCoy is appropriately using the expert networks to enhance her evaluation process. She neither asked for nor received information that may be considered material and nonpublic, such as preliminary trial results. McCoy is allowed to seek advice from professionals within the industry that she follows.

### Example 11 (Using an Expert Network)

Watson is a research analyst working for a hedge fund. To stay informed, Watson relies on outside experts for information on such industries as technology and pharmaceuticals, where new advancements occur frequently. The meetings with the industry experts often are arranged through networks or placement agents that have specific policies and procedures in place to deter the exchange of material nonpublic information.

Watson arranges a call to discuss future prospects for one of the fund's existing technology company holdings, a company that was testing a new semiconductor product. The scientist leading the tests indicates his disappointment with the performance of the new semiconductor. Following the call, Watson relays the insights he received to others at the fund. The fund sells its current position in the company and buys many put options because the market is anticipating the success of the new semiconductor and the share price reflects the market's optimism.

*Comment:* Watson violated Standard II(A) by passing along material nonpublic information concerning the ongoing product tests, which the fund used to trade in the securities and options of the related company. Watson cannot simply rely on the agreements signed by individuals who participate in expert networks that state that he has not received information that would prohibit his trading activity. He must make his own determination whether information he received through these arrangements reaches a materiality threshold that would influence his trading.

## Standard II(B) Market Manipulation

Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

### Guidance

Standard II(B) requires that members and candidates uphold market integrity by prohibiting market manipulation. Market manipulation includes practices that distort security prices or trading volume with the intent to deceive people or entities that rely on information in the market. Market manipulation damages the interests of all investors by disrupting the smooth functioning of financial markets and lowering investor confidence.

Market manipulation may lead to a lack of trust in the fairness of the capital markets, resulting in higher risk premiums and reduced investor participation. A reduction in the efficiency of a local capital market may negatively affect the growth and economic health of the country and may also influence the operations of the globally interconnected capital markets. Although market manipulation may be less likely to occur in mature financial markets than in emerging markets, cross-border investing exposes all global investors to the potential for such practices.

Market manipulation includes (1) the dissemination of false or misleading information and (2) transactions that deceive or would be likely to mislead market participants by distorting the price-setting mechanism of financial instruments. The development of new products and technologies increases the incentives, means, and opportunities for market manipulation. Additionally, the complexity and sophistication of the technologies used for communicating with market participants have created new avenues for manipulation.

### Information-Based Manipulation

Information-based manipulation includes, but is not limited to, spreading false rumors to induce trading by others. For example, members and candidates must refrain from “pumping up” the price of an investment by issuing misleading positive information or overly optimistic projections of a security’s worth only to later “dump” the investment (i.e., sell it) once the price, fueled by the misleading information’s effect on other market participants, reaches an artificially high level.

## Transaction-Based Manipulation

Transaction-based manipulation involves instances where a member or candidate knows or should know that his or her actions could distort the price of a security. This type of manipulation includes, but is not limited to, the following:

- Transactions that artificially affect prices or volume to give the impression of activity or price movement in a financial instrument, which represent a diversion from the expectations of a fair and efficient market
- Securing a controlling, dominant position in a financial instrument to exploit and manipulate the price of a related derivative and/or the underlying asset

Standard II(B) is not intended to preclude transactions undertaken on legitimate trading strategies based on perceived market inefficiencies. Legitimate trading activity may appear abusive, especially where the market is illiquid or volatile. The intent of the action is critical to determining whether it is a violation of this standard.

Manipulative practices can vary according to the type of asset class and the features of the particular market. The following is a nonexhaustive list of indicators that may signal market manipulation:

- Orders entered for an unusually short time period
- Orders above market price
- Orders resulting in no change in beneficial ownership
- Orders that intend to change the bid or offer prices and are canceled before they are executed
- Orders on both sides of the trade using different platforms
- Coordinated action by two or more traders in a market with a small number of participants

## Compliance Practices

Members and candidates must comply with their firm's policies and procedures designed to prevent manipulative trading, which could include the following:

- Procedures designed to prevent placing and canceling orders with the intent to deceive others into buying or selling securities at artificial prices
- Real-time monitoring or systematic surveillance practices across multiple platforms that are designed to identify such activities as suspicious order entries, potential improper coordination among customers, wash trading, transactions in cross-product securities that manipulate the price of an underlying security, and other types of manipulative trading activity

- Implementation of an automated order management system and pretrade controls to attempt to identify and prevent manipulative orders
- Controls that address the use of trading algorithms for manipulative trading practices
- Trade exception reporting

## Application of the Standard

### Example 1 (Independent Analysis and Company Promotion)

The principal owner of Financial Information Services (FIS) entered into an agreement with two microcap companies to promote the companies' stock in exchange for stock and cash compensation. The principal owner caused FIS to disseminate emails, design and maintain several websites, and distribute an online investment newsletter—all of which recommended investment in the two companies. The systematic publication of purportedly independent analyses and recommendations containing inaccurate and highly promotional and speculative statements increased public investment in the companies and led to dramatically higher stock prices.

*Comment:* The principal owner of FIS violated Standard II(B) by using inaccurate reporting and misleading information under the guise of independent analysis to artificially increase the stock price of the companies.

### Example 2 (Personal Trading Practices and Price)

Gray is a private investor in Belgium who bought a large position several years ago in Fame Pharmaceuticals, a German small-cap security with limited average trading volume. He has decided to significantly reduce his holdings owing to the poor performance of the company. Gray is worried that the low trading volume for the stock may cause the price to decline further as he attempts to sell his large position.

Gray divides his holdings into multiple accounts in different brokerage firms and private banks in the names of family members, friends, and even a private religious institution. He then creates a rumor campaign on various blogs and social media outlets promoting the company.

Gray begins to buy and sell the stock using the accounts in hopes of raising the trading volume and the price. He conducts the trades through multiple brokers, selling slightly larger positions than he bought on a tactical schedule, and over time, he is able to reduce his holding as desired without negatively affecting the sale price.

*Comment:* Gray violated Standard II(B) by fraudulently creating the appearance that there was greater investor interest in the stock through the online rumors. Additionally, through his trading strategy, he created the appearance that there was greater liquidity in the stock than actually existed. He manipulated the price through both misinformation and trading practices.

### Example 3 (Creating Artificial Price Volatility)

Murphy is an analyst at Divisadero Securities & Co., which has a significant number of hedge funds among its most important brokerage clients. Some of the hedge funds hold short positions on Wirewolf Semiconductor. Two trading days before the publication of a quarter-end report, Murphy alerts his sales force that he is about to issue a research report on Wirewolf that will include the following opinions:

- Quarterly revenues are likely to fall short of management’s guidance.
- Earnings will be as much as 5 cents per share (or more than 10%) below consensus.
- Wirewolf’s highly respected chief financial officer may be about to join another company.

Knowing that Wirewolf has already entered its declared quarter-end “quiet period” before reporting earnings (and thus would be reluctant to respond to rumors), Murphy times the release of his research report specifically to sensationalize the negative aspects of the message in order to create significant downward pressure on Wirewolf’s stock—to the distinct advantage of Divisadero’s hedge fund clients. The report’s conclusions are based on speculation, not on fact. The next day, the research report is broadcast to all of Divisadero’s clients and to the usual newswire services.

Before Wirewolf’s investor relations department can assess the damage on the final trading day of the quarter and refute Murphy’s report, its stock opens trading sharply lower, allowing Divisadero’s clients to cover their short positions at substantial gains.

*Comment:* Murphy violated Standard II(B) by aiming to create artificial price volatility designed to have a material impact on the price of an issuer’s stock.

### Example 4 (Personal Trading and Volume)

Sekar manages two funds—an equity fund and a balanced fund—whose equity components are supposed to be managed in accordance with the same model. According to that model, the funds’ holdings in stock of Digital Design Inc. (DD) are excessive. Reduction of the DD holdings would not be easy, however, because the stock has low liquidity. Sekar decides to start trading larger portions

of DD stock back and forth between his two funds to slowly increase the price; he believes market participants will see growing volume and increasing price and become interested in the stock. If other investors are willing to buy the DD stock because of such interest, then Sekar will be able to get rid of at least some of his overweight position without inducing price decreases. In this way, the whole transaction will be for the benefit of fund participants, even if additional brokers' commissions are incurred.

*Comment:* Sekar's plan would be beneficial for his funds' participants but is based on artificial distortion of both trading volume and the price of the DD stock and thus constitutes a violation of Standard II(B).

### Example 5 (Creating Artificial Price Volatility)

Gordon, an analyst of household products companies, is employed by a research boutique, Picador & Co. Based on information that she has gathered during a trip through Latin America, she believes that Hygene, Inc., a major marketer of personal care products, has generated better-than-expected sales from its new product initiatives in South America. After modestly boosting her projections for revenue and for gross profit margin in her worksheet models for Hygene, Gordon estimates that her earnings projection of US\$2.00 per diluted share for the current year may be as much as 5% too low. She contacts the chief financial officer (CFO) of Hygene to try to gain confirmation of her findings from her trip and to get feedback regarding her revised models. The CFO declines to comment and reiterates management's most recent guidance of US\$1.95–US\$2.05 for the year.

Gordon decides to try to force a comment from the company by telling Picador & Co. clients who follow a momentum investment style that consensus earnings projections for Hygene are much too low; she explains that she is considering raising her published estimate by an ambitious US\$0.15–US\$2.15 per share. She believes that when word of an unrealistically high earnings projection filters back to Hygene's investor relations department, the company will feel compelled to update its earnings guidance. Meanwhile, Gordon hopes that she is correct at least with respect to the earnings direction and that she will help clients who act on her insights to profit from a quick gain by trading on her advice.

*Comment:* By exaggerating her earnings projections in order to try to fuel a quick gain in Hygene's stock price, Gordon is in violation of Standard II(B). However, it would have been acceptable for Gordon to write a report that

- framed her earnings projection in a range of possible outcomes and
- outlined clearly the assumptions used in her Hygene models that took into consideration the findings from her trip through Latin America.

## Example 6 (Pump and Dump Strategy)

In an effort to pump up the price of his holdings in Moosehead & Belfast Railroad Company, Weinberg logs on to several investor chatrooms to start rumors that the company is about to expand its rail network in anticipation of receiving a large contract for shipping lumber.

*Comment:* Weinberg violated Standard II(B) by disseminating false information about Moosehead & Belfast with the intent to mislead market participants.

# STANDARD III: DUTIES TO CLIENTS

## Standard III(A) Loyalty, Prudence, and Care

Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

### Guidance

Standard III(A) clarifies that client interests are paramount. A member's or candidate's responsibility to a client includes a duty of loyalty and a duty to exercise reasonable care. Investment actions must be carried out for the sole benefit of the client and in a manner the member or candidate believes, given the known facts and circumstances, to be in the best interest of the client. Members and candidates must exercise the same level of prudence, judgment, and care that they would apply in the management and disposition of their own interests in similar circumstances.

Prudence requires caution and discretion. The exercise of prudence by investment professionals requires that they act with the care, skill, and diligence that a reasonable person acting in a like capacity and familiar with such matters would use. In the context of managing a client's portfolio, prudence requires following the investment parameters set forth by the client and balancing risk and return. Acting with care requires members and candidates to act in a prudent and judicious manner in avoiding harm to clients.

Standard III(A) sets minimum expectations for members and candidates when fulfilling their responsibilities to their clients. Regulatory and legal requirements for such duties can vary across the investment industry depending on a variety of factors, including job function of the investment professional, the existence of an adviser/client relationship, and the nature of the recommendations being offered. From the perspective of the end user of financial services, these different standards can be arcane and confusing, leaving investors unsure of what level of service to expect from investment professionals they employ. The single standard of conduct described in Standard III(A) benefits investors by establishing a benchmark for the duties of loyalty, prudence, and care and clarifies that all CFA Institute members and candidates, regardless of job title, local laws, or cultural differences, are required to comply with these fundamental responsibilities. Investors hiring members or candidates who must adhere to the duty of loyalty, prudence, and care set forth in this standard can

be confident that these responsibilities are a requirement regardless of any legally imposed fiduciary duties.

Standard III(A), however, is not a substitute for a member's or candidate's legal or regulatory obligations. As stated in Standard I(A) Knowledge of the Law, members and candidates must abide by the strictest requirements imposed on them by regulators or the Code and Standards, including any legally imposed fiduciary duty. Members and candidates must also be aware of whether they have "custody" or effective control of client assets. If so, a heightened level of responsibility arises. Members and candidates are considered to have custody if they have any direct or indirect access to client funds. Members and candidates must manage any pool of assets in their control in accordance with the terms of the governing documents (such as trust documents and investment management agreements), which are the primary determinant of the manager's powers and duties. Whenever their actions are contrary to provisions of those instruments or applicable law, members and candidates are at risk of violating Standard III(A).

## Understanding the Application of Loyalty, Prudence, and Care

Standard III(A) establishes a minimum benchmark for the duties of loyalty, prudence, and care that are required of all members and candidates regardless of whether a legal fiduciary duty applies. Although fiduciary duty often encompasses the principles of loyalty, prudence, and care, Standard III(A) does not render all members and candidates fiduciaries. The responsibilities of members and candidates for fulfilling their obligations under this standard depend greatly on the nature of their professional responsibilities and the relationships they have with clients. The conduct of members and candidates may or may not rise to the level of being a fiduciary, depending on the type of client, whether the member or candidate is giving investment advice, and the many facts and circumstances surrounding a particular transaction or client relationship.

Fiduciary duties are often imposed by law or regulation when an individual or institution is charged with the duty of acting for the benefit of another party, such as managing investment assets. The duty required in fiduciary relationships exceeds what is acceptable in many other business relationships because a fiduciary is in an enhanced position of trust. Although members and candidates must comply with any legally imposed fiduciary duty, the Code and Standards neither impose such a legal responsibility nor require all members or candidates to act as fiduciaries. However, Standard III(A) requires members and candidates to work in the client's best interest no matter what the job function.

Members and candidates who do not provide advisory services to clients but who act only as trade execution professionals must prudently work in the client's interest when completing requested trades. Acting in the client's best interest requires these professionals to use their skills and diligence to execute trades in the most favorable terms that can be achieved. Members and

candidates operating in such positions must use care to operate within the parameters set by the client's trading instructions.

Members and candidates may also operate in a blended environment where they execute client trades and offer advice on a limited set of investment options. The extent of the advisory arrangement and limitations should be outlined in the agreement with the client at the outset of the relationship. For instance, members and candidates should inform clients that the advice provided will be limited to the proprietary products of the firm and not include other products available on the market. Clients who want access to a wider range of investment products would then have the information necessary to decide not to engage with members or candidates working under these restrictions.

Members and candidates operating in this blended context comply with their obligations by recommending the allowable products that are consistent with the client's objectives and risk tolerances. They exercise care through diligently aligning the client's needs with the attributes of the products being recommended. Members and candidates must place the client's interests first by disregarding any firm or personal interest in motivating a recommended transaction.

A wide variety of professional relationships exists between members and candidates and their clients. Standard III(A) requires members and candidates to fulfill the obligations outlined explicitly or implicitly in the client agreements to the best of their abilities and with loyalty, prudence, and care. Whether a member or candidate is structuring a new securitization transaction, completing a credit rating analysis, or leading a public company, he or she must work with prudence and care in delivering the agreed-on services.

## Identifying the Client

The first step for members and candidates in fulfilling their duty of loyalty to clients is to determine the identity of the "client" to whom the duty of loyalty is owed. A client is a person or entity for which the member or candidate performs a professional service that is of the type usually provided in return for compensation. A prospective client is a person or entity that has expressed interest in retaining the services of a member, a candidate, or a firm or to whom the member, candidate, or firm actively solicits or plans to solicit and that has the potential to become a client.

Members and candidates must look at their roles and responsibilities when making a determination as to who their clients are. Generally, the client is easily identifiable. Such is the case with an investment adviser who works with individual retail or high-net-worth investors. A client relationship exists between a company executive and the firm's public shareholders. Members and candidates with positions whose responsibilities do not include direct investment management may also have "clients" that must be identified.

When the manager is responsible for the portfolios of pension plans or trusts, however, the client is not the person or entity that hires the manager but, rather, the beneficiaries of the plan or trust. The duty of loyalty is owed to the ultimate beneficiaries.

In some situations, an actual client or group of beneficiaries may not exist. Members and candidates managing a fund to an index or an expected mandate owe the duty of loyalty, prudence, and care to invest in a manner consistent with the stated mandate. The decisions of a fund's manager, although benefiting all fund investors, are not based on an individual investor's requirements and risk profile. Client loyalty and care for those investing in the fund are the responsibility of members and candidates who have an advisory relationship with those individuals.

Situations involving potential conflicts of interest with respect to responsibilities to clients may be extremely complex because they may involve a number of competing interests. The duty of loyalty, prudence, and care applies to a large number of persons in varying capacities, but the exact duties may differ in many respects in accordance with the relationship with each client or each type of account for which assets are managed. Members and candidates must not only put their obligations to clients first in all dealings but also endeavor to avoid all real or potential conflicts of interest.

## Developing the Client's Portfolio

The duty of loyalty, prudence, and care owed to the individual client is especially important because the professional investment manager typically possesses greater knowledge in the investment arena than the client does. This disparity places the individual client in a vulnerable position; the client must trust the manager. The manager in these situations must ensure that the client's objectives and expectations for the performance of the account are realistic and suitable to the client's circumstances and that the risks involved are appropriate. In most circumstances, recommended investment strategies must relate to the long-term objectives and circumstances of the client.

Particular care must be taken to detect whether the goals of the investment manager or the firm in conducting business, selling products, and executing security transactions potentially conflict with the best interests and objectives of the client. When members and candidates cannot avoid potential conflicts between their firms' and clients' interests, they must provide clear and factual disclosures of the circumstances to the clients. See Standard VI(A) Disclosure of Conflicts.

Members and candidates must follow any guidelines set by their clients for the management of their assets. Some clients, such as charitable organizations or those seeking to support or invest in companies based on environmental, social, and governance (ESG) goals or criteria, have strict investment policies that limit investment options to certain types or classes of investment or

prohibit investment in certain securities. Other organizations have policies that do not prohibit investments by type but, instead, set criteria on the basis of the portfolio's total risk and return.

Investment decisions must be judged in the context of the total portfolio rather than by individual investment within the portfolio. The member's or candidate's duty is satisfied with respect to a particular investment if the individual has thoroughly considered the investment's place in the overall portfolio, the risk of loss and opportunity for gains, tax implications, and the diversification, liquidity, cash flow, and overall return requirements of the assets or the portion of the assets for which the manager is responsible.

### Soft Commission Policies

An investment manager often has discretion over the selection of brokers executing transactions. Conflicts may arise when an investment manager uses client brokerage to purchase research services, a practice commonly called "soft dollars" or "soft commissions." A member or candidate who pays a higher brokerage commission than he or she would normally pay to allow for the purchase of goods or services, without corresponding benefit to the client, violates the duty of loyalty to the client.

Unless directed by the client, a member or candidate is obligated to seek "best price" and "best execution." "Best execution" refers to a trading process that seeks to maximize the value of the client's portfolio within the client's stated investment objectives and constraints. However, from time to time, some clients will direct a manager to use a specific brokerage firm for all or some of the client's trades, a practice commonly called "directed brokerage." Because brokerage commission is an asset of the client and is used to benefit that client, not the manager, this practice does not violate the duty of loyalty. The member or candidate should, however, seek confirmation from the client that the goods or services purchased from the brokerage will benefit the account beneficiaries. In addition, the member or candidate should disclose to the client that the client may not be getting best execution from the directed brokerage.

### Proxy Voting Policies

The duty of loyalty, prudence, and care may apply in a number of situations facing the investment professional besides those related directly to investing assets.

Part of a member's or candidate's duty of loyalty includes voting proxies in an informed and responsible manner. Proxies have economic value for a client, and members and candidates must ensure that they properly safeguard and maximize this value. An investment manager who fails to vote, casts a vote without considering the impact of the question, or votes blindly with management on nonroutine governance issues (e.g., a change in company

capitalization) may violate this standard. Voting of proxies is an integral part of the management of investments.

A cost-benefit analysis may show that voting all proxies may not benefit the client, so voting proxies may not be necessary in all instances. Members and candidates should disclose to clients their proxy voting policies.

## Compliance Practices

*Regular account information:* Members and candidates with control of client assets should (1) submit to each client, at least quarterly, an itemized statement showing the funds and securities in the custody or possession of the member or candidate plus all debits, credits, and transactions that occurred during the period, (2) disclose to the client where the assets are maintained, as well as where or when they are moved, and (3) separate the client's assets from any other party's assets, including the member's or candidate's own assets.

*Client approval:* If a member or candidate is uncertain about the appropriate course of action with respect to a client, the member or candidate should consider what he or she would expect or demand if the member or candidate were the client. If in doubt, a member or candidate should disclose the questionable matter in writing to the client and obtain client approval.

*Follow all applicable rules and laws:* Members and candidates must follow all legal requirements and applicable provisions of the Code and Standards.

*Establish the investment objectives of the client:* Members and candidates must make a reasonable inquiry into a client's investment experience, risk and return objectives, and financial constraints prior to making investment recommendations or taking investment actions.

*Consider all the information when taking actions:* When taking investment actions, members and candidates must consider the appropriateness and suitability of the investment relative to (1) the client's needs and circumstances, (2) the investment's basic characteristics, and (3) the basic characteristics of the total portfolio.

*Diversify:* Members and candidates should diversify investments to reduce the risk of loss, unless diversification is not consistent with plan guidelines or is contrary to the account objectives.

*Carry out regular reviews:* Members and candidates should establish regular review schedules to ensure that the investments held in the account adhere to the terms of the governing documents.

*Deal fairly with all clients with respect to investment actions:* Members and candidates must not favor some clients over others and should establish policies for allocating trades and disseminating investment recommendations.

*Avoid or disclose conflicts of interest:* Members and candidates must avoid or disclose all actual and potential conflicts of interest so that clients can evaluate those conflicts.

*Disclose compensation arrangements:* Members and candidates should make their clients aware of all forms of manager compensation.

*Vote proxies:* Members and candidates should determine who is authorized to vote shares and which proxies should be voted and vote proxies in the best interests of the clients and ultimate beneficiaries.

*Maintain confidentiality:* Members and candidates must preserve the confidentiality of client information.

*Seek best execution:* Unless directed by the client, members and candidates must seek best execution for their clients. (Best execution is defined in the preceding text.)

## Application of the Standard

### Example 1 (Identifying the Client—Plan Participants)

First Country Bank serves as trustee for the Miller Company's pension plan. Miller is the target of a hostile takeover attempt by Newton, Inc. In attempting to ward off Newton, Miller's managers persuade Wiley, an investment manager at First Country Bank, to purchase a significant amount of Miller common stock in the open market for the employee pension plan. Miller's officials indicate that such an action would be favorably received and would probably result in other accounts being placed with the bank. Although Wiley believes the stock is overvalued and would not ordinarily buy it, he purchases the stock to support Miller's managers, to maintain Miller's good favor toward the bank, and to realize additional new business. The heavy stock purchases cause Miller's market price to rise to such a level that Newton retracts its takeover bid.

*Comment:* Standard III(A) requires that a member or candidate, in evaluating a takeover bid, act prudently and solely in the interests of plan participants and beneficiaries. To meet this requirement, a member or candidate must carefully evaluate the long-term prospects of the company against the short-term prospects presented by the takeover offer and by the ability to invest elsewhere. In this instance, Wiley, acting on behalf of his employer, which was the trustee for a pension plan, clearly violated Standard III(A). He used the pension plan to perpetuate existing management, perhaps to the detriment of plan participants and the company's shareholders, and to benefit himself. Wiley's responsibilities to the plan participants and beneficiaries must take precedence over any ties of his bank to corporate managers and over his self-interest. Wiley had a duty to examine the takeover offer on its own merits and to make an independent decision. The guiding principle is

the appropriateness of the investment decision to the pension plan, not whether the decision benefited Wiley or the company that hired him.

### Example 2 (Client Commission Practices)

Jackson is CEO of JNI, a successful investment counseling firm that serves as investment manager for the pension plans of several large regional companies. JNI's trading activities generate a significant amount of commission-related business. Jackson uses the brokerage and research services of many firms, but most of his company's trading activity is handled through one large brokerage company, Thompson, Inc., because the executives of the two firms have a close friendship. Thompson's commission structure is high in comparison with charges for similar brokerage services from other firms. Jackson considers Thompson's research services and execution capabilities average. In exchange for JNI directing its brokerage to Thompson, Thompson absorbs a number of JNI overhead expenses, including those for rent.

*Comment:* Jackson is breaching his responsibilities by using client brokerage for services that do not benefit JNI clients and by not obtaining best price and best execution for JNI clients. Because Jackson is not upholding his duty of loyalty, he is violating Standard III(A).

### Example 3 (Brokerage Arrangements)

Everett, a struggling independent investment adviser, serves as investment manager for the pension plans of several companies. One of her brokers, Scott Company, is close to finalizing management agreements with prospective new clients whereby Everett would manage the new client accounts and trade the accounts exclusively through Scott. One of Everett's existing clients, Crayton Corporation, has directed Everett to place security transactions for Crayton's account exclusively through Scott. To induce Scott to exert effort to send more new accounts to her, Everett also directs transactions to Scott from other clients without their knowledge.

*Comment:* Everett has an obligation at all times to seek best price and best execution on all trades. Everett may direct new client trades exclusively through Scott Company as long as Everett receives best price and execution on the trades or receives a written statement from new clients that she is *not* to seek best price and execution and that they are aware of the consequence for their accounts. Everett may trade other accounts through Scott as a reward for directing clients to Everett only if the accounts receive best price and execution and the practice is disclosed to the accounts. Because Everett does not disclose the directed trading, Everett violated Standard III(A).

### Example 4 (Brokerage Arrangements)

Rome is a trust officer for Paget Trust Company. Rome's supervisor is responsible for reviewing Rome's trust account transactions and her monthly reports of personal stock transactions. Rome has been using Gray, a broker, almost exclusively for trust account brokerage transactions. When Gray makes a market in stocks, he has been giving Rome a lower price for personal purchases and a higher price for sales than he gives to Rome's trust accounts and other investors.

*Comment:* Rome is violating her duty of loyalty to the bank's trust accounts by using Gray for brokerage transactions simply because Gray trades Rome's personal account on favorable terms. Rome is placing her own interests before those of her clients.

### Example 5 (Client Commission Practices)

Parker, an analyst with Provo Advisors, covers South American equities for her firm. She likes to travel to the markets for which she is responsible and decides to go on a trip to Chile, Argentina, and Brazil. The trip is sponsored by SouthAM, Inc., a research firm with a small broker/dealer affiliate that uses the clearing facilities of a larger New York brokerage house. SouthAM specializes in arranging South American briefing trips for analysts, during which they can meet with central bank officials, government ministers, local economists, and senior executives of corporations. SouthAM accepts commission dollars at a ratio of 2 to 1 against the hard dollar costs of the research fee for the trip. Parker is not sure that SouthAM's execution is competitive, but without informing her supervisor, she directs the trading desk at Provo to start giving commission business to SouthAM so she can take the trip. SouthAM has conveniently timed the briefing trip to coincide with the beginning of Carnival season, so Parker also decides to spend five days of vacation in Rio de Janeiro at the end of the trip. Parker uses commission dollars to pay for the five days of hotel expenses.

*Comment:* Parker is violating Standard III(A) by not exercising her duty of loyalty to her clients. She must determine whether the commissions charged by SouthAM are reasonable in relation to the benefit of the research provided by the trip. She also must determine whether best execution and prices could be received from SouthAM. In addition, the five extra days are not part of the research effort, because they do not assist in the investment decision making. Thus, the hotel expenses for the five days must not be paid for with client commission dollars.

### Example 6 (Excessive Trading)

Knauss manages the portfolios of a number of high-net-worth individuals. A major part of her investment management fee is based on trading commissions. Knauss engages in extensive trading for each of her clients

to ensure that she attains the minimum commission level set by her firm. Although the securities purchased and sold for the clients are appropriate and fall within the acceptable asset classes for the clients, the amount of trading for each account exceeds what is necessary to accomplish the client's investment objectives.

*Comment:* Knauss violated Standard III(A) because she is using the assets of her clients to benefit her firm and herself.

### Example 7 (Managing Family Accounts)

Dill recently joined New Investments Asset Managers. To assist Dill in building a book of clients, both his father and brother opened new fee-paying accounts. Dill followed all the firm's procedures in noting his relationships with these clients and in developing their investment policy statements. After several years, the number of Dill's clients has grown, but he still manages the original accounts of his family members. An IPO is coming to market that is a suitable investment for many of his clients, including his brother. Dill does not receive the amount of stock he requested, so to avoid any appearance of a conflict of interest, he does not allocate any shares to his brother's account.

*Comment:* Dill violated Standard III(A) because he did not act for the benefit of his brother's account or his other accounts. The brother's account is a regular fee-paying account comparable to the accounts of his other clients. By not allocating the shares proportionately across *all* accounts for which he thought the IPO was suitable, Dill disadvantaged specific clients. Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm.

### Example 8 (Identifying the Client)

Hensley has been hired by a law firm to testify as an expert witness. Although the testimony is intended to represent impartial advice, she is concerned that her work may have negative consequences for the law firm. If the law firm is Hensley's client, how does she ensure that her testimony will not violate the required duty of loyalty, prudence, and care to one's client?

*Comment:* In this situation, the law firm represents Hensley's employer and the aspect of "who is the client" is not well defined. When acting as an expert witness, Hensley is bound by the standard of independence and objectivity in the same manner that an independent research analyst would be bound. Hensley must not let the law firm influence the testimony she provides in the legal proceedings.

## Example 9 (Identifying the Client)

Miller is a mutual fund portfolio manager. The fund is focused on the global financial services sector. Spears is a private wealth manager in the same city as Miller and is a friend of Miller. At a CFA Institute local society meeting, Spears mentions to Miller that her new client is an investor in Miller's fund. She states that the two of them now share a responsibility to this client.

*Comment:* Spears' statement is not entirely accurate. Because she provides the advisory services to her new client, she alone is bound by the duty of loyalty to this client. Miller's responsibility is to manage the fund according to the investment policy statement of the fund. His actions must not be influenced by the needs of any particular fund investor.

## Example 10 (Client Loyalty)

After providing client account investment performance to external-facing departments but prior to it being finalized for release to clients, Nguyen, an investment performance analyst, notices the reporting system missed a trade. Correcting the omission resulted in a large loss for a client that had previously placed the firm on "watch" for potential termination owing to underperformance in prior periods. Nguyen knows this news is unpleasant but informs the appropriate individuals that the report needs to be updated before releasing it to the client.

*Comment:* Nguyen's actions align with the requirements of Standard III(A). Even though the correction may lead to the firm's termination by the client, withholding information on errors is not in the best interest of the client.

## Example 11 (Execution-Only Responsibilities)

Sulejman recently became a candidate in the CFA Program. He is a broker who executes client-directed trades for several high-net-worth individuals. Sulejman does not provide any investment advice and only executes the trading decisions made by clients. He is concerned that the Code and Standards impose a fiduciary duty on him in his dealing with clients and sends an email to the CFA Institute Ethics Helpdesk ([ethics@cfainstitute.org](mailto:ethics@cfainstitute.org)) to seek guidance on this issue.

*Comment:* In this instance, Sulejman serves in an execution-only capacity. His duty of loyalty, prudence, and care is centered on the skill and diligence used when executing trades—namely, by seeking best execution and making trades within the parameters set by the clients (instructions on quantity, price, timing, etc.). Acting in the best interests of the client dictates that trades are executed on the most favorable terms that can be achieved for the client. Given this job function, the requirements of the Code and Standards for loyalty, prudence, and care clearly do not impose a fiduciary duty.

## Standard III(B) Fair Dealing

Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

### Guidance

Standard III(B) requires members and candidates to treat all clients fairly when disseminating investment recommendations, making material changes to prior investment recommendations, or taking other investment action for clients. Only through the fair treatment of all parties can the investment management profession maintain the confidence of the investing public.

When an investment adviser has multiple clients, the potential exists for the adviser to favor one client over another. This favoritism may take various forms—from the quality and timing of services provided to the allocation of investment opportunities.

The term “fairly” implies that the member or candidate must take care not to discriminate against any clients when disseminating investment recommendations or taking investment action. Standard III(B) does not state “equally” because members and candidates could not possibly reach all clients at exactly the same time. Each client has unique needs, investment criteria, and investment objectives, so not all investment opportunities are suitable for all clients. In addition, members and candidates may provide more personal, specialized, or in-depth service to clients who are willing to pay for premium services. Members and candidates may differentiate their services to clients, but different levels of service must not disadvantage or negatively affect clients. In addition, the different service levels should be disclosed to clients and prospective clients and should be available to everyone (i.e., different service levels should not be offered selectively).

### Investment Recommendations

For many members and candidates, their primary function is the preparation of investment recommendations to be disseminated either to the public or within a firm for the use of others in making investment decisions. This group includes members and candidates employed by investment counseling, advisory, or consulting firms, as well as banks, brokerage firms, and insurance companies. The criterion is that the member’s or candidate’s primary responsibility is the preparation of recommendations to be acted on by others, including those in the member’s or candidate’s organization.

An investment recommendation is any opinion expressed by a member or candidate relating to purchasing, selling, or holding a given security or other investment. There are many ways to disseminate opinions to customers or clients, including through an initial detailed research report, through a brief update report, by addition to or deletion from a list of recommended securities, or simply through verbal communication. A recommendation that is distributed to anyone outside the organization is considered a communication for general distribution under Standard III(B).

Standard III(B) addresses the manner in which investment recommendations or changes in prior recommendations are disseminated to clients. Each member or candidate is obligated to ensure that information is disseminated in such a manner that all clients have a fair opportunity to act on every recommendation. Communicating with all clients on a uniform basis may present practical problems for members and candidates because of differences in timing and methods of communication with various types of customers and clients. Members and candidates should use an equitable system to prevent selective or discriminatory disclosure and inform clients about the types of communications they will receive.

The duty to clients imposed by Standard III(B) also applies when members or candidates change their recommendations. Material changes in a member's or candidate's prior investment recommendations must be communicated to all current clients; particular care should be taken that the information reaches those clients who the member or candidate knows have acted on or been affected by the earlier advice. Clients who do not know that the member or candidate has changed a recommendation and who, therefore, place orders contrary to a current recommendation should be advised of the changed recommendation before the order is accepted.

## Investment Action

Some members and candidates take investment action (manage portfolios) on the basis of recommendations prepared internally or received from external sources. Investment action, like investment recommendations, can affect market value. Consequently, Standard III(B) requires that members and candidates treat all clients fairly in light of their investment objectives and circumstances. For example, when making investments in new offerings or in secondary financings, members and candidates must distribute the issues to all customers for whom the investments are appropriate in a manner consistent with the policies of the firm for allocating blocks of stock. If the issue is oversubscribed, then the issue should be prorated to all suitable accounts. This action should be taken on a round-lot basis to avoid odd-lot distributions. In addition, if the issue is oversubscribed, members and candidates must forgo any sales to themselves or their immediate families in order to free up additional shares for clients. If the investment professional's family-member accounts are managed similarly to the accounts of other clients of the firm, however, the family-member accounts must not be excluded from buying such shares.

Members and candidates must make every effort to treat all individual and institutional clients in a fair and impartial manner. A member or candidate may have multiple relationships with an institution; for example, the member or candidate may be a corporate trustee, pension fund manager, manager of funds for individuals employed by the customer, loan originator, or creditor. A member or candidate must exercise care to treat all clients fairly.

Members and candidates should disclose to clients and prospective clients the documented allocation procedures they or their firms have in place and how the procedures would affect the client or prospect. The disclosure should be clear and complete so that the client can make an informed investment decision. Even when complete disclosure is made, however, members and candidates must put client interests ahead of their own. A member's or candidate's duty of fairness and loyalty to clients can never be overridden by client consent to patently unfair allocation procedures.

## Compliance Practices

### Comply with Firm Policies

Members and candidates must follow their firm's compliance procedures for treating clients fairly. The extent of the formality and complexity of such compliance procedures depends on the nature and size of the organization and the services it provides. Members and candidates should recommend appropriate procedures to management if none are in place. Members and candidates should also make management aware of possible violations of fair-dealing practices when they come to the attention of the member or candidate.

Members and candidates who have responsibility and authority to implement compliance procedures for their firm should work to implement formal written procedures to ensure that all clients receive fair investment action.

Members and candidates should consider the following points for fair-dealing compliance practices:

- *Disseminate investment recommendations based on indications of interest and suitability:* Make initial investment recommendations available to all clients who indicate an interest. Although a member or candidate need not communicate a recommendation to all customers, the selection process by which customers receive information should be based on suitability and known interest, not on any preferred or favored status. A common practice to ensure fair dealing is to communicate recommendations simultaneously within the firm and to customers.
- *Limit the number of people involved:* Members and candidates should make reasonable efforts to limit the number of people who are aware that a recommendation is going to be disseminated.

- *Shorten the time frame between decision and dissemination:* Members and candidates should make reasonable efforts to limit the amount of time that elapses between the decision to make an investment recommendation and the time the actual recommendation is disseminated. If a detailed recommendation could take two or three weeks to publish, a short summary report including the conclusion might be published in advance.
- *Publish guidelines for predissemination behavior:* Members and candidates who have prior knowledge of an investment recommendation should refrain from discussing or taking any action on the pending recommendation and must follow any firm policies regarding conduct prior to dissemination of investment recommendations.
- *Simultaneous dissemination:* Members and candidates should establish procedures for the timing of dissemination of investment recommendations so that all clients are treated fairly—that is, informed at approximately the same time. For example, if a firm is going to announce a new recommendation, supervisory personnel should time the announcement to avoid placing any client or group of clients at an unfair advantage relative to other clients. Once this distribution has occurred, the member or candidate may follow up separately with individual clients, but members and candidates must not give favored clients advance information when such advance notification may disadvantage other clients.
- *Maintain a list of clients and their holdings:* Members and candidates should maintain a list of all clients and the securities or other investments each client holds in order to facilitate notification of customers or clients of a change in an investment recommendation. If a particular security or other investment is to be sold, such a list can be used to ensure that all holders are treated fairly in the liquidation of that particular investment.
- *Develop and document trade allocation procedures:* When formulating procedures for allocating trades, members and candidates should develop a set of guiding principles that ensure
  - fairness to advisory clients, both in priority of execution of orders and in the allocation of the price obtained in execution of block orders or trades,
  - timeliness and efficiency in the execution of orders, and
  - accuracy of the member's or candidate's records as to trade orders and client account positions.

With these principles in mind, members and candidates should follow certain allocation practices, especially with regard to block trades and new issues. Practices to consider include

- requiring orders and modifications or cancellations of orders to be documented and time stamped;
- processing and executing orders on a first-in, first-out basis, with consideration of bundling orders for efficiency as appropriate for the asset class or the security;

- developing a policy to address such issues as calculating execution prices and “partial fills” when trades are grouped, or in a block, for efficiency;
  - giving all client accounts participating in a block trade the same execution price and charging the same commission;
  - when the full amount of the block order is not received, allocating partially executed orders among the participating client accounts pro rata on the basis of order size while not going below an established minimum lot size for some securities (e.g., bonds); and
  - when allocating trades for new issues, obtaining advance indications of interest, allocating securities by client (rather than portfolio manager), and providing a method for calculating allocations.
- *Disclose trade allocation procedures:* Members and candidates should disclose to clients and prospective clients how they select accounts to participate in an order and how they determine the amount of securities each account will buy or sell. Trade allocation procedures must be fair and equitable, and disclosure of inequitable allocation methods does not relieve the member or candidate of this obligation.
  - *Establish systematic account review:* Members and candidates who are supervisors should review each account on a regular basis to ensure that no client or customer is being given preferential treatment and that the investment actions taken for each account are suitable for each account’s objectives. Because investments must be based on individual needs and circumstances, an investment manager may have good reasons for placing a given security or other investment in one account while selling it from another account and should fully document the reasons behind both sides of the transaction. Members and candidates should encourage firms to establish review procedures, however, to detect whether trading in an account is being used to benefit a favored client.
  - *Disclose levels of service:* Members and candidates must disclose to all clients whether the organization offers different levels of service to clients for the same fee or different fees. Different levels of service should not be offered to clients selectively.

## Application of the Standard

### Example 1 (Selective Disclosure)

Ames, a well-known and respected analyst, follows the computer industry. In the course of his research, he finds that a small, relatively unknown company whose shares are traded over the counter has just signed significant contracts with some of the companies he follows. After a considerable amount of investigation, Ames decides to write a research report on the small company and recommend purchase of its shares. While the report is being reviewed by

the company for factual accuracy, Ames schedules a luncheon with several of his best clients to discuss the company. At the luncheon, he mentions the purchase recommendation scheduled to be sent early the following week to all the firm's clients.

*Comment:* Ames violated Standard III(B) by disseminating the purchase recommendation to the clients with whom he had lunch a week before the recommendation is sent to all clients.

## Example 2 (Fair Dealing between Funds)

Rivers, president of XYZ Corporation, moves his company's growth-oriented pension fund to a particular bank primarily because of the excellent investment performance achieved by the bank's commingled fund for the prior five-year period. Later, Rivers compares the results of his pension fund with those of the bank's commingled fund. He is startled to learn that, even though the two accounts have the same investment objectives and similar portfolios, his company's pension fund has significantly underperformed the bank's commingled fund. Questioning this result at his next meeting with Jackson, the pension fund's manager, Rivers is told that, as a matter of policy, when a new security is placed on the recommended list, Jackson first purchases the security for the commingled account and then purchases it on a pro rata basis for all other pension fund accounts. Similarly, when a sale is recommended, the security is sold first from the commingled account and then sold on a pro rata basis from all other accounts. Rivers also learns that if the bank cannot get enough shares (especially of hot issues) to be meaningful to all the accounts, its policy is to place the new issues only in the commingled account.

Seeing that Rivers is neither satisfied nor pleased by the explanation, Jackson quickly adds that nondiscretionary pension accounts and personal trust accounts have an even lower priority on purchase and sale recommendations than discretionary pension fund accounts. Furthermore, Jackson states that the company's pension fund had the opportunity to invest up to 5% in the commingled fund.

*Comment:* The bank's policy does not treat all customers fairly, and Jackson violated her duty to her clients by giving priority to the growth-oriented commingled fund over all other funds and to discretionary accounts over nondiscretionary accounts. Jackson must execute orders on a systematic basis to be fair to all clients.

## Example 3 (Fair Dealing and IPO Distribution)

Morris works for a small regional securities firm. His work consists of corporate finance activities and investing for institutional clients. PickleDilly, Ltd., is planning to go public. The partners have secured rights to buy a professional pickleball franchise and plan to use the funds from the issue to complete the purchase. Because pickleball is the current rage, Morris believes he has a hot

issue on his hands. He has quietly negotiated some options for himself for helping convince PickleDilly to do the financing through his securities firm. When he seeks expressions of interest, institutional buyers oversubscribe the issue. Morris, assuming that the institutions have the financial clout to drive the stock up, fills all orders (including his own) but decreases the institutional blocks.

*Comment:* Morris violated Standard III(B) by not treating all customers fairly. To meet his obligations under the standard, Morris needed to refrain from taking any shares himself and needed to prorate the distribution of the shares to clients or use some other distribution method for treating clients fairly. In addition, he should have avoided the conflict of interest caused by the options by not seeking those additional benefits. Because Morris did not avoid the conflict, he must disclose to his firm and to his clients that he received options as part of the deal [see Standard VI(A) Disclosure of Conflicts].

#### Example 4 (Fair Dealing and Transaction Allocation)

Preston, the chief investment officer of Porter Williams Investments (PWI), a medium-size money management firm, has been trying to retain a client, Colby Company. Management at Colby, which accounts for almost half of PWI's revenues, recently told Preston that if the performance of its account did not improve, it would find a new money manager. Shortly after this threat, Preston purchases mortgage-backed securities (MBSs) for several accounts, including Colby's. Preston is busy with a number of transactions that day, so she fails to allocate the trades immediately or write up the trade tickets. A few days later, when Preston is allocating trades, she notes that some of the MBSs have significantly increased in price and some have dropped. Preston decides to allocate the profitable trades to Colby and spread the losing trades among several other PWI accounts.

*Comment:* Preston violated Standard III(B) by failing to deal fairly with her clients in taking these investment actions. Preston should have allocated the trades prior to executing the orders, or she should have had a systematic approach to allocating the trades, such as pro rata, as soon as it was practical after they were executed.

#### Example 5 (Selective Disclosure)

Saunders Industrial Waste Management (SIWM) publicly indicates to analysts that it is comfortable with the somewhat disappointing earnings-per-share projection of US\$1.16 for the quarter. Roberts, an analyst at Coffey Investments, is confident that SIWM management understated the forecasted earnings so that the real announcement would cause an "upside surprise" and boost the price of SIWM stock. The "whisper number" (rumored) estimate based on

extensive research and discussed among knowledgeable analysts is higher than US\$1.16. Roberts repeats the US\$1.16 figure in his research report to all Coffey clients but informally tells his large clients that he expects the earnings per share to be higher, making SIWM a good buy.

*Comment:* By not sharing his opinion regarding the potential for a significant upside earnings surprise with all clients, Roberts did not treat all clients fairly and violated Standard III(B).

### Example 6 (Additional Services for Select Clients)

Weng uses email to issue a new recommendation to all his clients. He then calls his three largest institutional clients to discuss the recommendation in detail, and they compensate him for the personal outreach.

*Comment:* Weng did not violate Standard III(B). He widely disseminated the recommendation and information to all his clients prior to discussing it with a select few. Weng's largest clients received additional personal service because they pay higher fees. If Weng had discussed the report with a select group of clients prior to distributing it to all his clients, he would have violated Standard III(B).

### Example 7 (Minimum Lot Allocations)

Hampton is a well-respected private wealth manager in her community with a diversified client base. She determines that a new 10-year bond being offered by Healthy Pharmaceuticals is appropriate for five of her clients. Three clients request to purchase US\$10,000 each, and the other two request US\$50,000 each. The minimum lot size is established at US\$5,000, and the issue is oversubscribed at the time of placement. Her firm's policy is that odd-lot allocations, especially those below the minimum, should be avoided because they may affect the liquidity of the security at the time of sale.

Hampton is informed she will receive only US\$55,000 of the offering for all accounts. Hampton distributes the bond investments as follows: The three accounts that requested US\$10,000 are allocated US\$5,000 each, and the two accounts that requested US\$50,000 are allocated US\$20,000 each.

*Comment:* Hampton did not violate Standard III(B), even though the distribution is not on a completely pro-rata basis, because of the required minimum lot size. With the total allocation being significantly below the amount requested, Hampton ensured that each client received at least the minimum lot size of the issue and that the filled allocations were close in percentage to the requested allocations. This approach allowed the clients to efficiently sell the bond later, if necessary.

### Example 8 (Excessive Trading)

Chan manages the accounts for many pension plans, including the plan of his father's employer. Chan developed similar but not identical investment policies for each client, so the investment portfolios are rarely the same. To minimize the cost to his father's pension plan, he intentionally trades more frequently in the accounts of other clients to ensure the required brokerage commissions are incurred to continue receiving free research that benefits all the pension plans.

*Comment:* Chan is violating Standard III(B) because his trading actions are disadvantaging his clients to enhance a relationship with a preferred client. All clients are benefiting from the research being provided and should incur their fair portion of the costs. This does not mean that additional trading should occur if a client has not paid an equal portion of the commission; trading should occur only as required by the strategy.

### Example 9 (Limited Social Media Disclosures)

Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm, including on Facebook, LinkedIn, and X (formerly known as Twitter). Burdette's supervisor, Graf, encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients.

As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto Ltd.'s new solar technology for compact automobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette posts a brief message to FIM LinkedIn followers summarizing her "buy" recommendation for Sun Drive Auto stock.

*Comment:* Burdette violated Standard III(B) by sending an investment recommendation to a select group of contacts prior to distributing it to all clients.

### Example 10 (Performance Analysis)

Rove, a performance analyst for Alpha-Beta Investment Management, is describing to the firm's chief investment officer (CIO) two new reports he would like to develop to assist the firm in meeting its obligations to treat clients fairly. Because many of the firm's clients have similar investment objectives and portfolios, Rove suggests a report detailing securities owned across several client accounts and the percentage of the portfolio each security represents. The second report would compare the monthly performance of portfolios with similar strategies. The outliers in each report would be submitted to the CIO for review.

*Comment:* As a performance analyst, Rove likely has little direct contact with clients and thus has limited opportunity to treat clients differently. The recommended reports comply with Standard III(B) while helping the firm conduct after-the-fact reviews of how effectively the firm's advisers are dealing with their clients' portfolios. Reports that monitor the fair treatment of clients are an important oversight tool to ensure that clients are treated fairly.

## Standard III(C) Suitability

1. When Members and Candidates are in an advisory relationship with a client, they must:
  - a. Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
  - b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
  - c. Judge the suitability of investments in the context of the client's total portfolio.
2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

## Guidance

Standard III(C) requires that members and candidates who are in an investment advisory relationship with clients carefully consider the needs, circumstances, and objectives of the clients when determining the appropriateness and suitability of a given investment or course of investment action. An appropriate suitability determination will not, however, prevent some investments or investment actions from losing value.

In judging the suitability of a potential investment, the member or candidate must review many aspects of the client's knowledge, experience related to investing, and financial situation. These aspects include but are not limited to the risk profile of the investment as compared with the constraints of the client, the impact of the investment on the diversity of the portfolio, and whether the client has the means or net worth to assume the associated risk. Not every investment opportunity will be suitable for every portfolio, regardless of the potential return being offered.

The responsibilities of members and candidates to gather information and conduct a suitability analysis prior to making a recommendation or taking

investment action fall on those members and candidates who provide investment advice in the course of an advisory relationship with a client. Other members and candidates may be simply executing specific instructions for retail clients when buying or selling securities, such as shares in mutual funds. These members and candidates, as well as others, such as sell-side analysts, may not have the opportunity to judge the suitability of a particular investment for the ultimate client.

## Developing an Investment Policy

When an advisory relationship exists, members and candidates must gather client information at the inception of the relationship. Such information includes the client's financial circumstances, personal data (such as age and occupation) relevant to investment decisions, attitudes toward risk, and investment objectives. Best practice dictates incorporating this information into a written investment policy statement (IPS) that addresses the client's risk tolerance and return requirements and all relevant investment limitations (including time horizon, liquidity needs, tax concerns, and legal and regulatory factors). For some clients, the IPS may include unique constraints or preferences, such as incorporating environmental, social, and governance (ESG) factors during the investment decision-making process. Without identifying such client factors, members and candidates cannot judge whether a particular investment or strategy is suitable for a particular client. The IPS also should identify and describe the roles and responsibilities of the parties to the advisory relationship and investment process, as well as schedules for review and evaluation of the IPS. After formulating long-term capital market expectations, members and candidates can assist in developing an appropriate strategic asset allocation and investment program for the client, whether these are presented in separate documents or incorporated in the IPS or in appendices to the IPS.

## Understanding the Client's Risk Profile

One of the most important factors to be considered in matching appropriateness and suitability of an investment with a client's needs and circumstances is measuring the client's tolerance for risk. The investment professional must consider the possibilities of rapidly changing investment environments and their likely impact on a client's holdings, both individual holdings and the collective portfolio. The risk of investment strategies must be analyzed and quantified in advance.

The use of synthetic investment vehicles and derivative investment products introduces particular risks. Members and candidates must pay careful attention to the leverage inherent in many of these vehicles or products when considering them for use in a client's investment program. Leverage and limited liquidity, depending on the degree to which they are hedged, directly impact suitability for the client.

## Updating an Investment Policy

An IPS should be reviewed at least annually and also prior to material changes to any specific investment recommendations or decisions on behalf of the client. The effort to determine the needs and circumstances of each client is not a one-time occurrence. Investment recommendations or decisions are usually part of an ongoing process that takes into account the diversity and changing nature of portfolio and client characteristics. The passage of time is bound to produce changes that are important with respect to investment objectives.

For an individual client, important changes might include the number of dependents, personal tax status, health, liquidity needs, risk tolerance, amount of wealth beyond that represented in the portfolio, and extent to which compensation and other income provide for current income needs. With respect to an institutional client, such changes might relate to the magnitude of unfunded liabilities in a pension fund, the withdrawal privileges in an employee savings plan, or the distribution requirements of a charitable foundation. For both individual and institutional clients, the perspective on investment valuation and strategy factors may change with time. As an example, an initial IPS may not include client concerns related to ESG policies, which may have increased in importance since the start of the advisory relationship. Without efforts to update information concerning client factors, one or more factors could change without the investment manager's knowledge.

Members and candidates should encourage their clients to fully disclose their complete financial portfolio, including those portions not managed by the member or candidate, to facilitate an effective suitability determination. If clients withhold information about their financial portfolios, the suitability analysis conducted by members and candidates must be based on the information provided and cannot be expected to be complete.

## Diversification

The investment profession has long recognized that a portfolio composed of several different investments is likely to provide a more acceptable level of risk exposure than having all assets in a single investment. The unique characteristics (or risks) of an individual investment may become partially or entirely neutralized when it is combined with other individual investments in a portfolio. Some reasonable amount of diversification is thus the norm for many portfolios, especially those managed by individuals or institutions that have some degree of legal fiduciary responsibility.

An investment with high relative risk on its own may be a suitable investment in the context of the entire portfolio or when the client's stated objectives contemplate speculative or risky investments. The manager may be responsible for only a portion of the client's total portfolio, or the client may not have provided a full financial picture. Members and candidates are responsible for

assessing the suitability of an investment only on the basis of the information and criteria actually provided to them by the client.

## Addressing Unsolicited Trading Requests

Members and candidates may receive requests from a client for trades that do not properly align with the risk and return objectives outlined in the client's IPS. Members and candidates need to make reasonable efforts to balance their clients' trading requests with their responsibilities to follow the agreed-on IPS.

In cases of unsolicited trade requests that a member or candidate knows are unsuitable for a client, the member or candidate should refrain from making the trade until he or she discusses the concerns with the client. The discussions and resulting actions may encompass a variety of scenarios depending on how the requested unsuitable investment relates to the client's full portfolio. In discussing the trade, the member or candidate should focus on educating the investor on how the request deviates from the current policy statement. The member or candidate should require the client to acknowledge the discussion, including that the trade is against the advice of the member or candidate because it is unsuitable for the portfolio.

If the unsolicited request is expected to have a material impact on the portfolio, the member or candidate should use this opportunity to update the IPS. Doing so would allow the client to fully understand the potential effect of the requested trade on his or her current goals or risk levels.

Members and candidates may have clients who decline to modify their policy statements while insisting an unsolicited trade be made. In such instances, members or candidates should evaluate the effectiveness of their services to the client and determine whether they should continue the advisory arrangement with the client.

## Managing to an Index or Mandate

Some members and candidates do not manage money for individuals but are responsible for managing a fund to an index or an expected mandate. The responsibility of these members and candidates is to invest in a manner consistent with the stated mandate. For example, a member or candidate who serves as the fund manager for a large-cap income fund would not be following the fund mandate by investing heavily in small-cap companies or start-ups whose stock is speculative in nature. Members and candidates who manage pooled assets to a specific mandate are not responsible for determining the suitability of the *fund* as an investment for investors who may be purchasing shares in the fund. The responsibility for determining the suitability of an investment for clients can be conferred only on members and candidates who have an advisory relationship with clients.

## Compliance Practices

### IPS

To fulfill the basic provisions of Standard III(C), a member or candidate should put the needs and circumstances of each client and the client's investment objectives into a written IPS. In formulating an investment policy for the client, the member or candidate should take the following into consideration:

- Client identification—(1) type and nature of client, (2) the existence of separate beneficiaries, and (3) approximate portion of total client assets that the member or candidate is managing
- Client expectations—(1) return objectives (income, growth in principal, maintenance of purchasing power) and (2) risk tolerance (suitability, stability of values)
- Client constraints—(1) liquidity needs; (2) expected cash flows (patterns of additions and/or withdrawals); (3) investable funds (assets and liabilities or other commitments); (4) time horizon; (5) tax considerations; (6) regulatory and legal circumstances; (7) investor preferences, prohibitions, circumstances, and unique needs, such as a framework for incorporating ESG factors; and (8) proxy voting responsibilities and guidance
- Performance measurement benchmarks

### Regular Updates

Members and candidates should periodically review the investor's objectives and constraints and reflect any changes in the client's circumstances in an updated IPS. Members and candidates should regularly compare client constraints with capital market expectations to arrive at an appropriate asset allocation. Changes in either factor may result in a fundamental change in asset allocation. Members and candidates should review each client's IPS annually unless business or other reasons, such as a major change in market conditions, dictate more frequent review.

### Suitability Test Policies

Members and candidates must comply with their firm's policies and procedures relating to suitability. Appropriate suitability test procedures require the investment professional to look beyond the return potential of the investment and include the following:

- an analysis of the impact on the portfolio's diversification,
- a comparison of the investment risks with the client's assessed risk tolerance, and
- the fit of the investment with the required investment strategy.

## Application of the Standard

### Example 1 (Investment Suitability—Risk Profile)

Smith, an investment adviser, has two clients: Robertson, who is 60 years old, and Lanai, who is 40 years old. Both clients earn roughly the same salary, but Robertson has a much higher risk tolerance because he has a large asset base and low income needs. Robertson is willing to invest part of his assets very aggressively; Lanai wants only to achieve a steady rate of return with low volatility to pay for his children's education. Smith recommends investing 20% of both portfolios in zero-yield, small-cap, high-technology equity issues.

*Comment:* In Robertson's case, the investment may be appropriate because of his financial circumstances and aggressive investment position, but this investment is not suitable for Lanai. Smith violated Standard III(C) by applying Robertson's investment strategy to Lanai because the two clients' financial circumstances and objectives differ.

### Example 2 (Investment Suitability—Entire Portfolio)

McDowell, an investment adviser, suggests to Crosby, a risk-averse client, that covered call options be used in his equity portfolio. The purpose would be to enhance Crosby's income and partially offset any untimely depreciation in the portfolio's value should the stock market or other circumstances affect his holdings unfavorably. McDowell educates Crosby about all possible outcomes, including the risk of incurring an added tax liability if a stock rises in price and is called away and, conversely, the risk of his holdings losing protection on the downside if prices drop sharply.

*Comment:* When determining suitability of an investment, the primary focus should be the characteristics of the client's entire portfolio, not the characteristics of single securities on an issue-by-issue basis. The basic characteristics of the entire portfolio will largely determine whether investment recommendations are taking client factors into account. In this case, McDowell properly considers the investment in the context of the entire portfolio and thoroughly explains the investment to the client.

### Example 3 (IPS Updating)

Evans, a portfolio manager at Blue Chip Investment Advisers, learns that some significant changes have recently taken place in Jones's life. A wealthy relative left Jones an inheritance that increased his net worth fourfold, to US\$1 million.

*Comment:* The inheritance may have significantly increased Jones's ability (and possibly his willingness) to assume risk and perhaps has diminished the average yield required to meet his current income needs. Jones's financial circumstances have changed considerably,

so Evans must review and potentially update Jones's IPS to reflect how his investment objectives have changed.

### Example 4 (Following an Investment Mandate)

Perkowski manages a high-income mutual fund. He purchases zero-dividend stock in a financial services company because he believes the stock is undervalued and is in a potential growth industry, which makes it an attractive investment.

*Comment:* A zero-dividend stock does not seem to fit the mandate of the fund that Perkowski manages. Unless Perkowski's investment fits within the mandate or is in the realm of allowable investments the fund has made clear in its disclosures, Perkowski violated Standard III(C).

### Example 5 (IPS Requirements and Limitations)

Gubler, chief investment officer of a property/casualty insurance subsidiary of a large financial conglomerate, wants to improve the diversification of the subsidiary's investment portfolio and increase its returns. The subsidiary's IPS provides for liquid investments, such as large-cap equities and government, supranational, and corporate bonds with a minimum credit rating of AA and maturity of no more than five years. In a recent presentation, a venture capital group offered very attractive prospective returns on some of its private equity funds that provide seed capital to ventures. Investors would have to observe a minimum three-year lockup period and a subsequent ladder exit option for a maximum of one-third of their shares per year. Gubler does not want to miss this opportunity. In an effort to optimize the return on the equity assets in the subsidiary's current portfolio and after extensive analysis, he invests 4% in this seed fund, leaving the portfolio's total equity exposure still well below its upper limit.

*Comment:* Gubler violated Standard III(C). His new investment locks up part of the subsidiary's assets for at least three years and up to as many as five years or more. The IPS requires investments in highly liquid investments and describes accepted asset classes; private equity investments with a lockup period would not fall within the mandate. Even without a lockup period, an asset class with only an occasional and thus implicitly illiquid market may not be suitable for the portfolio.

### Example 6 (Investment Suitability—Risk Profile)

Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark

indexes. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy for the retirement funds she manages and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' IPSs. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

*Comment:* Snead violated Standard III(C) by investing the clients' assets in high-beta stocks. These high-risk investments are contrary to the long-term risk profile established in the clients' IPSs. Snead has changed the investment strategy of the clients in an attempt to reap short-term rewards offered by her firm's new compensation arrangement, not in response to changes in clients' IPSs.

### Example 7 (Constraints)

DeVries is trustee of the MPG pension fund. Recently, the fund conducted a survey on the preferences of the beneficiaries. The survey asked several questions about the return impact and risks associated with the incorporation of ESG issues into the investment selection process. The results of the survey showed that the beneficiaries like high pension payouts, but the investment returns should be achieved while considering ESG issues.

DeVries introduces an amendment to the IPS to incorporate an ESG framework into the investment decision-making process. Among the specific factors in the ESG framework is a restriction on investing in producers of products that negatively affect the health of consumers. The changes to the IPS are approved by the MPG pension board and communicated to all external managers.

After receiving communications on the update to the IPS, Van Cleef, an external manager for the MPG pension fund, purchases stock in a tobacco firm. He reasons that tobacco, although not healthy, exhibits an attractive risk-return profile and will contribute to the high pension payouts that the beneficiaries so desire. Van Cleef believes that investment return is his first priority as a manager.

*Comment:* Van Cleef violated Standard III(C) because he failed to consider the constraints and unique circumstances of the beneficiaries of the pension fund. In this case, a preference for incorporating ESG issues into the investment process is clearly mandated.

The trustees have a duty to ensure that the fund's assets are invested in accordance with the IPS. Any trustee who is required to abide by the Code and Standards, such as DeVries, would need to ensure that Van Cleef sells the inappropriate tobacco securities.

## Example 8 (Suitability Factors)

Kim is the portfolio manager of a family office. The family office's IPS objectives include long-term capital preservation and mitigation of downside risk. Kim is considering two investments in the chemical industry: Park Inc. and Dong Inc. Solely on the basis of financial statement analysis, the Park Inc. investment is the most attractive. Upon further analysis, Kim finds that Dong Inc. scores much higher than Park Inc. on other factors, including ESG criteria.

Kim believes that companies scoring high on ESG factors typically have higher-quality management and reduced environmental risks, such as risks that might lead to costly accidents or regulatory fines. Such factors ultimately benefit the expected return and risk profile of the investment. On that basis, Kim invests in Dong Inc. for the family office.

*Comment:* Kim has a responsibility to select investments that are suitable for the IPS objectives. He is permitted to incorporate criteria beyond financial metrics, including but not limited to ESG issues, into the investment decision-making process. Kim's actions are not in conflict with his obligation to make effective suitability determinations.

## Standard III(D) Performance Presentation

When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

### Guidance

Standard III(D) requires members and candidates to provide credible performance information to clients and prospective clients and to avoid misstating performance or misleading clients and prospective clients about the investment performance of members or candidates or their firms. This standard encourages full disclosure of investment performance data to clients and prospective clients.

Standard III(D) covers any practice that would lead to misrepresentation of a member's or candidate's performance record, whether the practice involves performance presentation or performance measurement. This standard prohibits misrepresentations of past performance or expected performance. A member or candidate must give a fair and complete presentation of performance information whenever communicating data with respect to the performance history of individual accounts, composites, or groups of accounts.

The requirements of this standard are not limited to members and candidates managing separate accounts. Whenever a member or candidate provides performance information for which the manager is claiming responsibility, such as for pooled funds, the history must be accurate. Research analysts promoting the success or accuracy of their recommendations must ensure that their claims are fair, accurate, and complete.

If the presentation is brief, the member or candidate must make available to clients and prospects, on request, the detailed information supporting that communication. Best practice dictates that brief presentations include a reference to the limited nature of the information provided.

### Compliance Practices

#### Compliance with the GIPS Standards

For members and candidates who are showing the performance history of the assets they manage, compliance with the GIPS standards is the best method to meet their obligations under Standard III(D). Members and candidates should encourage their firms to comply with the GIPS standards.

Members and candidates whose firms do not comply with the GIPS standards can meet their obligations under Standard III(D) to present fair, accurate, and complete investment performance history by, among other things,

- considering the knowledge and sophistication of the audience to whom a performance presentation is addressed when determining what information to provide and tailoring it accordingly,
- presenting the performance of a composite of similar portfolios rather than using a single representative account,
- including terminated accounts as part of any composite performance history,
- including disclosures that fully explain the performance results being reported (for example, stating, when appropriate, that results are simulated when model results are used; clearly indicating when the performance record is that of a prior entity; or disclosing whether the performance is gross of fees, net of fees, or after tax), and
- maintaining the data and records used to calculate the performance being presented.

## Application of the Standard

### Example 1 (Performance Calculation and Length of Time)

Taylor of Taylor Trust Company distributes a brochure to potential clients stating that the firm consistently achieves “25% annual growth” of assets. Taylor Trust’s common trust fund did increase 25% for the previous year, which mirrored the increase of the overall market. The fund never had an annual growth rate of 25% prior to last year, and the average rate of growth of all of Taylor Trust accounts for five years is 5% per year.

*Comment:* Taylor’s brochure is in violation of Standard III(D). Taylor must disclose that the 25% growth occurred only in one year and only for the firm’s common trust fund. A general claim of firm performance must take into account the performance of all categories of accounts. By stating that clients can expect a steady 25% annual compound growth rate, Taylor is misrepresenting one portfolio’s single-year actual performance as expected performance.

### Example 2 (Performance Calculation and Asset Weighting)

Judd, a senior partner at Alexander Capital Management, circulates a performance report for the capital appreciation accounts for the years 2008 through 2022. The firm claims compliance with the GIPS standards. Returns are not calculated in accordance with the requirements of the GIPS standards,

however, because the composite returns are not calculated by asset weighting portfolio returns.

*Comment:* Judd violated Standard III(D). When claiming compliance with the GIPS standards, firms must meet all the requirements, make mandatory disclosures, and meet any other requirements that apply to that firm's specific situation. The GIPS standards require firms to asset weight portfolio returns to calculate composite returns. Judd's violation is not from any misuse of the data but from publishing a performance report with her firm's false claim of GIPS compliance.

### Example 3 (Performance Presentation and Prior Fund/Employer)

McCoy is vice president and managing partner of the equity investment group of Mastermind Financial Advisers, a new business. Mastermind recruited McCoy because he had a proven six-year track record with G&P Financial. In developing Mastermind's advertising and marketing campaign, McCoy prepares an advertisement that includes the equity investment performance he achieved at G&P Financial. The advertisement for Mastermind does not identify the equity performance as being earned while at G&P. The advertisement is distributed to existing clients and prospective clients of Mastermind.

*Comment:* McCoy violated Standard III(D) by distributing an advertisement that contains material misrepresentations about the historical performance of Mastermind. Standard III(D) requires that members and candidates make reasonable efforts to ensure that performance information is a fair, accurate, and complete representation of an individual's or firm's performance. As a general matter, this standard does not prohibit showing past performance of accounts managed at a prior firm as part of a performance track record as long as showing that record is accompanied by appropriate disclosures about where the performance took place and the person's specific role in achieving that performance. If McCoy chooses to use his past performance from G&P in Mastermind's advertising, he must make full disclosure of the source of the historical performance.

### Example 4 (Performance Presentation and Simulated Results)

Davis developed a mutual fund selection product based on historical information from 2000 to 2015. Davis tests his methodology by applying it retroactively to data from the 2016–22 period, thus producing simulated performance results for those years. In January 2023, Davis's employer decides to offer the product and Davis begins promoting it through trade journal advertisements and direct dissemination to clients. The advertisements include the performance results for the 2016–22 period but do not indicate that the results were simulated.

*Comment:* Davis violated Standard III(D) by failing to clearly identify simulated performance results. Standard III(D) prohibits members and candidates from making any statements that misrepresent the performance achieved by them or their firms and requires members and candidates to make every reasonable effort to ensure that performance information presented to clients is fair, accurate, and complete. Davis's use of simulated results must be accompanied by full disclosure as to the source of the performance data, including the fact that the results from 2016 through 2022 are the result of applying the model retroactively to that time period.

### Example 5 (Performance Calculation and Selected Accounts Only)

In a presentation prepared for prospective clients, Kilmer shows the rates of return realized over a five-year period by a "composite" of his firm's discretionary accounts that have a "balanced" objective. This composite, however, consists of only a few of the accounts that met the balanced criterion set by the firm, excludes accounts under a certain asset level without disclosing the fact of their exclusion, and includes accounts that do not have the balanced mandate, because those accounts help increase the investment results. In addition, to achieve better results, Kilmer manipulates the narrow range of accounts included in the composite by changing the accounts that make up the composite over time.

*Comment:* Kilmer violated Standard III(D) by misrepresenting the facts in the promotional material sent to prospective clients, distorting his firm's performance record, and failing to include disclosures that would have clarified the presentation.

### Example 6 (Performance Attribution Changes)

Purell is reviewing the quarterly performance attribution reports for distribution to clients. Purell works for an investment management firm with a bottom-up, fundamentals-driven investment process that seeks to add value through stock selection. The attribution methodology compares each stock's return with its sector return. The attribution report indicates that the value added this quarter came from asset allocation and that stock selection contributed negatively to the calculated return.

After trying several different approaches, Purell discovers that calculating attribution by comparing each stock with its industry and then rolling the effect to the sector level improves the appearance of the manager's stock selection activities. Because the firm defines the attribution terms and the results better reflect the stated strategy, Purell recommends that the client reports should use the revised methodology.

*Comment:* Modifying the attribution methodology without proper disclosure fails to meet the requirements of Standard III(D). Purell's recommendation is being done solely for the interest of the firm to improve its perceived ability to meet the stated investment strategy. Such changes obscure the facts regarding the firm's abilities.

### Example 7 (Performance Calculation Methodology Disclosure)

While developing a new reporting package for existing clients, Singh, a performance analyst, discovers that her company's new system automatically calculates both time-weighted and money-weighted returns. She asks the head of client services and retention which return type is preferred given that the firm has various investment strategies that include bonds, equities, securities without leverage, and alternatives. Singh is told not to label the returns so that the firm may show whichever performance calculation provides the highest return for the period.

*Comment:* Following these instructions would lead to Singh violating Standard III(D). In reporting inconsistent return types, Singh would not be providing complete information to the firm's clients. Complete information is provided when clients have sufficient information to judge the performance generated by the firm.

## Standard III(E) Preservation of Confidentiality

Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client,
2. Disclosure is required by law, or
3. The client or prospective client permits disclosure of the information.

### Guidance

Standard III(E) requires that members and candidates preserve the confidentiality of information communicated to them by their clients, prospective clients, and former clients. This standard is applicable when (1) the member or candidate receives information because of his or her special ability to conduct a portion of the client's business or personal affairs and (2) the member or candidate receives information that arises from or is relevant to that portion of the client's business that is the subject of the special or confidential relationship. If disclosure of the information is required by law or the information concerns illegal activities by the client, however, the member or candidate may have an obligation to report the activities to the appropriate authorities.

### Status of Client

This standard protects the confidentiality of client information even if the person or entity is no longer a client of the member or candidate. Therefore, members and candidates must continue to maintain the confidentiality of client records even after the client relationship has ended. If a client or former client expressly authorizes the member or candidate to disclose information, however, the member or candidate may follow the terms of the authorization and provide the information.

### Compliance with Laws

Standard I(A) Knowledge of the Law requires members and candidates to comply with applicable law. If applicable law requires disclosure of client information in certain circumstances, members and candidates must comply with the law. Similarly, if applicable law requires members and candidates to maintain confidentiality, even if the information concerns illegal activities on the part of the client, members and candidates must comply with the law and not disclose such information. When in doubt, members and candidates should

consult with their employer's compliance personnel or legal counsel before disclosing confidential information about clients.

## Vulnerable Investors

Standard III(A) Loyalty, Prudence, and Care requires members and candidates to diligently work to safeguard the interests of all clients, including potentially vulnerable investors, and faithfully exercise their professional responsibilities. Actions involving dishonesty and fraud damage security markets beyond the financial losses of some investors by undermining the faith and confidence of every participant in the investment industry. Understanding the obligations and how to recognize the red flags of diminished capacity and financial exploitation by others is critical to protecting the interests of potentially vulnerable investors.

Standard III(E) establishes a duty for members and candidates to keep client information confidential from third parties. Doing so can be problematic if the member or candidate suspects that the client's mental acuity is declining and thus believes it is necessary to consult with outside parties. Best practice for members and candidates is to establish a secondary contact at the beginning of the client relationship. This contact could be a trusted family member, a legal adviser, or some other third-party intermediary whom clients permit contacting should concerns arise about their ability to make informed decisions about their finances. The nominated secondary contact provides members and candidates an avenue to prevent and/or address potential financial abuse of the client.

Without such an agreement, requirements of members and candidates in regard to maintaining the confidentiality of client relationships and accounts may prevent discussing concerns with anyone other than the direct account holders. Local law and regulations may not provide clarity about the circumstances under which the investment professional can consult with others about the client's account. Previously agreed-on parameters with the client and appropriate compliance policies, procedures, and training by employers are important to determine the best course of action.

As long as it is legally permissible, a member's or candidate's duty of loyalty to clients may allow limited disclosures pertaining to the existence of a client account and concerns about the vulnerability of the client as directed by applicable law. Often, regulatory or governmental agencies provide resources for intervening when such concerns arise. These agencies have the authority to properly investigate the situation of the investor. Members and candidates seeking to protect client interests and following applicable law on permitted disclosures do not violate Standard III(E).

All conversations with the client and any outside parties regarding the reasons for disclosing any sensitive or confidential information should be fully documented and retained in the client files.

## Electronic Information and Security

Because of the ever-increasing use of electronically stored information, members and candidates need to be particularly aware of potential accidental disclosures. Many employers have strict policies about how to electronically communicate sensitive client information and store client information on personal laptops, mobile devices, or external storage devices or systems. Standard III(E) does not require members or candidates to become experts in information security technology, but they should have a thorough understanding of the policies of their employer for ensuring the security of confidential information maintained by the firm.

## Professional Conduct Investigations by CFA Institute

Standard III(E) does not prevent members and candidates from cooperating with an investigation by Professional Conduct (PC) at CFA Institute. Instead, members and candidates must cooperate with investigations into their conduct unless prevented from doing so by law. Under the CFA Institute Rules of Procedure for Conduct Related to the Profession (as amended and restated 1 January 2022), members and candidates are also required to cooperate with investigations into the conduct of others. PC will exercise reasonable care to ensure that all documents and information it receives during an investigation remain confidential.

## Compliance Practices

Members and candidates should avoid disclosing any information received from a client except to authorized fellow employees who are also working for the client.

Members and candidates must understand and follow their firm's electronic information communication and storage procedures. If the firm does not have procedures in place, members and candidates should encourage the development of procedures that appropriately reflect the firm's size and business operations. Members and candidates should encourage their firm to conduct regular periodic training on confidentiality procedures for all firm personnel, including noninvestment staff who have routine direct contact with clients and their records.

Members and candidates should be diligent in discussing with clients the appropriate methods for providing confidential information. Members and candidates must make reasonable efforts to ensure that methods for communicating with clients are designed to prevent accidental distribution of confidential information.

Members and candidates should take steps to protect the interests of vulnerable investors by

- complying with any firm policies and procedures specifically dealing with vulnerable clients,
- asking for a secondary contact during the establishment of every account,
- undertaking training and education to understand issues related to vulnerable investors,
- undergoing training on how to interact and address issues with clients who may exhibit diminished mental capacity,
- following internal firm reporting procedures when concerns are raised, and
- implementing additional compliance review for the accounts of vulnerable investors.

## Application of the Standard

### Example 1 (Possessing Confidential Information)

Connor, a financial analyst employed by Johnson Investment Counselors, Inc., provides investment advice to the trustees of City Medical Center. The trustees have given her a number of internal reports concerning City Medical's needs for physical plant renovation and expansion. They have asked Connor to recommend investments that would generate capital appreciation in endowment funds to meet projected capital expenditures. Connor is approached by a local businessman, Kasey, who is considering a substantial contribution either to City Medical Center or to another local hospital. Kasey wants to find out the building plans of both institutions before making a decision, but he does not want to speak to the trustees.

*Comment:* The trustees gave Connor the internal reports so she could advise them on how to manage their endowment funds. Because the information in the reports is clearly both confidential and within the scope of the confidential relationship, Standard III(E) prohibits Connor from divulging the information to Kasey.

### Example 2 (Disclosing Confidential Information)

Moody is an investment officer at the Lester Trust Company. She has an advisory client who has talked to her about giving approximately US\$50,000 to charity to reduce her income taxes. Moody is also treasurer of the Home for Indigent Widows (HIW), which is planning its annual giving campaign. HIW hopes to expand its list of donors, particularly those capable of substantial gifts. Moody recommends that HIW's vice president for corporate gifts call on her client and ask for a donation in the US\$50,000 range.

*Comment:* Even though the attempt to help the Home for Indigent Widows was well intended, Moody violated Standard III(E) by revealing confidential information about her client.

### Example 3 (Disclosing Possible Illegal Activity)

Samuel, the portfolio manager for Garcia Company's pension plan, has learned from one of Garcia's corporate officers that potentially excessive and improper charges were being made to the pension plan by the CEO of Garcia. They tell her that Garcia's corporate tax returns are being audited and the pension fund is being reviewed. Samuel consults her employer's general counsel and is advised that Garcia likely violated tax and fiduciary regulations and laws. Two days later, government officials contact Samuel with a request to examine pension fund records.

*Comment:* Samuel and her employer should seek the advice of legal counsel to determine the appropriate steps to take to protect the interests of the participants and beneficiaries of the pension plan and comply with applicable law for responding to government regulators. Samuel may well have a duty to provide the pension fund records her firm possesses to the government.

### Example 4 (Disclosing Possible Illegal Activity)

Bradford manages money for a family-owned real estate development corporation. He also manages the individual portfolios of several of the family members and officers of the corporation, including the chief financial officer (CFO). Based on the financial records of the corporation and some questionable practices of the CFO that Bradford has observed, Bradford believes that the CFO is embezzling money from the corporation and putting it into his personal investment account.

*Comment:* Bradford should check with his firm's compliance department or appropriate legal counsel to determine whether applicable securities regulations require reporting the CFO's financial records to authorities.

### Example 5 (Accidental Disclosure of Confidential Information)

Moody is an investment officer at the Lester Trust Company (LTC). She has stewardship of a significant number of individually managed taxable accounts. In addition to receiving quarterly written reports, about a dozen high-net-worth individuals have indicated to Moody a willingness to receive communications about overall economic and financial market outlooks directly from her through social media. Under the direction of her firm's technology and compliance departments, she establishes a new group page on an existing LTC social media platform specifically for her clients. In the instructions provided to clients, Moody asks them to "join" the group so they may be granted access to the posted content. The instructions also advise clients that the platform is not an appropriate method for communicating personal or confidential information.

Six months later, in early January, Moody posts LTC's year-end "Market Outlook." The report outlines a new asset allocation strategy that the firm is adding to its

recommendations in the new year. In the report, Moody indicates that she will be discussing the changes with clients individually in their upcoming meetings.

One of Moody's clients responds directly on the group page that his family recently experienced a major change in their financial profile. The client describes highly personal and confidential details of the event. Unfortunately, all clients that were part of the group are also able to read the detailed posting until Moody has the comment removed.

*Comment:* Moody has taken reasonable steps to protect the confidentiality of client information while using the social media platform. She provided instructions clarifying that all information posted on the site would be publicly viewable to all group members and warned against using this method for communicating confidential information. The accidental disclosure of confidential information by a client is not under Moody's control. Her actions to remove the information promptly once she became aware further align with Standard III(E).

### Example 6 (Vulnerable Investor)

Gonzales, a financial adviser, provides investment advice to a number of private wealth clients. At the beginning of all client arrangements, as a part of the onboarding process, Gonzales requires the client to designate a secondary contact who Gonzales can communicate with should she become concerned about the client's ability to make judicious financial decisions. Gonzales meets with a longtime client, Brennan, a widow, on a regular basis to discuss her portfolio. Brennan has named her son as the person to contact in the event of her mental decline. Gonzales has growing concerns about Brennan's mental capacity over the past several months because Brennan has forgotten the last three meetings and has had to reschedule follow-up meetings. At those meetings, Brennan not only seems confused by routine matters that Gonzales knows she easily grasped in the past but also seems unclear about her long-established investment objectives. When Gonzales tries to make light of these lapses, Brennan grows uncharacteristically irritable with her. Gonzales details these meetings and interactions in her files. At the next meeting, Brennan directs Gonzales to liquidate 50% of her portfolio. Brennan informs Gonzales that she wishes to invest that money in a highly speculative private health club venture being opened by her physical therapist. Gonzales has been working with Brennan over many years, and she has always favored a widely diversified portfolio. Prior to acting on Brennan's directive, Gonzales contacts her client's son to discuss this situation with him. She documents in Brennan's file the conversation with both Brennan and her son and her reasons for disclosing confidential information.

*Comment:* Gonzales has taken the appropriate steps to protect Brennan's interests by disclosing her concerns about the vulnerability of her client. Brennan previously indicated that in the event of concerns about her mental capacity, Gonzales should contact her son.

Gonzales's observation of Brennan's mental decline and concern over the dependent relationship with her physical therapist are valid reasons to question the sudden instruction to liquidate a large portion of her investments. Gonzales is thus not in violation of the Standard III(E) Preservation of Confidentiality.

### Example 7 (Confidential Information to Family Members)

Smith-Pelley, a financial planner, receives a call from longtime client, Carlson, who shares the news that, after a recent divorce from her husband of 37 years, she met and married a man 25 years her junior while on a holiday in another country. The man is a citizen of that country but will be moving home with Carlson. Carlson asks Smith-Pelley to liquidate half of her investment account so she can move out of her flat and into an expensive country estate with her new husband. Carlson also directs Smith-Pelley to add her new husband's name to all her investment account documents. Carlson does as directed. Over the next six months, more funds are withdrawn from the account, mostly by Carlson's new husband. Carlson's children from her first marriage, also clients of Smith-Pelley, contact him to demand that their mother's accounts be frozen, claiming she has diminished mental capacity and is being taken advantage of by the new man in her life. Smith-Pelley does nothing and refuses to discuss Carlson's accounts with her children.

*Comment:* Smith-Pelley is not in violation of his ethical duties by failing to act on Carlson's children's directions or discussing her account with them. Although Carlson's recent decisions may raise red flags because the changes were sudden and unexpected, they do not indicate a loss of Carlson's decision-making ability. As such, he is right to act for the benefit of his client, follow her direction, and keep her investment information confidential.

# STANDARD IV: DUTIES TO EMPLOYERS

## Standard IV(A) Loyalty

In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

### Guidance

Standard IV(A) requires members and candidates to protect the interests of their employer by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the member's or candidate's skills and ability. In matters related to their employment, members and candidates must not engage in conduct that harms the interests of their employer. Implicit in this standard is the obligation of members and candidates to comply with the policies and procedures established by their employers that govern the employer–employee relationship—to the extent that such policies and procedures do not conflict with applicable laws, rules, and regulations or the Code and Standards.

This standard is not meant to be a blanket requirement to place employer interests ahead of personal interests in all matters. The standard does not require members and candidates to subordinate important personal and family obligations to their work. Members and candidates should enter into a dialogue with their employer about balancing personal and employment obligations when personal matters may interfere with their work on a regular or significant basis.

The employer–employee relationship imposes duties and responsibilities on both parties. Employers must recognize the duties and responsibilities that they owe to their employees if they expect to have contented and productive employees. The employer is also responsible for a positive working environment, which includes an ethical workplace.

Members and candidates are encouraged to provide their employers with a copy of the Code and Standards. These materials will inform the employer of the responsibilities of a CFA Institute member or candidate in the CFA Program. The Code and Standards also serve as a basis for questioning employer policies and practices that conflict with these responsibilities.

## Independent Business

Although Standard IV(A) does not preclude members or candidates from engaging in an independent business while still employed, members and candidates are prohibited from providing a service offered by their employer without their employer's consent because such conduct would conflict with the interests of their employer. Members and candidates are not prohibited from preparing to enter into an independent business so long as they do not solicit or provide services to clients or otherwise cause harm to their employer. Members and candidates who plan to engage in an independent business for compensation while employed must notify their employer and describe the types of services they will render to prospective independent clients, the expected duration of the services, and the compensation for the services. Members and candidates must not render services until they receive consent from their employer to all of the terms of the arrangement.

## Leaving an Employer

When members and candidates are planning to leave their current employer, they must continue to act in the employer's best interest until the employment relationship ends. A letter of resignation does not necessarily signify the end of the relationship, especially if there is still a period of employment to complete. Generally, the employment relationship ends once the employee is no longer being paid or no longer has responsibilities at the company. Members and candidates must not engage in any activities that could conflict with their duty of loyalty to their employer until their employment relationship ends. Activities that may constitute a violation of Standard IV(A) include the following:

- unauthorized use of trade secrets;
- misuse of confidential information, explicit or implicit solicitation of an employer's clients, or promotion of a new employer prior to cessation of employment;
- self-dealing (appropriating for one's own benefit property, a business opportunity, or information belonging to one's employer);
- unauthorized use of any firm property, including clients or client lists; and
- discussing a change in employment in a manner that disparages or denigrates the current employer such that it could cause harm to the firm's interests.

A departing employee is generally free to make arrangements or preparations to go into a competitive business before terminating the relationship with his or her employer as long as such preparations do not breach the employee's duty of loyalty. Members and candidates who are contemplating seeking other employment must not contact existing clients or potential clients prior to leaving their employer to discuss a potential change in their employment status. After providing notice to their employer of their intent to resign, members and

candidates may inform the clients with whom they work that they are leaving and going to a new firm but must not communicate information in a manner that could be seen as explicitly or implicitly soliciting clients or business for the new employer. For instance, while they may provide the name of their new employer, members and candidates must not provide their contact information at their new employer before their employment ends without permission of their current employer. They also must not describe to clients the services available at the new firm or in other ways implicitly or explicitly promote their new employer to their current firm's clients without the permission of their current employer.

Members and candidates cannot promote the services of a new firm in the name of protecting the interests of clients until their employment with their current firm ends. Members and candidates who believe the conduct or business practices of their employer are so egregious that they harm client interests are free to resign their position and subsequently notify their former clients or other appropriate parties of their concerns.

Once notice is provided to the employer of the intent to resign, the member or candidate must follow the employer's policies and procedures related to notifying clients of his or her planned departure. In addition, the member or candidate must not take records or files to a new employer without the written permission of the previous employer. Members and candidates also must comply with their employer's policies regarding the use of social media during their employment, including the manner of disclosing their departure on firm social media platforms.

Once an employee has left the firm, the skills and experience that the employee obtained while employed are not "confidential" or "privileged" information. Similarly, simple knowledge of the names and existence of former clients is generally not confidential information unless deemed as such by an agreement or by law. Standard IV(A) does not prohibit experience or knowledge gained at one employer from being used at another employer. Work performed on behalf of the employer, client lists, or other firm records—whether stored as paper copies or electronically on personal devices, such as phones, tablets, or laptop computers, for the member's or candidate's convenience—must be returned to the employer or erased unless the firm gives permission to keep those records after employment ends.

Once employment with the former firm has ended, the standard does not prohibit members and candidates from contacting clients of their previous firm as long as the contact information does not come from the records of or as a result of work for their former employer or such outreach does not violate an applicable agreement with the former firm. Members and candidates are free to use public information after departing to contact former clients without violating Standard IV(A) as long as there is no specific agreement not to do so. However, employers may require employees to sign agreements that preclude departing employees from engaging in certain conduct after they have left the

firm. Members and candidates should take care to review the terms of any such agreement when leaving their employer to determine what, if any, conduct those agreements may prohibit.

## Use of Social Media

Members and candidates must understand and abide by all applicable firm policies and regulations as to the acceptable use of social media to interact with clients and prospective clients. This requirement is especially important when a member or candidate is planning to leave an employer.

Social media use makes determining how and when departure notification is delivered to clients more complex. Members and candidates may have developed profiles on these platforms that include connections with individuals who are clients of the firm. Communications through social media platforms that potentially reach current clients must adhere to the employer's policies and procedures regarding notification of departing employees.

Social media connections with clients also raise questions concerning the differences between public information and firm property. Members and candidates may create social media profiles solely for professional reasons, including firm-approved accounts for client engagements. Such firm-approved business-related accounts are part of the firm's assets, thus requiring members and candidates to transfer or delete the accounts as directed by their firm's policies and procedures. Best practice for members and candidates is to maintain separate accounts for their personal and professional social media activities.

## Whistle-Blowing

A member's or candidate's personal interests, as well as the interests of his or her employer, are secondary to protecting the integrity of capital markets and the interests of clients. Therefore, circumstances may arise (e.g., when an employer is engaged in illegal or unethical activity) in which members and candidates must act contrary to their employer's interests in order to comply with their duties to the market and clients. In such instances, certain activities that would normally violate a member's or candidate's duty to his or her employer (such as contradicting employer instructions, violating certain policies and procedures, or preserving a record by copying employer records) may be justified. Such action would be permitted only if the intent is clearly aimed at protecting clients or the integrity of the market, not for personal gain.

## Nature of Employment

Standard IV(A) applies in the employment context. A wide variety of business relationships exists in the investment industry. For instance, a member or candidate may be an employee or an independent contractor. Members and

candidates must determine whether they are employees or independent contractors in order to determine the applicability of Standard IV(A).

A member's or candidate's duties in an independent contractor relationship are governed by the oral or written agreement between the member and the client. Members and candidates should take care to clearly define the scope of their responsibilities and the expectations of each client in the context of each relationship. Once a member or candidate establishes a relationship with a client, he or she has a duty to abide by the terms of the agreement.

## Compliance Practices

Employers may establish codes of conduct and operating procedures for their employees to follow. Members and candidates should fully understand those policies and procedures to ensure that they are not in conflict with the Code and Standards. Members and candidates must understand any restrictions placed by the employer on offering similar services outside the firm while employed by the firm. The policy may outline the procedures for requesting approval to undertake the outside service or may be a strict prohibition of such service. Members and candidates should clearly understand the termination policies of their employer, including those that relate to the resignation process, how the termination will be disclosed to clients and staff, and whether updates posted through social media will be allowed. Members and candidates should be aware of their firm's policies related to whistle-blowing and encourage their firms to adopt industry best practices in this area. Many firms are required by regulatory mandates to establish confidential and anonymous reporting procedures that allow employees to report potentially unethical and illegal activities in the firm.

## Application of the Standard

### Example 1 (Soliciting Current Clients and Prospects)

Magee manages pension accounts for Trust Assets, Inc. He has become frustrated with the working environment and has been offered a position with Fiduciary Management. Before resigning from Trust Assets, Magee asks four big accounts to leave that firm and open accounts with Fiduciary. Magee also persuades several prospective clients to sign agreements with Fiduciary Management. Magee previously made presentations to these prospects on behalf of Trust Assets.

*Comment:* Magee violated the employer–employee principle requiring him to act solely for his employer's benefit. Magee's duty is to Trust Assets as long as he is employed there. Magee's solicitation of Trust Assets' current clients and prospective clients while still employed by the firm is unethical and violates Standard IV(A).

## Example 2 (Former Employer's Documents and Files)

Hightower has been employed by Jason Investment Management Corporation for 15 years. He began as an analyst but assumed increasing responsibilities and is now a senior portfolio manager and a member of the firm's investment policy committee. Hightower has decided to leave Jason Investment and start his own investment management business. He has been careful not to tell any of Jason Investment's clients that he is leaving; he does not want to be accused of breaching his duty to Jason Investment by soliciting its clients before his departure. Hightower is planning to copy and take with him the following documents and information he developed or worked on while at Jason Investment: (1) the client list, with addresses, telephone numbers, and other pertinent client information; (2) client account statements; (3) sample marketing presentations to prospective clients containing the firm's performance record; (4) Jason Investment's recommended list of securities; (5) computer models to determine asset allocations for accounts with various objectives; (6) computer models for stock selection; and (7) spreadsheets for Hightower's major corporate recommendations, which he developed when he was an analyst.

*Comment:* Except with the consent of their employer, departing members and candidates may not take employer property, which includes books, records, reports, and other materials, because taking such materials may interfere with their employer's business opportunities. Taking any employer records, even those the member or candidate prepared, violates Standard IV(A). Employer records include items stored in hard copy or any other medium (e.g., home computers, portable storage devices, cell phones).

## Example 3 (Ownership of Completed Prior Work)

Madeline, a recent college graduate and a candidate in the CFA Program, spends her summer as an unpaid intern at Murdoch and Lowell. The senior managers at Murdoch are attempting to bring the firm into compliance with the GIPS standards, and Madeline is assigned to assist in its efforts. Two months into her internship, Madeline applies for a job at McMillan & Company, which has plans to become GIPS compliant. Madeline accepts the job with McMillan. Before leaving Murdoch, she copies the firm's software that she helped develop because she believes this software will assist her in her new position.

*Comment:* Even though Madeline does not receive monetary compensation for her services at Murdoch, she used firm resources in creating the software and is considered an employee because she receives compensation and benefits in the form of work experience and knowledge. By copying the software, Madeline violated Standard IV(A) because she misappropriated Murdoch's property without permission.

### Example 4 (Disparaging Employer)

Nash is hired as an investment adviser working with retail clients for a regional investment advisory firm. Shortly after starting work, Nash realizes that the advisers at the firm are under pressure to churn investments in client accounts to generate fees. He brings his concerns to his immediate manager, the chief compliance officer, and ultimately to the senior managers of the firm. He is unsuccessful in getting the firm to change its practices and finds other employment at a competing firm. Upon handing in his resignation but prior to leaving his current employer, at the employer's direction, he sends notice to clients he worked with that he will be leaving the firm and informs them that their accounts will be transferred to other portfolio managers at the firm. One of his clients contacts him and inquires more about the circumstances of his departure. Nash describes in detail the unethical practices of his firm, gives the client information about his new employer, and encourages the client to transfer her account and follow Nash to his new firm.

*Comment:* Nash violated Standard IV(A) by disparaging his current employer to his client and soliciting her business for his future employer. His actions are a violation even if the client would be better off at the new firm. After leaving the firm, Nash can inform his former clients of his concerns about their treatment and suggest they change investment managers.

### Example 5 (Soliciting Former Clients)

Elliot has hired Chisolm, who previously worked for a competing firm. Chisolm left his former firm after 18 years of employment. When Chisolm begins working for Elliot, he wants to contact his former clients because he knows them well and is certain that many will follow him to his new employer. Is Chisolm in violation of Standard IV(A) if he contacts his former clients?

*Comment:* Because client records are the property of the firm, contacting former clients for any reason through the use of client lists or other information taken from a former employer without permission is a violation of Standard IV(A).

Simple knowledge of the names and existence of former clients is not confidential information, just as skills or experience that an employee obtains while employed are not "confidential" or "privileged" information. The Code and Standards do not impose a prohibition on the use of experience or knowledge gained at one employer from being used at another employer. The Code and Standards also do not prohibit former employees from contacting clients of their previous firm in the absence of an agreement that prohibits such conduct. Members and candidates are free to use public information about their former firm after departing to contact former clients without violating Standard IV(A).

In the absence of an agreement that prohibits such conduct, as long as Chisolm maintains his duty of loyalty to his employer before joining Elliot's firm, does not take steps to solicit clients until he has left his former firm, and does not use material from his former employer without its permission after he has left, he is not in violation of the Code and Standards.

### Example 6 (Preparation for Leaving Employer)

Allen currently works at a registered investment company as an equity analyst. Without notice to her employer, she registers with government authorities to start an investment company that will compete with her employer, but she does not seek clients. Does registration of this competing company with the appropriate regulatory authorities constitute a violation of Standard IV(A)?

*Comment:* Allen's preparation for the new business by registering with the regulatory authorities does not conflict with the work for her employer if the preparations have been done on Allen's own time outside the office and if Allen will not be soliciting clients for the business or otherwise operating the new company until she has left her current employer.

### Example 7 (Competing with Current Employer)

Several employees are planning to depart their current employer in a few weeks and have been careful to not engage in any activities that would conflict with their duty to their current employer. They have just learned that one of their employer's clients has created a request for proposal (RFP) to review and possibly hire a new investment consultant. The RFP has been sent to the employer and all its competitors. The group believes that the new entity to be formed would be qualified to respond to the RFP and be eligible for the business. The RFP submission period is likely to conclude before the employees' resignations are effective. Is it permissible for the group of departing employees to respond to the RFP for their anticipated new firm?

*Comment:* A group of employees responding to an RFP that their employer is also responding to would lead to direct competition between the employees and the employer. Such conduct violates Standard IV(A) unless the group of employees receives permission from their employer to respond to the RFP.

### Example 8 (Soliciting Former Clients)

Crome has been a private banker for YBSafe Bank for the past eight years. She has been very successful and built a considerable client portfolio during that time but is extremely frustrated by the recent loss of reputation by her current employer and subsequent client insecurity. A locally renowned recruiting agent contacted Crome to offer her an attractive position with a competing private

bank. This bank offers a substantial signing bonus for advisers with their own client portfolios. Crome believes that she can solicit at least 70% of her clients to follow her and gladly enters into the new employment contract.

*Comment:* Crome may contact former clients upon termination of her employment with YBSafe Bank, but she is prohibited from using client records built and kept with her in her capacity as an employee of YBSafe Bank. Client lists are proprietary information of her former employer and must not be used for her or her new employer's benefit. The use of written, electronic, or any other form of records from her prior employer, other than publicly available information, to contact her former clients at YBSafe Bank would be a violation of Standard IV(A).

### Example 9 (Leaving an Employer)

Research Systems Inc. (RSI) terminated the employment of Webb, one of its portfolio analysts. Webb's employment contract included a nonsolicitation agreement that requires her to wait two years before soliciting RSI clients for any investment-related services. While at RSI, Webb connected with clients, other industry associates, and friends through her LinkedIn network. Her business and personal relationships were intermingled because she considered many of her clients to be personal friends. Upon Webb's departure, RSI informed her clients and introduced her replacement. Webb updated her LinkedIn profile several days after her departure from RSI. LinkedIn automatically sent a notification to Webb's entire network that her employment status had changed.

*Comment:* Webb's actions did not violate Standard IV(A). Webb updated her LinkedIn profile only after her employment ended. The updated employment profile notification by LinkedIn does not amount to solicitation of clients. Best practice would dictate that Webb maintain separate accounts for her personal and professional social media activities. At a minimum, prior to her departure from the firm, Webb should discuss with RSI how to address any client information contained in her social media networks.

### Example 10 (Confidential Firm Information)

Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process to develop recommendations on investment opportunities covered by the team members. Gupta, like others, provides commentary for NIM's clients through the company blog, which is posted weekly on NIM's password-protected website. According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting. Any opinions expressed on the website are disclosed as representing the perspective of NIM. Gupta also writes a personal blog to share his experiences with friends and family. Gupta's personal blog is widely available to interested readers. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to

express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.

*Comment:* Gupta violated Standard IV(A) by disclosing confidential firm information through his personal blog. The recommendations on the firm's blog to clients are not freely available across the internet, but his personal blog post indirectly provides the firm's recommendations. Additionally, by posting research commentary on his personal blog, Gupta is using firm resources for his personal advantage.

## Standard IV(B) Additional Compensation Arrangements

Members and Candidates 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.

### Guidance

Standard IV(B) requires members and candidates to obtain permission from their employer before accepting compensation or other benefits from third parties for the services rendered to the employer or for any services that might create a conflict with their employer's interest. Compensation and benefits include direct compensation by the client and any indirect compensation or other benefits received from third parties. "Written consent" includes any form of communication that can be documented (for example, communication via email that can be retrieved and documented).

Members and candidates must obtain permission for additional compensation/benefits because such arrangements may affect loyalties and objectivity and create potential conflicts of interest. Disclosure allows an employer to consider the outside arrangements when evaluating the actions and motivations of members and candidates. Moreover, the employer is entitled to have full knowledge of all compensation/benefit arrangements so as to be able to assess the true cost of the services members or candidates are providing.

There may be instances in which a member or candidate is hired by an employer on a part-time or contract basis, allowing the member or candidate to work for multiple firms. During the contracting and hiring process, members and candidates should address and negotiate with their employer the parameters around their ability to provide services to other employers that may be competitive with their employer.

### Compliance Practices

Members and candidates must disclose to their employer, through their supervisor or compliance officer, any compensation they propose to receive for services that is in addition to the compensation or benefits received from their employer, including performance incentives offered by clients. The disclosure should include the terms of any agreement under which a member or candidate will receive additional compensation, including the nature of the compensation, the approximate amount of compensation, and the duration of the agreement.

The party offering the additional compensation should acknowledge and confirm the details in the disclosure.

## Application of the Standard

### Example 1 (Notification of Client Bonus Compensation)

Whitman, a portfolio analyst for Adams Trust Company (ATC), manages the account of Cochran, a client. Whitman is paid a salary by his employer, and Cochran pays ATC a standard fee based on the market value of assets in her portfolio. Cochran proposes to Whitman that "any year that my portfolio achieves at least a 15% return before taxes, you and your wife can fly to Monaco at my expense and use my condominium during the third week of January." Whitman does not inform his employer of the arrangement and vacations in Monaco the following January as Cochran's guest.

*Comment:* Whitman violated Standard IV(B) by failing to inform his employer in writing of this supplemental, contingent compensation arrangement. The nature of the arrangement could result in partiality to Cochran's account, which could detract from Whitman's performance with respect to other accounts he handles for ATC. Whitman must obtain the consent of his employer to accept such a supplemental compensation arrangement.

### Example 2 (Notification of Outside Compensation)

Jones, a senior portfolio manager for Clarksville Asset Management, is on the board of directors of Exercise Unlimited, Inc. In return for his services on the board, Jones receives unlimited membership privileges for his family at all Exercise Unlimited facilities. Jones recommends purchasing Exercise Unlimited stock for his Clarksville client accounts for which it is appropriate. Jones does not disclose this arrangement to his employer because he does not receive monetary compensation for his services on the board.

*Comment:* Jones violated Standard IV(B) by failing to disclose to his employer benefits received in exchange for his services on the board of directors. Jones' service as a board director creates a conflict of interest because he has a personal incentive for recommending Exercise Unlimited stock. Nonmonetary compensation may create a conflict of interest in the same manner as being paid to serve as a director.

### Example 3 (Prior Approval for Outside Compensation)

Hollis is an analyst of oil-and-gas companies for Specialty Investment Management. He is currently recommending the purchase of ABC Oil Company shares and has published a long, well-thought-out research report to substantiate his recommendation. Several weeks after publishing the report,

Hollis receives a call from the investor relations office of ABC Oil saying that Andrews, CEO of the company, saw the report and likes the analyst's grasp of the business and his company. The investor relations officer invites Hollis to visit ABC Oil to discuss the industry further. ABC Oil offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after gaining the appropriate approvals, accepts the meeting with the CEO but declines the offered travel arrangements. Several weeks later, Andrews and Hollis meet to discuss the oil business and Hollis's report. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC Oil's headquarters. Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.

*Comment:* Hollis's actions did not violate Standard IV(B). Through gaining approval before accepting the meeting and declining the offered travel arrangements, Hollis sought to avoid any potential conflicts of interest between his company and ABC Oil. By disclosing the dinner upon his return, Hollis enabled Specialty Investment Management to assess whether it has any impact on future reports and recommendations by Hollis related to ABC Oil.

## Standard IV(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.

### Guidance

Standard IV(C) states that members and candidates must promote actions by all employees under their supervision and authority to comply with applicable laws, rules, regulations, and firm policies and the Code and Standards.

Any investment professional who has employees subject to her or his control or influence—whether or not the employees are CFA Institute members, CFA charterholders, or candidates in the CFA Program—exercises supervisory responsibility.

The conduct that constitutes reasonable supervision in a particular case depends on the number of employees supervised and the work performed by those employees. Members and candidates with oversight responsibilities for large numbers of employees may not be able to personally evaluate the conduct of these employees on a continuing basis. These members and candidates may delegate supervisory duties to subordinates who directly oversee the other employees. A member's or candidate's responsibilities under Standard IV(C) include instructing those subordinates to whom supervision is delegated about methods to promote compliance, including preventing and detecting violations of laws, rules, regulations, firm policies, and the Code and Standards.

At a minimum, Standard IV(C) requires that members and candidates with supervisory responsibility make reasonable efforts to prevent and detect violations by ensuring the establishment of effective compliance systems. An effective compliance system goes beyond enacting a code of ethics; it also includes establishing policies and procedures to achieve compliance with the code and applicable law and reviewing employee actions to determine whether they are following the rules.

To be effective supervisors, members and candidates should implement education and training programs on a recurring or regular basis for employees under their supervision. Such programs will assist the employees with meeting their professional obligations to practice in an ethical manner within the applicable legal system. Further, establishing incentives—monetary or otherwise—for employees not only to meet business goals but also to reward ethical behavior can be an effective method for encouraging employees to comply with their legal and ethical obligations.

Often, especially in large organizations, members and candidates may have supervisory responsibility but not the authority to establish or modify firm-wide compliance policies and procedures or incentive structures. Such limitations should not prevent members and candidates from working with their own superiors and within the firm structure to develop and implement effective compliance tools, including but not limited to

- a code of ethics,
- compliance policies and procedures,
- education and training programs,
- an incentive structure that rewards ethical conduct, and
- adoption of firm-wide best practice standards (e.g., the GIPS standards and the CFA Institute Asset Manager Code of Professional Conduct).

A member or candidate with supervisory responsibility must bring an inadequate compliance system to the attention of the firm's senior managers and recommend corrective action. If the member or candidate clearly cannot discharge supervisory responsibilities because of the absence of a compliance system or because of an inadequate compliance system, the member or candidate should decline to accept supervisory responsibility until the firm adopts reasonable procedures to allow adequate exercise of supervisory responsibility.

## System for Supervision

Members and candidates with supervisory responsibility must understand what constitutes an adequate compliance system for their firms and make reasonable efforts to see that appropriate compliance procedures are established, documented, communicated to covered personnel, and followed. "Adequate" procedures are those designed to meet industry standards, regulatory requirements, the requirements of the Code and Standards, and the circumstances of the firm. Once compliance procedures are established, the supervisor must also make reasonable efforts to ensure that the procedures are monitored and enforced.

To be effective, compliance procedures must be in place prior to the occurrence of a legal or ethical violation. Although compliance procedures cannot be designed to anticipate every potential violation, they should be designed to anticipate the activities most likely to result in misconduct. Compliance programs must be appropriate for the size and nature of the organization. The member or candidate should review model compliance procedures or other industry resources to ensure that the firm's procedures are adequate.

Once a supervisor learns that an employee has violated or may have violated the law or engaged in unethical behavior, the supervisor must promptly initiate an assessment to determine the extent of the wrongdoing. Relying on an

employee's statements about the extent of the violation or assurances that the wrongdoing will not reoccur is not enough. Reporting the misconduct to the appropriate compliance and management personnel and warning the employee to cease the activity are also not enough. Pending the outcome of the investigation, a supervisor must take steps to ensure that the violation will not be repeated, such as placing limits on the employee's activities or increasing the monitoring of the employee's activities.

## Supervision Includes Detection

Members and candidates with supervisory responsibility must also make reasonable efforts to detect violations of laws, rules, regulations, and firm policies as well as unethical behavior. Supervisors exercise reasonable supervision by establishing and implementing written compliance procedures and ensuring that those procedures are followed through periodic review. If a member or candidate has adopted reasonable procedures and taken steps to institute an effective compliance program, then the member or candidate may not be in violation of Standard IV(C) if he or she does not detect violations that occur despite these efforts. The fact that violations do occur may indicate, however, that the compliance procedures are inadequate. In addition, in some cases, merely enacting such procedures may not be sufficient to fulfill the duty required by Standard IV(C). Members and candidates may be in violation of Standard IV(C) if they know or should know that the procedures designed to promote compliance, including detecting and preventing violations, are not being followed.

## Compliance Practices

### Codes of Ethics or Compliance Procedures

Members and candidates are encouraged to recommend that their employers adopt a code of ethics. Adoption of a code of ethics is critical to establishing a strong ethical foundation for investment advisory firms and their employees. Codes of ethics formally emphasize and reinforce the client loyalty responsibilities of investment firm personnel, protect investing clients by deterring misconduct, and protect the firm's reputation for integrity.

There is a distinction, however, between codes of ethics and the specific policies and procedures needed to ensure compliance with the codes and with securities laws and regulations. Although both are important, codes of ethics should consist of fundamental, principle-based ethical concepts that apply to all the firm's employees. In this way, firms can effectively convey to employees and clients the ethical ideals that investment professionals strive to achieve. Supervisors implement these concepts through detailed, firm-wide compliance policies and procedures. Compliance procedures help employees fulfill the ethical responsibilities enumerated in the code of ethics and facilitate compliance with these principles in the day-to-day operation of the firm.

Standalone codes of ethics should be written in plain language and should address general ethical concepts. They should be unencumbered by numerous detailed procedures or boilerplate legal terminology. Codes presented in this way are the most effective in conveying to employees that they are in positions of trust and must act with integrity at all times. Mingling compliance procedures in the firm's code of ethics is contrary to the goal of reinforcing the ethical obligations of employees in a simple, straightforward manner. To ensure a culture of ethics and integrity rather than one that merely focuses on following the rules, the principles in the code of ethics must be stated in a way that is accessible and easily understandable.

Members and candidates should encourage their employers to provide their codes of ethics to clients. A simple, straightforward code of ethics, unencumbered by compliance procedures, will be effective in conveying that the firm is committed to conducting business in an ethical manner and in the best interests of the clients.

### Adequate Compliance Procedures

A supervisor complies with Standard IV(C) by identifying situations in which legal or ethical violations are likely to occur and by establishing and enforcing compliance procedures to prevent such violations. Adequate compliance procedures should

- be contained in a clearly written and accessible resource that is tailored to the firm's operations,
- be drafted so that the procedures are easy to understand,
- designate a compliance officer whose authority and responsibility are clearly defined and who has the necessary resources and authority to implement the firm's compliance procedures and investigate potential legal and ethical violations,
- describe the hierarchy of supervision and assign duties among supervisors,
- implement a system of checks and balances,
- describe the scope of the procedures,
- include procedures to document the monitoring and testing of compliance procedures,
- detail permissible conduct, and
- delineate procedures for reporting violations and sanctions.

Once a compliance program is in place, a supervisor should

- disseminate the contents of the program to appropriate personnel;
- seek to periodically update the program to ensure that the compliance measures are relevant, effective, and legally adequate;

- continually educate personnel regarding the compliance procedures;
- issue periodic compliance reminders to appropriate personnel;
- incorporate a professional conduct evaluation as part of an employee's performance review;
- monitor and review the actions of employees to ensure compliance and identify violators; and
- take the necessary steps to enforce the procedures once a violation has occurred.

Once a violation is discovered, a supervisor should

- respond promptly,
- ensure a thorough investigation of the activities is conducted to determine the scope of the wrongdoing,
- increase supervision or place appropriate limitations on the alleged offender pending the outcome of the investigation, and
- review procedures for potential changes necessary to prevent future violations from occurring.

## Implementation of Compliance Education and Training

Regular ethics and compliance training, in conjunction with adoption of a code of ethics, is critical to employers seeking to establish a strong culture of integrity and to provide an environment in which employees routinely engage in ethical conduct and comply with the law. Training and education assist individuals in both recognizing areas that are prone to ethical and legal pitfalls and identifying those circumstances and influences that can impair ethical judgment.

By implementing education programs, supervisors can train their subordinates to put into practice what the firm's code of ethics requires. Education helps employees make the link between legal and ethical conduct and the long-term success of the business; a strong culture of compliance signals to clients and potential clients that the firm has embraced ethical conduct as fundamental to the firm's mission to serve its clients.

## Establish an Appropriate Incentive Structure

Even if individuals want to make the right choices and follow an ethical course of conduct and are aware of the obstacles that impair ethical conduct, they can still be influenced to act improperly by a corporate culture that embraces a "succeed at all costs" mentality, stresses results regardless of the methods used to achieve those results, and does not reward ethical behavior. Supervisors can reinforce an individual's natural desire to act ethically by building a culture of integrity in the workplace.

Supervisors and firms must look closely at their incentive structure to determine whether the structure encourages profits and returns at the expense of ethically appropriate conduct. Problematic reward structures may not take into account how desired outcomes are achieved and encourage dysfunctional or counterproductive behavior. Employees will work to achieve a culture of integrity when compensation and incentives are tied to how outcomes are achieved rather than how much revenue is generated for the firm.

## Application of the Standard

### Example 1 (Supervising Research Activities)

Mattock is senior vice president and head of research at H&V, Inc., a regional brokerage firm. She is responsible for H&V's compliance procedures related to dissemination of research. Mattock has decided to change her recommendation for Timber Products from buy to sell. She orally advises other H&V executives of her proposed actions before the report is prepared for publication, as required by H&V's compliance procedures. However, Mattock did not implement procedures designed to prevent dissemination of or trading on the information by those who are informed of changed recommendations. As a result of Mattock's conversation with Frampton, one of the H&V executives reporting to Mattock, Frampton immediately sells Timber's stock from his own account and from certain discretionary client accounts. In addition, other personnel inform certain institutional customers of the changed recommendation before it is printed and disseminated to all H&V customers who have received previous Timber reports.

*Comment:* Mattock violated Standard IV(C) by failing to reasonably and adequately supervise the actions of those accountable to her. In her role as senior vice president and head of research, she must ensure that her firm has procedures for reviewing or recording any trading in the stock of a corporation that has been the subject of an unpublished change in recommendation. If adequate procedures had been established and followed, subordinates would have been informed of their duties, which would have facilitated detection of the improper sales by Frampton and prevented selected disclosure of the recommendation to clients.

### Example 2 (Supervising Trading Activities)

Edwards, a trainee trader at Wheeler & Company, a major national brokerage firm, assists a client in paying for the securities of Highland, Inc., by using anticipated profits from the immediate sale of the same securities. Despite the fact that Highland is not on Wheeler's recommended list, a large volume of the company's stock is traded through Wheeler in this manner. Mason is a vice president at Wheeler, responsible for supervising compliance with the securities laws in the trading department. Part of her compensation from Wheeler is based

on commission revenues from the trading department. Although she notices the increased trading activity, she does nothing to investigate or halt it.

*Comment:* Mason's failure to adequately review and investigate purchase orders in Highland stock executed by Edwards and her failure to supervise the trainee's activities violate Standard IV(C). Supervisors must be especially sensitive to actual or potential conflicts between their own self-interests and their supervisory responsibilities.

### Example 3 (Supervising Trading Activities and Recordkeeping)

Tabbing is senior vice president and portfolio manager for Crozet, Inc., a registered investment advisory and registered broker/dealer firm. She reports to Claudius, the president of Crozet. Crozet serves as the investment adviser and principal underwriter for ABC and XYZ public mutual funds. The two funds' prospectuses allow Crozet to trade financial futures for the funds for the limited purpose of hedging against market risks. Claudius, extremely impressed by Tabbing's performance in the past two years, directs Tabbing to act as portfolio manager for the funds. For the benefit of its employees, Crozet has also organized the Crozet Employee Profit-Sharing Plan (CEPSP), a defined contribution retirement plan. Claudius assigns Tabbing to manage 20% of the assets of CEPSP. Tabbing's investment objective for her portion of CEPSP's assets is aggressive growth. Unbeknownst to Claudius, Tabbing frequently places S&P 500 Index futures purchase and sale orders for the funds and the CEPSP without providing the futures commission merchants (FCMs) who take the orders with any prior or simultaneous designation of the account for which the trade has been placed. Frequently, neither Tabbing nor anyone else at Crozet completes an internal trade ticket to record the time an order was placed or the specific account for which the order was intended. FCMs often designate a specific account only after the trade, when Tabbing provides such designation. Crozet has no written operating procedures or compliance manual concerning its futures trading, and its compliance department does not review such trading. After observing the market's movement, Tabbing assigns to CEPSP the S&P 500 positions with more favorable execution prices and assigns positions with less favorable execution prices to the funds.

*Comment:* Claudius violated Standard IV(C) by failing to adequately supervise Tabbing with respect to her S&P 500 trading. Claudius further violated Standard IV(C) by failing to establish recordkeeping and reporting procedures to prevent or detect Tabbing's violations. Claudius must make a reasonable effort to determine that adequate compliance procedures covering all employee trading activity are established, documented, communicated, and followed.

## Example 4 (Accepting Responsibility)

Rasmussen works on a buy-side trading desk and concentrates on in-house trades for a hedge fund subsidiary managed by a team at the investment management firm. The hedge fund has been very successful and is marketed globally by the firm. From her experience as the trader for much of the activity of the fund, Rasmussen has become quite knowledgeable about the hedge fund's strategy, tactics, and performance. When a distinct break in the market occurs and many of the securities involved in the hedge fund's strategy decline markedly in value, however, Rasmussen observes that the reported performance of the hedge fund does not at all reflect this decline. From her experience, this lack of an effect is a very unlikely occurrence. She approaches Blair, her supervisor and the head of trading, about her concern and is told that she should not ask any questions and that the fund is too big and successful and is not her concern. She is certain that something is not right, so she contacts Saunders, the firm's compliance officer, and is again told not to pursue the hedge fund reporting issue.

*Comment:* Rasmussen has concerns about potential misconduct at her firm and brings them to the attention of supervisory personnel. Under Standard IV(C), Blair and Saunders, the supervisor and the compliance officer, have the responsibility to review the concerns brought forth by Rasmussen. Supervisors have the responsibility of establishing and encouraging an ethical culture in the firm and investigating potential misconduct. The dismissal of Rasmussen's question violates Standard IV(C) and undermines the firm's ethical operations.

## Example 5 (Supervising Research Activities)

Burdette is hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. She is expected to expand the social media presence of the firm. Burdette's supervisor, Graf, encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. Graf has not yet established policies and procedures for the firm that govern online communications.

As part of her auto industry research for FIM, Burdette is drafting a report on the financial impact of Sun Drive Auto Ltd.'s new solar technology for compact automobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette posts a summary of her "buy" recommendation for Sun Drive Auto stock on her personal social media accounts.

*Comment:* Graf violated Standard IV(C) by failing to reasonably supervise Burdette with respect to her actions. He did not establish reasonable procedures to prevent the unauthorized dissemination of company research through social media networks. Graf must make sure all employees receive regular training about FIM's policies and procedures, including the appropriate business use of personal social media networks.

## Example 6 (Supervising Branch Employees)

Sokol is an investment adviser at a regional branch of Final Frontier Wealth Management (FFWM). Bartlett, FFWM's compliance officer, is responsible for overall compliance of the firm's investment advisers at all the company's branches. For several years, Sokol directs over 100 of his retail clients to invest in a Feeder Fund, which provides its clients access to invest in another fund, the Alpha Fund. Alpha's strategy uses complex option strategies and synthetic futures positions, which carry speculative and substantial risks with high volatility. Sokol recommends that his clients invest in the Feeder Fund without adequately assessing whether the product is suitable for them. Consequently, some of his clients with low risk tolerances and conservative trading preferences invest in the Feeder Fund. Due to extreme volatility in equity markets, Alpha loses about 35% of its value, resulting in losses of approximately \$16 million for Frontier's clients who invested in the Feeder Fund.

*Comment:* Bartlett's actions violated Standard IV(C). Bartlett's inadequate policies, procedures, training, and supervision allowed Sokol to recommend the Feeder Fund without properly assessing whether the investment was suitable for each client. Bartlett failed to supervise Sokol and failed to adopt and implement written policies and procedures for FFWM designed to prevent investment advisory representatives at FFWM from recommending complex financial products to clients when they are not suitable.

## Example 7 (Detecting Violations)

D'Addario is a trader for a broker/dealer, BOAC. D'Addario enters into an agreement with Amity Point Investments, a significant customer of BOAC, to provide artificially inflated price quotes for mortgage-backed securities in return for the promise of security trades being sent to BOAC. Amity Point uses those quotes to inflate the value of securities it holds and report inflated monthly valuations and net asset values for several of its funds. As part of the arrangement, Amity Point tells D'Addario the prices it wants to receive for certain bonds in the funds' portfolios, and D'Addario gives Amity Point the valuations it requests. Bartolucci, BOAC's chief executive officer, who is responsible for overall supervision at BOAC and is also D'Addario's supervisor, knows that D'Addario is providing price quotes to BOAC customers as part of the brokerage business. However, Bartolucci does not develop policies or procedures concerning the provision of price quotes to clients.

*Comment:* Bartolucci's conduct violated Standard IV(C) by failing to develop, promote, and train employees on adequate policies governing the provision of price quotes to their customers. Bartolucci failed to supervise D'Addario to prevent and detect D'Addario's illegal and unethical activities.

# STANDARD V: INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

## Standard V(A) Diligence and Reasonable Basis

Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

## Guidance

Diligence requires careful, consistent, and thorough work or effort. To have a reasonable basis for making a decision or taking action requires using sound judgment, understanding, care, and caution appropriate under the circumstances when undertaking an investment action or making a decision; it involves following a rational and well-considered process that is designed to remedy or address an issue or affect an outcome.

The application of Standard V(A) depends on the investment philosophy the member, candidate, or his or her firm is following, the role of the member or candidate in the investment decision-making process, and the support and resources provided by the member's or candidate's employer. These factors will dictate the nature of the diligence and thoroughness of the research and the level of investigation required by Standard V(A).

## Investment Recommendations and Actions

Members and candidates must make reasonable efforts to consider and address all pertinent issues when arriving at a recommendation.

Clients turn to members and candidates for advice and expect advisers to have more information and knowledge than the clients themselves do. This information and knowledge form the basis from which members and candidates apply their professional judgment in taking investment actions and making recommendations.

At a basic level, clients want assurance that members and candidates are putting forth the necessary effort to support the recommendations they are making. Members and candidates enhance transparency by providing supporting information to clients when making a recommendation or taking action. Communicating the level and thoroughness of the information reviewed before the member or candidate makes a judgment allows clients to understand the reasonableness of the recommended investment actions.

As with determining the suitability of an investment for the client, the necessary level of research and analysis will differ with the product, security, or service being offered. In providing an investment service, members and candidates typically use a variety of resources, including company reports, third-party research, and results from quantitative models. Members and candidates form a reasonable basis for investment recommendations and actions through consideration of a balance of these resources.

The following list includes selected examples of attributes members and candidates may consider when forming the basis for an investment recommendation:

- Global, regional, and country macroeconomic conditions
- A company's operating and financial history
- The industry's and sector's current conditions and the stage of the business cycle
- A pooled fund's fee structure and management history
- The output and potential limitations of quantitative models
- The quality of the assets included in a securitization
- The appropriateness of selected peer-group comparisons

Even though an investment recommendation may be well informed, downside risk remains for any investment. Every investment decision is based on a set of facts known and understood at the time. Members and candidates can base their decisions only on the information available at the time decisions are made. The steps taken in developing a diligent and reasonable recommendation will help minimize unexpected negative outcomes.

## Information Sources

Members and candidates should make reasonable inquiries into the sources and accuracy of all data used in conducting their investment analysis and forming their recommendations. The sources of the information and data will influence the level of the review a member or candidate must undertake. Information and data taken from certain sources, such as blogs, independent research aggregation websites, or social media, may require a greater level of review than information from more established research organizations.

If members and candidates rely on secondary or third-party research, they must make reasonable and diligent efforts to determine that such research is sound. Secondary research is research conducted by someone else in the member's or candidate's firm. Third-party research is research conducted by entities outside the member's or candidate's firm, such as a brokerage firm, bank, or research firm. If a member or candidate has reason to suspect that either secondary or third-party research or information comes from a source that may be biased, unreliable, or otherwise deficient, the member or candidate must not rely on that information.

Criteria that a member or candidate may use in forming an opinion on whether research is sound include but are not limited to

- assumptions used,
- rigor of the analysis performed,
- date/timeliness of the research, and
- evaluation of the objectivity and independence of the recommendations.

Members and candidates may rely on others in their firm to determine whether secondary or third-party research is sound and use the information in good faith unless they have reason to question its validity or the processes and procedures used by those responsible for the research. For example, portfolio managers may not have a choice of which data source to use, because the firm's senior managers conducted due diligence to determine which vendor would provide information or research services. A member or candidate in this position can use the information in good faith assuming the due diligence process was deemed adequate.

## Quantitative Research and Techniques

Standard V(A) applies to quantitatively oriented research models and processes, such as backtesting investment strategies; computer-generated modeling, screening, and ranking of investment securities; the creation or valuation of derivative instruments; and quantitative portfolio construction techniques. Members and candidates must understand the parameters used in models and quantitative research that are incorporated into their investment recommendations. Although they are not required to become experts in every technical aspect of the models, they must understand the assumptions and limitations inherent in any model and how the results are used in the decision-making process.

Members and candidates must make reasonable efforts to test the output of investment models and other preprogrammed analytical tools they use. Such validation must occur before incorporating the process into their methods, models, or analyses.

Individuals who create new quantitative models and services must exhibit a higher level of diligence in reviewing new products than that of the individuals who ultimately use the analytical output. Members and candidates involved in the development and oversight of quantitatively oriented models, methods, and algorithms must understand the technical aspects of the products. A thorough testing of the model and resulting analysis must be completed prior to product distribution.

Although not every model tests for every factor or outcome, members and candidates must ensure that their analyses incorporate a broad range of assumptions sufficient to capture the underlying characteristics of investments. Analysis that fails to consider potentially negative outcomes or levels of risk outside the norm may not accurately measure the true economic value of an investment. In reviewing computer models or the resulting output, members and candidates must include factors and assumptions that are likely to have a substantial influence on an investment's value to ensure that the model incorporates a wide range of possible input expectations, including negative market events.

Members and candidates must also consider the source and time horizon of the data used as inputs in financial models. The information from databases may not effectively incorporate both positive and negative market cycles. In the development of a recommendation, the member or candidate may need to test the models by using volatility and performance expectations that represent scenarios outside the observable databases.

## Selecting External Advisers and Subadvisers

The use of specialized managers to invest in specific asset classes or diversification strategies that complement a firm's in-house expertise is common. Standard V(A) applies to the level of review necessary in selecting an external adviser or subadviser to manage a specifically mandated allocation. Members and candidates must review such advisers as diligently as they review individual investment opportunities.

Members and candidates who are directly involved with the use of external advisers and subadvisers should develop and use consistent, objective criteria for selecting and evaluating these advisers. Such criteria include but are not limited to

- reviewing the adviser's established code of ethics,
- understanding the adviser's compliance and internal control procedures,
- assessing the quality of the published return information, and
- reviewing the adviser's investment process and adherence to its stated strategy.

One factor in evaluating external advisers or subadvisers is whether they adhere to recognized industry standards to guide their work. Codes, standards, and guides on best practice published by CFA Institute establish practices for advisers and may be used by members and candidates as criteria for selecting external advisers or subadvisers. The following guides are available at the CFA Institute Research and Policy Center website (<https://rpc.cfainstitute.org/en/>): the CFA Institute Asset Manager Code™, the Global Investment Performance Standards (GIPS®), and the Model Request for Proposal (for equity, credit, or real estate managers).

## Group Research and Decision Making

Often, members and candidates are part of a group or team that is collectively responsible for producing investment analysis or research. The conclusions or recommendations of a group report represent the consensus of the group but not necessarily the views of a member or candidate, even though the name of the member or candidate is included on the report. In some instances, a member or candidate will not agree with the view of the group. If, however, the member or candidate believes that the consensus opinion has a reasonable and adequate basis and is independent and objective, the member or candidate does not need to dissociate from the report even if it does not reflect his or her opinion.

## Compliance Practices

Members and candidates should encourage their firms to consider the following policies and procedures to support the conduct required under Standard V(A):

- Establish policies requiring that research reports, credit ratings, and investment recommendations have a basis that can be substantiated as reasonable and adequate.
- Develop detailed, written guidance that establishes the due diligence procedures for judging whether a particular recommendation has a reasonable and adequate basis.
- Develop measurable criteria for assessing the quality of research, the reasonableness and adequacy of the basis for any recommendation or rating, and the accuracy of recommendations over time.
- Develop detailed, written guidance that establishes minimum levels of scenario testing of all computer-based models used in developing, rating, and evaluating financial instruments. The policy should contain criteria related to the breadth of the scenarios tested, the accuracy of the output over time, and the analysis of cash flow sensitivity to inputs.
- Develop measurable criteria for assessing outside providers, including the quality of information being provided, the reasonableness and adequacy of the provider's information collection practices, and the accuracy of the

information over time. The established policy should outline how often the provider's products are reviewed.

- Adopt a consistent, objective set of criteria for evaluating the adequacy of external advisers and subadvisers. The policy should include how often and on what basis the allocation of funds to the external adviser or subadviser will be reviewed.

## Application of the Standard

### Example 1 (Sufficient Due Diligence)

Hawke manages the corporate finance department of Sarkozi Securities, Ltd. The firm is anticipating that the government will soon close a tax loophole that currently allows oil-and-gas exploration companies to pass on drilling expenses to holders of a certain class of shares. Because market demand for this tax-advantaged class of stock is currently high, Sarkozi convinces several companies to undertake new equity financings at once, before the loophole closes. Time is of the essence, but Sarkozi lacks sufficient resources to conduct adequate research on all the prospective issuing companies. Hawke decides to estimate the IPO prices based on the relative size of each company and to justify the pricing later when her staff has time.

*Comment:* By categorizing the issuers by general size, Hawke bypassed researching all the other relevant aspects that must be considered when pricing new issues and thus did not perform sufficient due diligence. Hawke violated Standard V(A).

### Example 2 (Timely Client Updates)

Chandler is an investment consultant in the London office of Dalton Securities, a major global investment consultant firm. One of her UK pension funds has decided to appoint a specialist US equity manager. Dalton's global manager of research relies on local consultants to review and assess managers in their regions and, after conducting thorough due diligence, puts their views and ratings in Dalton's manager database. Chandler accesses Dalton's global manager research database and conducts a screen of all US equity managers on the basis of a match with the client's desired philosophy/style, performance, and tracking-error targets. She selects the five managers that meet these criteria and puts them in a briefing report that is delivered to the client. Between the time of her database search and the delivery of the report to the client, Chandler discovers that one of the firms that she recommended for consideration lost its chief investment officer, the head of its US equity research, and the majority of its portfolio managers on the US equity product—all of whom have left to establish their own firm. Chandler does not revise her report with this updated information.

*Comment:* Chandler failed to satisfy the requirement of Standard V(A) because she did not update her report to reflect the new information.

### Example 3 (Group Research Opinions)

Mastakis is a junior analyst who has been asked by her firm to write a research report predicting the expected interest rate for residential mortgages over the next six months. Mastakis submits her report to the fixed-income investment committee of her firm for review, as required by the firm's procedures. Although some committee members support Mastakis's conclusion, the majority of the committee disagrees with her conclusion, and the report is significantly changed to indicate that interest rates are likely to increase more than originally predicted by Mastakis. Mastakis asks that her name be taken off the report when it is disseminated.

*Comment:* Generally, analysts must write research reports that reflect their own opinion. But the results of research are not always definitive, and different people may have different opinions based on the same factual evidence. When research is a group effort, however, not all members of the team may agree with all aspects of the report. In this case, the committee may have valid reasons for issuing a report that differs from the analyst's original research if there is a reasonable and adequate basis for its conclusions. Ultimately, members and candidates can ask to have their names removed from the report, but if they are satisfied that the process has produced results or conclusions that have a reasonable and adequate basis, members and candidates do not have to dissociate from the report even when they do not agree with its contents. If Mastakis is confident in the process, she does not need to dissociate from the report even if it does not reflect her opinion.

### Example 4 (Reliance on Third-Party Research)

McDermott runs a two-person investment management firm. McDermott's firm subscribes to a service from a large investment research firm that provides research reports. McDermott's firm makes investment recommendations based on these reports.

*Comment:* Members and candidates may rely on third-party research but must make reasonable and diligent efforts to determine that such research is sound. If McDermott undertakes due diligence efforts on a regular basis to ensure that the research produced by the large firm is objective and reasonably based, McDermott may rely on that research when making investment recommendations to clients.

### Example 5 (Due Diligence in Subadviser Selection)

Ostrowski's business has grown significantly over the past few years, and some clients want to diversify internationally. Ostrowski decides to find a subadviser to handle international investments. Because this will be his first subadviser, Ostrowski uses the CFA Institute Model Request for Proposal to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications but feels unqualified in choosing the best firm. He decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm's bottom line.

*Comment:* The selection of an external adviser or subadviser must be based on a full and complete review of the adviser's services, performance history, and cost structure. In basing the decision on the fee structure alone, Ostrowski violated Standard V(A).

### Example 6 (Sufficient Due Diligence)

Thompson provides research for the portfolio manager of the fixed-income department at his firm. The manager asks Thompson to conduct sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives "prepays" (prepayments of mortgages) and potential losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. To project a worst-case scenario, Thompson insists that the analysis should include a scenario run with an assumed HPA of -10% for Year 1, -5% for Year 2, and 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative. Thompson conducts research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, an unlikely but possible environment. Based on the results of these scenarios, Thompson does not recommend the purchase of the investment.

*Comment:* Thompson understands the limitations of his model, when combined with the limited available historical information, to accurately predict the performance of the funds if market conditions change negatively. Thompson's actions in running the scenario test with inputs beyond the historical trends available in the firm's databases adhere to the principles of Standard V(A).

### Example 7 (Use of Quantitatively Oriented Models)

Liakos works in sales for Hellenica Securities, a firm specializing in developing intricate derivative strategies to profit from particular views on market expectations. One of her clients is Carapalis, who is convinced that commodity

prices will become more volatile over the coming months. Carapalis asks Liakos to quickly engineer a strategy that will benefit from this expectation. Liakos turns to Hellenica's modeling group to fulfill this request. Because of the tight deadline, the modeling group outsources parts of the work to several trusted third parties. Liakos implements the disparate components of the strategy as the firms complete them. Within a month, Carapalis is proven correct: Volatility across a range of commodities increases sharply. But her derivatives position with Hellenica suffers huge losses, and the losses increase daily. Liakos investigates and realizes that although each of the various components of the strategy had been validated, they had never been evaluated as an integrated whole. In extreme conditions, portions of the model worked at cross-purposes with other portions, causing the overall strategy to fail dramatically.

*Comment:* Liakos violated Standard V(A). Members and candidates must understand the statistical significance of the results of the models they recommend and must be able to explain them to clients. Liakos did not take adequate care to ensure a thorough review of the whole model; its components were evaluated only individually. Because Carapalis clearly intended to implement the strategy as a whole rather than as separate parts, to comply with the standard, Liakos should have tested how the components of the strategy interacted in addition to how they performed individually.

### Example 8 (Successful Due Diligence/Failed Investment)

Newbury is an investment adviser to high-net-worth clients. A client with an aggressive risk profile in his investment policy statement asks about investing in the Top Shelf hedge fund. This fund has reported 20% returns for the first three years. The fund prospectus states that its strategy involves long and short positions in the energy sector and extensive leverage. Based on his analysis of the fund's track record, the principals involved in managing the fund, the fees charged, and the fund's risk profile, Newbury recommends the fund to the client and secures a position in it. Six months later, the fund announces that it has suffered a loss of 60% of its value and is suspending operations and redemptions until after a regulatory review.

*Comment:* Newbury's actions were consistent with Standard V(A). Analysis of an investment that results in a reasonable basis for recommendation does not guarantee that the investment has no downside risk. Newbury must discuss the analysis process with the client while reminding the client that past performance does not lead to guaranteed future gains and that losses in an aggressive investment portfolio should be expected.

## Example 9 (Quantitative Model Diligence)

Cannon is the lead quantitative analyst at CityCenter Hedge Fund. He is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Cannon reads several high-level mathematical publications and blogs to stay informed of current developments. One blog, run by "Expert CFA," presents some intriguing research that may benefit one of CityCenter's current models. Cannon is under pressure from the firm's executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

*Comment:* Cannon violated Standard V(A) by failing to have a reasonable basis for the new recommendations made to the portfolio managers. He needed to diligently research the effect of incorporating the new factors before offering the output recommendations. Cannon may use the blog for ideas, but it is his responsibility to determine the effect on the firm's proprietary models.

## Example 10 (Selecting a Service Provider)

Stefansson is a performance analyst at Artic Global Advisers, a firm that manages global equity mandates for institutional clients. Her supervisor asks her to review five new performance attribution systems and recommend one that would best explain the firm's investment strategy to clients. On the list is a system she recalls learning about when visiting an exhibitor booth at a recent conference. The system is highly quantitative and opaque in how it calculates the attribution values. Stefansson recommends this option without researching the others on the basis of the impressive discussion she had at the exhibitor booth with company representatives.

*Comment:* Stefansson's actions violate Standard V(A) because they do not demonstrate a sufficient level of diligence in reviewing the performance attribution product to make a recommendation for selecting the service. Besides not reviewing or considering the other four potential systems, she did not determine whether the attribution process aligns with the investment practices of the firm, including its investments in different countries and currencies. Stefansson must review and understand the process of any software or system before recommending its use as the firm's attribution system.

## Example 11 (Subadviser Selection)

Jackson works for Armaniams Partners, Inc., and is assigned to select a hedge fund subadviser to improve the diversification of the firm's large fund-of-funds product. The allocation must be in place before the start of the next quarter. Jackson uses a consultant database to find a list of suitable firms that claim compliance with the GIPS standards. He calls more than 20 firms on the list to

confirm their potential interest and to determine their most recent quarterly and annual total returns. Because of the short turnaround, Jackson recommends the firm with the greatest total returns for selection.

*Comment:* By considering only performance and GIPS compliance, Jackson did not conduct sufficient review of potential firms to satisfy the requirements of Standard V(A). Jackson must thoroughly investigate the firms and their operations to ensure that their addition would increase the diversification of clients' portfolios and that they are suitable for the fund-of-funds product.

## Example 12 (Technical Model Requirements)

Dupont works for the credit research group of XYZ Asset Management, where he is in charge of developing and updating credit risk models. In order to perform accurately, his models need to be regularly updated with the latest market data. Dupont does not interact with or manage money for any of the firm's clients. He is in contact with the firm's US corporate bond fund manager, Reichardt, who has only very superficial knowledge of the model.

Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. The firm is planning to expand into emerging credit, and the development of such a model is a critical step in this process. Because Reichardt seems to follow the model's recommendations without much concern for its quality as he develops his clients' investment strategies, Dupont decides to focus his time on the development of the new emerging market model and neglects to update the US model.

After several months without regular updates, Dupont's diagnostic statistics start to show alarming signs with respect to the quality of the US credit model. Instead of conducting a long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix." He thinks this change will address the issue without needing to complete the full data update.

Several months later, another set of diagnostic statistics reveals nonsensical results, and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Reichardt, who has made trades based on the erroneous model's results.

*Comment:* Dupont violated Standard V(A) even if he does not trade securities or make investment decisions. Dupont's models give investment recommendations, and Dupont is accountable for the quality of those recommendations. Members and candidates must make reasonable efforts to test the output of preprogrammed analytical tools they use. Such validation must occur before incorporating the tools into their decision-making process. Reichardt violated standard V(A) because he does not understand the model he is relying on to manage money.

Members and candidates must understand the parameters used in models that are incorporated into their investment recommendations. Although they are not required to become experts in every technical aspect of the models they use, they must understand the assumptions and limitations inherent in these models and how the results are used in the decision-making process.

## Standard V(B) Communication with Clients and Prospective Clients

Members and Candidates must:

1. Disclose to clients and prospective clients the nature of the services provided, along with information about the costs to the client associated with those services.
2. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
3. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
4. 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.
5. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

### Guidance

Standard V(B) addresses member and candidate conduct with respect to communicating with clients. Both developing and maintaining clear, frequent, and thorough communication practices are critical to providing high-quality financial services to clients. When clients understand the information communicated to them, they also can understand exactly how members and candidates are acting on their behalf, which gives clients the opportunity to make well-informed decisions about their investments. Such understanding can be accomplished only through clear communication.

For the purposes of Standard V(B), communication is not confined to a written report of the type traditionally generated by an analyst researching a security, company, or industry. A presentation of information can be made via any means of communication, including in-person recommendations or descriptions, electronic communications, social media posts, or media broadcasts.

The nature of client communications is highly diverse—from one word (“buy” or “sell”) to in-depth reports of more than 100 pages. A communication may contain a general recommendation about the market, asset allocations, or classes of investments or may relate to a specific security. If recommendations

are contained in abbreviated form (such as a recommended stock list), members and candidates should notify clients that additional information and analyses are available from the producer of the report.

When providing information to clients in electronic or digital format, members and candidates must take reasonable steps to ensure that such delivery treats all clients fairly. Members and candidates using any social media service to communicate business information must be diligent in their efforts to avoid unintended problems because these services may not be available to all clients.

## Disclosing the Nature of Services and Information about Costs to Clients and Prospective Clients

A fundamental goal of the Code and Standards is to protect client interests and allow clients to make fully informed decisions about their investments and financial well-being. Providing clients with a description of the nature of the services they can expect from investment professionals and information about the costs of those services is critical to achieving this goal. The disclosures required by Standard V(B) permit clients to make informed decisions as to whether to engage in professional services with members, candidates, or their firms.

Full and fair disclosure builds trust with clients, and the disclosure of information about costs benefits clients and protects their interests. Standard V(B) makes clear that required disclosures cover all professional services provided by members and candidates. A clear understanding of the services that members and candidates provide is a foundational element to the client relationship. Clients must understand what services members and candidates will provide and, critically, what services they will not provide so that members and candidates can set appropriate expectations. Best practice is for members and candidates with client-facing responsibilities to clearly set out in written form at the outset of the engagement a description of the nature and parameters of the professional services as part of the engagement agreement, contract, or other documents stipulating the terms of the client relationship.

In addition to understanding the nature of the services, clients must understand the costs they will be expected to pay for those services so they can make informed decisions about the professional services being provided. Standard V(B) requires members and candidates to inform their clients and prospective clients about the services they will receive and the associated costs. Disclosures regarding the costs of the services to clients mandated by this standard are those expected to be charged to and paid for by the client. Members and candidates should provide a reasonable amount of detail regarding the costs to be incurred by clients. The standard, however, does not require members and candidates to provide specific dollar amounts. For example, a firm that charges clients a quarterly fee based on the market value of assets under management will be unable to specify a dollar amount in advance. Members and candidates are also not required to disclose a description

of the costs to the firm of providing those services. Again, best practice is for members and candidates with client-facing responsibilities to disclose information about the nature of the services and the related costs at the outset of the relationship as part of the client agreement.

The disclosure responsibilities of members and candidates under this standard are ongoing. Initial disclosures at the outset of the relationship alone may not meet the requirements of the standard. If the services or costs change, members and candidates must update the disclosures and provide the updated information to all affected clients and prospective clients on a timely basis.

In addition, the scope of the disclosures is not limited to only those costs charged by the entity with which the client is in a direct relationship. Members and candidates with client-facing responsibilities must provide disclosures about all the costs associated with the investment services and products provided to the client. These disclosures include information on costs arising from services provided by affiliates, related entities, or third parties for products and services used by members, candidates, or their firms in providing services to clients. Members and candidates may not rely on the sophistication of clients and their supposed understanding of the nature and details of the investment process as a reason for not providing the information required by this standard. However, the information may be tailored to the knowledge and sophistication of each individual client.

## Disclosures Regarding the Investment Process

Members and candidates must adequately describe to clients and prospective clients the basic parameters of their investment decision-making process. Such disclosure must address important factors that have positive and negative influences on the recommendations, including significant risks and limitations of the investment process used. Members and candidates must keep clients informed on an ongoing basis about changes to the investment process, especially newly identified significant risks and limitations. Only by thoroughly understanding the nature of the investment product or service can a client determine whether changes to that product or service could materially affect his or her investment objectives.

Understanding the basic characteristics of an investment is of great importance for judging the suitability of that investment on a standalone basis, but it is especially important for determining the impact each investment will have on the characteristics of a portfolio. Although the risk and return characteristics of a common stock might seem to be essentially the same for any investor when the stock is viewed in isolation, the effects of those characteristics greatly depend on the other investments held. For instance, if the particular stock will represent 90% of an individual's investments, the stock's importance in the portfolio is vastly different from what it would be to an investor with a highly diversified portfolio for whom the stock will represent only 2% of the holdings.

A firm's investment process may include the use of external advisers to manage various portions of clients' assets under management. Members and candidates must inform clients about the use of external advisers as part of their investment process. This disclosure allows clients to understand the full mix of products and strategies being applied that may affect their investment objectives. Disclosure of the use of external advisers also provides insight into the capabilities of the investment manager and the manager's reliance on other investment professionals to provide services.

## Identifying Risks and Limitations

Members and candidates must disclose to clients and prospective clients significant limitations and risks associated with the investment process and notify them when significant changes in the risk characteristics of a security or asset strategy occur. The type and nature of significant risks depend on the investment process that members and candidates are following and the personal circumstances of the client.

Members and candidates must adequately disclose the general market-related risks and the risks associated with the use of complex financial instruments that are deemed significant. Other types of risks that members and candidates may consider disclosing include but are not limited to counterparty risk, country risk, sector or industry risk, security-specific risk, and credit risk. In general, the use of leverage constitutes a significant risk and must be disclosed.

Investment securities and vehicles may have limiting factors that influence a client's or prospective client's investment decision. Members and candidates must report to clients and prospective clients the existence of limitations significant to the decision-making process. Examples of such factors and attributes include but are not limited to investment liquidity and capacity. Liquidity is the ability to liquidate an investment on a timely basis at a reasonable cost. Capacity is the investment amount beyond which returns will be negatively affected by new investments.

Members and candidates must disclose significant risks known to them at the time of the disclosure. Members and candidates cannot be expected to disclose risks they are unaware of at the time recommendations or investment actions are made. In assessing compliance with Standard V(B), it is important to establish knowledge of a purported significant risk or limitation. Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis of the research of the member or candidate but may not constitute a breach of Standard V(B).

## Disclosing Factors Important to Investment Analyses and Recommendations

When publishing a research report or recommendation, the member or candidate must present the basic characteristics of the investments being analyzed. Doing so will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision-making process. In preparing a recommendation about an asset allocation strategy, alternative investment vehicle, or structured investment product, for example, the member or candidate must include factors that are relevant and important to the asset classes or investment types that are the subject of the report. Follow-up communication of significant changes in the report or recommendation is required.

Once the analytical process has been completed, the member or candidate must include those elements that are important to the analysis and conclusions of the report so that the reader can follow and challenge the report's reasoning. A report writer who has done adequate investigation may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant. For instance, a report may dwell on a quarterly earnings release or new product introduction and omit other matters as long as the analyst clearly stipulates the limits to the scope of the report.

Members and candidates must support investment advice based on quantitative research and analysis with readily available reference material. Members and candidates must also disclose any changes in methodology.

## Distinction between Facts and Opinions

Standard V(B) requires that opinions be separated from facts. Violations of this standard occur when members and candidates fail to separate the past from the future by not indicating that earnings estimates, changes in the outlook for dividends, or future market price information are *opinions* subject to future circumstances.

In the case of complex quantitative analyses, members and candidates must clearly separate fact from statistical conjecture and must identify the known limitations of an analysis. Members and candidates who fail to identify the limits of statistically developed projections leave investors unaware of the limits of the published projections. Members and candidates must use caution when promoting the perceived accuracy of any model or process because the ultimate output is merely an estimate of future results and not a certainty.

## Manner of Disclosures

The manner in which members and candidates provide the disclosures required by Standard V(B) is at their individual discretion so long as the disclosures are appropriate, accurate, timely, and complete. Best practice dictates that such disclosures be made in written form. Often in large firms, disclosures about charges to and payments expected from clients are dictated by firm policy and practice. However, this situation does not relieve members and candidates of their responsibility to provide such information when doing so is part of their professional responsibilities. While members and candidates rely on and can be directed to use firm-generated disclosures, members and candidates should ensure that these disclosures meet the requirements of the Code and Standards. They have the responsibility to alert their firm when the communication is lacking, flawed, or insufficient to meet their responsibilities under the Code and Standards. In such cases, members and candidates should, when possible, supplement disclosures from the firm that they consider insufficient to meet the requirements of this standard. Ultimately, if members and candidates cannot rectify or supplement inadequate disclosures mandated by the firm, they should document their objections and take steps to dissociate from the activity.

Generally, this standard affects only client-facing members. While CFA Institute encourages all investment professionals to help ensure that clients receive sufficient disclosures, this standard does not impose a duty on members and candidates who do not interact with clients to ensure that others comply with Standard V(B). As with other standards that may not be applicable to the professional responsibilities of all members and candidates (e.g., investment performance and suitability), those members and candidates who are part of a team of investment professionals providing services to clients but who do not have client-facing responsibilities need not expand their realm of responsibility to ensure appropriate disclosures to clients.

## Compliance Practices

Because the selection of relevant factors is an analytical skill, determination of whether a member or candidate has used reasonable judgment in excluding and including information in research reports depends heavily on case-by-case reviews rather than a specific checklist.

Members and candidates should encourage their firms to have a rigorous methodology for reviewing research that is created for publication and dissemination to clients.

To assist in the review of a report after its release, the member or candidate must maintain records indicating the nature of the research and should, if asked, be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

## Application of the Standard

### Example 1 (Costs of Services to Clients)

The nature of ABC Capital Private Equity Fund III's investments requires ABC Capital to routinely provide structuring advice to the companies in which the fund invests, for which ABC Capital charges a fee to those companies. The policy of ABC Capital is to remit the fees it earns for structuring advice to the fund if the investment in the underlying company decreases in value but to retain the fees if the investment increases in value. The private placement memorandum does not disclose this arrangement, because the firm's CEO, Alphonso, views it as a common industry practice and believes it provides a "win-win" for investors. ABC Capital's services contribute significantly to the returns enjoyed by the fund's investors, and ABC Capital earns a substantial fee.

*Comment:* Alphonso is in violation of Standard V(B) because the compensation received by ABC Capital has not been disclosed to clients who are investors in the fund. Alphonso may not rely on the sophistication of clients and their assumed understanding of the nature and details of the fee arrangements with underlying companies in which ABC Capital invests as a reason for not providing the information required by this standard. This is true even though investors in ABC Capital Private Equity Fund III benefit from the arrangement.

### Example 2 (Costs of Services to Clients)

Jones is an investment adviser tasked with completing a manager search for a client's portfolio. The search mandate is to identify a short list of investment managers who offer core fixed-income strategies managed to the benchmark identified in the client's investment policy statement. Jones begins her search with a set of criteria defined by her firm's manager search process policy. She identifies three candidates that fulfill these criteria but notices that her top-ranked manager has significantly higher fees than the other candidates on her list. Her firm's search criteria list fees as less important relative to the other criteria to rank investment managers. To present investment performance for uniform comparison, Jones creates a fee comparison chart that lists each manager's performance on a gross-of-fees basis. She presents gross-of-fees performance over the same time periods and relative to the same benchmark. She also calculates the total amount of fees that would have been paid during each of the performance time periods presented. Finally, she lists each manager's fee schedule and any fees that may be charged in addition to the published fees. She explains to her client that prior to final selection, the investment managers will be required to present their final fee proposal.

*Comment:* Jones's presentation of manager fees is appropriate because she provided a uniform comparison of manager services. Her presentation adheres to Standard V(B), which requires disclosure

about the nature of services provided, along with information about the costs associated with those services.

### Example 3 (Disclosure of Changed Fee Calculation Methodology)

Maalouf works in a branch office for a large wealth management firm. The firm's fees are based on a percentage of the value of the assets managed in each client account. The firm has a standard method for valuing assets and calculating fees for all its clients, which is disclosed to each client at the outset of the relationship. Maalouf becomes aware that, over time, the firm has transitioned to (1) using the market value of client assets at the end of the billing cycle instead of the average daily balance of the account and (2) including cash and cash equivalents in the fee calculation, which were previously excluded.

*Comment:* Advisory fees are critical information that clients need to know. When investment advisers develop and maintain clear, frequent, and thorough communication with clients about the costs of their services, clients can make well-informed decisions about their investments, including about whether to engage or retain an investment adviser. Maalouf and his firm may change the advisory fee calculation methodology and policies over time for existing accounts, but Maalouf must make clients aware of any such changes. Maalouf violated Standard V(B); it is improper to change the fee calculation methodology without disclosure even if it results in lower fees.

### Example 4 (Sufficient Disclosure of Investment System)

Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technicians' income and diversifying its product base. Williamson plans to build on Country Technicians' reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technicians' investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio construction rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top five "buy" and "sell" recommendations and to leave out details of the valuation models and the portfolio structuring scheme.

*Comment:* Williamson's plans for the newsletter violate Standard V(B). Williamson need not describe the investment system in detail in order to implement the advice effectively, but she must inform clients of Country Technicians' basic process. Without understanding the basis for a recommendation, clients cannot evaluate its limitations or its inherent risks.

### Example 5 (Providing Opinions as Facts)

Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation on the basis of the core samples from the company's latest drilling. According to Dox's calculations, the company has more than 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong *buy*."

*Comment:* Dox violated Standard V(B). His calculation of the total gold reserves for the property based on the company's recent sample drilling is a quantitative opinion, not a fact. Opinion must be distinguished from fact in research reports.

### Example 6 (Proper Description of a Security)

Thomas, an analyst at Government Brokers, Inc., a brokerage firm specializing in government bond trading, has produced a report that describes an investment strategy designed to benefit from an expected decline in US interest rates. The firm's derivative products group has designed a structured product that will allow the firm's clients to benefit from this strategy. Thomas's report describing the strategy indicates that high returns are possible if various scenarios for declining interest rates are assumed. Citing the proprietary nature of the structured product underlying the strategy, the report does not describe in detail how the firm may be able to offer such returns or the related risks in the scenarios, nor does the report address the likely returns of the strategy if, contrary to expectations, interest rates rise.

*Comment:* Thomas violated Standard V(B) because her report fails to describe properly the basic characteristics of the actual and implied risks of the investment strategy, including how the structure was created and the degree to which leverage was embedded in the structure. The report must include a balanced discussion of how the strategy would perform in the case of both rising and falling interest rates, preferably illustrating how the strategies might be expected to perform in the event of a reasonable variety of interest rate and credit risk-spread scenarios. If liquidity issues are relevant to the valuation of either the derivatives or the underlying securities, Thomas must address those risks as well.

### Example 7 (Notification of Fund Mandate Change)

May & Associates is an aggressive growth manager that represents itself as a specialist at investing in small-cap US stocks. One of May's selection criteria is a maximum capitalization of US\$2 billion for any given company. After a string of successful years of superior performance relative to its peers, May has expanded its client base significantly, to the point at which assets under management

now exceed US\$20 billion. For liquidity purposes, May's chief investment officer, Clio, decides to lift the maximum permissible market-cap ceiling to US\$8 billion and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

*Comment:* Although Clio appropriately informs potentially interested parties about the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap specialists in a multiple-manager approach. Such clients may regard May's change of criteria as a style change that distorts their overall asset allocations.

### Example 8 (Notification of Fund Mandate Change)

In addition to lifting the ceiling for May & Associates' universe from US\$2 billion to US\$8 billion, Clio extends the firm's small-cap universe to include a number of non-US companies.

*Comment:* Standard V(B) requires Clio to advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in US small-cap stocks. Clio must disclose changes in the investment process to all interested parties.

### Example 9 (Notification of Changes to the Investment Process)

RJZ Capital Management is an active value-style equity manager that selects stocks by using a combination of four multifactor models. The firm has found favorable results when backtesting the most recent 10 years of available market data in a new dividend discount model designed by the firm. This model is based on projected inflation rates, earnings growth rates, and interest rates. Rodriguez, the president of RJZ, decides to replace its simple model that uses price to trailing 12-month earnings with the new model.

*Comment:* Because the introduction of a new and different valuation model represents a material change in the investment process, Rodriguez must communicate the change to the firm's clients. RJZ is replacing a model based on hard data with a new model that is at least partly dependent on the firm's forecasting skills. This is a significant change rather than a mere refinement of RJZ's process.

### Example 10 (Notification of Changes to the Investment Process)

At Fundamental Asset Management, Inc., the responsibility for selecting stocks for the firm's "approved" list recently shifted from individual security analysts to a committee consisting of the research director and three senior portfolio managers. Morales, a portfolio manager with Fundamental Asset Management, believes this change is not important enough to communicate to her clients.

*Comment:* Standard V(B) requires Morales to disclose the process change to all her clients because this is a fundamental change to stock selection for the fund.

### Example 11 (Sufficient Disclosure of Investment System)

Chinn is the investment director for Diversified Asset Management, which manages the endowment of a charitable organization. Because of recent staff departures, Diversified has decided to limit its direct investment focus to large-cap securities and supplement the needs for small-cap and mid-cap management by hiring outside fund managers. In describing the planned strategy change to the charity, Chinn's update letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have to be considered.

*Comment:* Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the endowment fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is an example of information about the investment process that must be communicated to clients. The charity can now make a reasonable decision about whether Diversified Asset Management remains the appropriate manager for its endowment.

### Example 12 (Notification of Risks and Limitations)

Quantitative analyst Yakovlev has developed an investment strategy that selects small-cap stocks on the basis of quantitative signals. Yakovlev's strategy typically identifies only a small number of stocks (10-20) that tend to be illiquid, but according to his backtests, the strategy generates significant risk-adjusted returns. The partners at Yakovlev's firm, QSC Capital, are impressed by these results. After a thorough examination of the strategy's risks, stress testing, historical backtesting, and scenario analysis, QSC decides to seed the strategy with US\$10 million of internal capital in order for Yakovlev to create a track record for the strategy.

After two years, the strategy has generated performance returns greater than those of the appropriate benchmark and the Sharpe ratio of the fund is close to 1.0. On the basis of these results, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. The extent of the limitation is difficult to ascertain with precision; it depends on market liquidity and other factors in his model that can evolve over time. Yakovlev indicates that given the current market conditions, investments in the

fund beyond US\$3 billion of capital could become more difficult and negatively affect expected fund returns.

Wellard, the manager of the marketing team and a partner with 30 years of marketing experience, explains to Yakovlev that these are complex technical issues that will muddy the marketing message. According to Wellard, the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund has only US\$100 million of capital, very far from the US\$3 billion threshold.

*Comment:* Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund. Although the fund is currently far from the US\$3 billion mark, current and prospective investors must be made aware of this capacity issue.

### Example 13 (Notification of Risks and Limitations)

Brickell Advisers offers investment advisory services mainly to South American clients. Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that the firm's process of calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an *ex ante* Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.

*Comment:* Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B). The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts. Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.

## Standard V(C) Record Retention

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.

### Guidance

Members and candidates must retain records that substantiate the scope of their research and reasons for their actions or conclusions. The retention requirement applies to decisions to buy or sell a security as well as to reviews undertaken that do not lead to a change in position. Which records are required to support recommendations or investment actions depends on the role of the member or candidate in the investment decision-making process.

The following are examples of supporting documentation that assists the member or candidate in meeting the requirements for record retention:

- personal notes from meetings with the covered company,
- press releases or presentations issued by the covered company,
- computer-based model outputs and analyses,
- computer-based model input parameters,
- risk analyses of securities' impacts on a portfolio,
- selection criteria for external advisers,
- notes from meetings with clients, and
- outside research reports.

Electronic and online formats for gathering and sharing information create challenges in maintaining the appropriate records and files. The nature or format of the information does not remove members' and candidates' responsibility to maintain a record of information used in their analysis or communicated to clients.

Examples of electronic or digital formats for records that must be retained include but are not limited to

- emails,
- text messages,

- blog posts, and
- social media posts.

## Records Are Property of the Firm

As a general matter, records created as part of members' and candidates' professional activity on behalf of their employer are the property of the firm. When members and candidates leave a firm to seek other employment, they cannot take the property of the firm, including original forms or copies of supporting records of their work, to the new employer without the express consent of the previous employer.

Members and candidates must not use historical recommendations or research reports created at a previous firm if the supporting documentation is unavailable. For future use of any work from a previous firm for a new employer, members and candidates must recreate the supporting records at the new firm. However, these new records cannot be recreated from sources obtained at a previous employer without that employer's permission.

## Firm and Regulatory Requirements

Members and candidates must be aware of and understand employer policies and regulatory rules relating to record retention. However, these policies and regulations may lag behind the advent of new communication methods, which places a greater responsibility on the individual for retaining all relevant records.

Local regulators often impose requirements on members, candidates, and their firms related to record retention time frames that members and candidates must follow. Firms may also implement policies detailing the applicable time frame for retaining research and client communication records. Fulfilling such regulatory and firm requirements satisfies the requirements of Standard V(C). In the absence of regulatory guidance or firm policies, CFA Institute recommends maintaining records for at least seven years.

## Compliance Practices

The responsibility to maintain records that support investment action generally rests with the firm rather than individuals. Members and candidates should, however, archive research notes and other documents, either electronically or in hard copy, that support their current investment-related communications even if it is not required by the firm. Doing so will assist their firms in complying with requirements for preservation of internal or external records.

## Application of the Standard

### Example 1 (Record Retention and IPS Objectives and Recommendations)

One of Lindstrom's clients is upset by the negative investment returns of his equity portfolio. The investment policy statement (IPS) for the client requires that the portfolio manager follow a benchmark-oriented approach. The benchmark for the client includes a 35% investment allocation to the technology sector. The client acknowledges that this allocation was appropriate, but over the past three years, technology stocks have suffered severe losses. The client complains to the investment manager for allocating so much money to this sector.

*Comment:* For Lindstrom, having appropriate records is important to show that over the past three years, the portion of technology stocks in the benchmark index was 35%, as called for in the client's IPS. To comply with Standard V(C), Lindstrom would have been required to retain the client's IPS stating that the benchmark was appropriate for the client's investment objectives. He would also have had to keep records indicating that the investment process was explained appropriately to the client and that the IPS was updated on a regular basis. By taking these actions, Lindstrom would have been in compliance with Standard V(C).

### Example 2 (Record Retention and Research Process)

Young is a research analyst who writes numerous reports rating companies in the luxury retail industry. His reports are based on a variety of sources, including interviews with company managers, manufacturers, and economists; on-site company visits; customer surveys; and secondary research from analysts covering related industries.

*Comment:* Young must document and keep copies of all the information that goes into his reports, including the secondary or third-party research of other analysts. Failure to maintain such files would violate Standard V(C).

### Example 3 (Records as Firm, Not Employee, Property)

Blank develops an analytical model while he is employed by Buku Investment Management, LLP. While at the firm, he systematically documents the assumptions that make up the model and his reasoning behind the assumptions. As a result of the success of his model, Blank is hired as the head of the research department of one of Buku's competitors. Blank takes copies of the records supporting his model to his new firm.

*Comment:* The records created by Blank supporting the research model he developed at Buku are the records of Buku. Taking the documents with him to his new employer without Buku's permission violates Standard V(C). To use the model in the future, Blank must recreate the records supporting his model at the new firm.

# STANDARD VI: CONFLICTS OF INTEREST

## Standard VI(A) Avoid or Disclose Conflicts

Members and Candidates must avoid or make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

### Guidance

A conflict of interest is any matter that could reasonably be expected to impair independence and objectivity or raise a question about whether actions, judgment, or decision making is free from bias. Conflicts of interest occur when there is a personal or professional interest that may impair a member's or candidate's ability to perform his or her professional responsibilities in an independent and objective manner. Conflicts of interest often arise in the investment profession. They can occur between the interests of clients, the interests of employers, and the member's or candidate's own personal interests. A common source of conflict is compensation structure, especially incentive and bonus structures that provide immediate returns for members and candidates with little or no consideration of long-term value creation. Identifying and managing conflicts of interest are critically important to engaging in ethical conduct.

Best practice is to avoid actual conflicts of interest and the appearance of them. When it is not reasonable for members and candidates to avoid a conflict, clear and complete disclosure of the conflict is necessary. Members and candidates should also seek to mitigate the conflict to the extent possible and disclose how the conflict has been mitigated.

Standard VI(A) protects investors and employers by requiring members and candidates to avoid or fully disclose to clients, potential clients, and employers all actual and potential conflicts of interest. When a member or candidate has made full disclosure of an unavoidable conflict, the member's or candidate's employer, clients, and prospective clients will have the information needed to evaluate the objectivity of the investment advice or action taken on their behalf.

To be effective, disclosures must be prominent and must be made in plain language and in a manner designed to effectively communicate the information. Members and candidates are responsible for determining how often, in what manner, and in what particular circumstances the disclosure of conflicts must be made. Best practice dictates updating disclosures when the nature of a conflict of interest changes materially—for example, if the nature of a conflict of interest worsens through the introduction of bonuses based on each quarter's profits as opposed to annual profits. In making and updating disclosures of conflicts of interest, members and candidates should err on the side of caution to ensure that conflicts are effectively communicated.

## Disclosure of Conflicts to Employers

Disclosure of conflicts to employers may be appropriate in many instances. When reporting conflicts of interest to employers, members and candidates must give their employers enough information to assess the impact of the conflict. By complying with employer guidelines, members and candidates allow their employers to avoid potentially embarrassing and costly ethical or regulatory violations.

Reportable situations include conflicts that would interfere with rendering unbiased investment advice and conflicts that would cause a member or candidate to act not in the employer's best interest. The same circumstances that generate conflicts to be reported to clients and prospective clients also dictate reporting to employers. Ownership of stocks analyzed or recommended, participation on outside boards, and financial or other pressures that could influence a decision are to be promptly reported to the employer so that their impact can be assessed and a decision on how to resolve the conflict can be made.

The mere appearance of a conflict of interest may create problems for members, candidates, and their employers. Therefore, many of the conflicts previously mentioned may be explicitly prohibited by an employer in order to avoid those conflicts altogether. For example, many employers restrict personal trading, outside board membership, and related activities to prevent situations that might not normally be considered problematic from a conflict-of-interest point of view but that could give the appearance of a conflict of interest. Members and candidates must comply with these employer restrictions. Members and candidates should take reasonable steps to avoid conflicts. However, if the conflicts are not resolved, they must report conflicts promptly.

Standard VI(A) also deals with a member's or candidate's conflicts of interest that might be detrimental to the employer's business. Any potential conflict situation that could prevent clear judgment about or full commitment to the execution of a member's or candidate's duties to the employer should be avoided. If the member or candidate does not avoid the conflict, it must be reported to the member's or candidate's employer.

## Disclosure of Conflicts to Clients

Members and candidates must maintain their objectivity when rendering investment advice or taking investment action. Investment advice or actions may be perceived to be tainted in numerous situations. For instance, a member or candidate may not be objective if he or she owns stock in the company that is the subject of an investment recommendation or if the member or candidate has a close personal relationship with the company's managers. Requiring members and candidates to disclose all matters that reasonably could be expected to impair their objectivity when a conflict exists allows clients and prospective clients to judge motives and possible biases for themselves.

While avoiding conflicts altogether is preferred, often in the investment industry, a conflict or the perception of a conflict is not reasonably avoidable. The most obvious conflicts of interest, which must always be avoided or disclosed, are relationships between an issuer and the member, the candidate, or his or her firm (such as a directorship or consultancy by a member; investment banking, underwriting, and financial relationships; broker/dealer market-making activities; and material beneficial ownership of stock). For the purposes of Standard VI(A), members and candidates beneficially own securities or other investments if they have a direct or indirect pecuniary interest in the securities, have the power to vote or direct the voting of the shares of the securities or investments, or have the power to dispose or direct the disposition of the security or investment.

Members and candidates must take reasonable steps to determine whether a conflict of interest exists and disclose to clients any known conflicts of their firm. As an example, disclosure of broker/dealer market-making activities alerts clients that a stock purchase or sale might be made from or to the firm's proprietary account and that the firm has a special interest in the price of the stock.

Additionally, disclosures must be made to clients regarding conflicts that may arise in fee arrangements, subadvisory agreements, or other situations involving nonstandard fee structures. Equally important is the disclosure of arrangements in which the firm benefits directly from investment recommendations. An obvious conflict of interest is the rebate of a portion of the service fee some classes of mutual funds charge to investors. Members and candidates must disclose such relationships so clients can fully understand such conflicts.

## Cross-Departmental Conflicts

Other circumstances may give rise to actual or potential conflicts of interest. For instance, sell-side analysts working for broker/dealers may be encouraged, not only by members of their own firm but also by corporate issuers themselves, to write research reports about particular companies. Buy-side analysts are likely to face similar conflicts as banks exercise their underwriting and security-dealing powers. A marketing division may ask

an analyst to recommend the stock of a certain company in order to obtain business from that company.

The potential for conflicts of interest also exists with broker-sponsored limited partnerships formed to invest venture capital. Members and candidates may be expected not only to follow issues from these partnerships once they are offered to the public but also to promote the issues in the secondary market after public offerings. Members and candidates must resolve situations presenting potential conflicts of interest or disclose them in accordance with the principles set forth in Standard VI(A).

## Conflicts with Stock Ownership

The most prevalent conflict requiring disclosure under Standard VI(A) is members' and candidates' ownership of stock in companies that they recommend to clients or that clients hold. The simplest method for preventing such a conflict is to prohibit members and candidates from owning any such securities, but this approach may be overly burdensome and too restrictive. Members and candidates must disclose any beneficial ownership interest in securities or other investments that they recommend. Conflicts arising from personal investing are discussed more fully in the guidance for Standard VI(B).

## Conflicts as a Board Member or Director

Service as a board member or director poses three basic conflicts of interest. First, a conflict may exist between the duties owed to clients and the duties owed to shareholders of the company. Second, investment personnel who serve as directors may receive securities or options to purchase securities of the company as compensation for serving on the board, which could raise questions about trading actions that might increase the value of those securities. Third, board service creates the opportunity to receive material nonpublic information involving the company. Even though the information is confidential, the perception could be that information not available to the public is being communicated to a director's firm—whether a broker, investment adviser, or other type of organization. When members and candidates providing investment services also serve as directors, they should be isolated from those making investment decisions by firewalls or similar restrictions.

## Application of the Standard

### Example 1 (Conflict of Interest and Business Relationships)

Weiss is a research analyst with Williamsburg Company, a broker and investment banking firm. Williamsburg's merger and acquisition department has represented Jimco, a conglomerate, in all of Jimco's acquisitions for the last 20 years. From time to time, Williamsburg officers sit on the boards of directors of various Jimco subsidiaries. Weiss is writing a research report on Jimco.

*Comment:* Weiss must disclose in his research report Williamsburg's special relationship with Jimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company entails a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report writer and must be disclosed.

### Example 2 (Conflict of Interest and Business Stock Ownership)

The investment management firm of Dover & Roe sells a 25% interest in its partnership to a multinational bank holding company, First of New York. Immediately after the sale, Hobbs, president of Dover & Roe, changes her recommendation for First of New York's common stock from "sell" to "buy" and adds First of New York's commercial paper to Dover & Roe's approved list for purchase.

*Comment:* Best practice would be for Hobbs to discontinue research coverage of First of New York because the new ownership interest in this company creates a conflict of interest. At minimum, Hobbs must disclose the new relationship with First of New York to all Dover & Roe clients. Hobbs must also require the ownership interest to be disclosed to clients by the firm's portfolio managers when they make specific investment recommendations or take investment actions with respect to First of New York's securities.

### Example 3 (Conflict of Interest and Personal Stock Ownership)

Fargmon, a research analyst who follows firms producing office equipment, has been recommending the purchase of stock in Kincaid Printing because of its innovative new line of copiers. After his initial report on the company, Fargmon's wife inherits from a distant relative US\$3 million of Kincaid stock. One year after his initial report on the company, Fargmon is asked to write a follow-up report on Kincaid.

*Comment:* At minimum, Fargmon must disclose his wife's ownership of Kincaid stock to his employer and in his follow-up report. Best practice is to avoid the conflict by asking his employer to assign another analyst to draft the follow-up report.

### Example 4 (Conflict of Interest and Personal Stock Ownership)

Roberts is speculating in penny stocks for her own account and purchases 100,000 shares of Drew Mining, Inc., for US\$0.30 a share. She intends to sell these shares at the sign of any substantial upward price movement of the stock. A week later, her employer asks her to write a report on penny stocks in the mining industry to be published in two weeks. Even without owning the Drew

stock, Roberts would recommend it in her report as a “buy.” A surge in the price of the stock to the US\$2 range is likely to result once the report is issued.

*Comment:* Roberts must disclose the conflict to her employer and should consider declining the research assignment on Drew Mining. If Roberts’s employer has her write the report despite the conflict, Roberts must disclose the conflict in her report.

### Example 5 (Conflict of Interest and Compensation Arrangements)

Snead, a portfolio manager for Thomas Investment Counsel, LLC, specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead’s employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indexes. To improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients’ investment policy statements (IPSs). No change in objective or strategy has been recommended by Snead during the year.

*Comment:* Snead violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her employer, which created a conflict of interest between her compensation and her clients’ IPSs. Firms may pay employees based on performance, but pressure by Thomas Investment Counsel to achieve short-term performance goals conflicts with the requirement to take only investment actions that are consistent with the objectives of Snead’s accounts.

### Example 6 (Conflict of Interest and Compensation Arrangements)

Carter is a representative with Bengal International, a registered broker/dealer. A stock promoter for Badger Company offers to pay Carter additional compensation for sales of Badger Company’s stock to Carter’s clients. Carter accepts the stock promoter’s offer but does not disclose the arrangement to his clients or to his employer. Carter sells shares of Badger stock to his clients.

*Comment:* Carter violated Standard VI(A) by failing to disclose to clients that he is receiving additional compensation for recommending and selling Badger stock. At minimum, Carter must disclose the arrangement with Badger to his clients so they can evaluate whether Carter’s recommendations to buy Badger were affected by this arrangement. Best practice is for Carter to avoid this conflict of interest altogether by declining the offer of additional compensation from Badger Company.

## Example 7 (Conflict of Interest and Requested Favors)

Papis is the chief investment officer of his state's retirement fund. The fund has always used external managers for the real estate allocation, and this information is clearly presented in all fund communications. Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management, and he contacts Papis about gaining some of the retirement fund's real estate allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in managers appears in the next annual report in the listing of external managers.

*Comment:* Papis violated Standard VI(A) by not disclosing to his employer his personal relationship with Nagle. Disclosure of his history with Nagle would allow his firm to determine whether the conflict may have impaired Papis's independence in deciding to change external managers.

## Standard VI(B) Priority of Transactions

Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

### Guidance

Standard VI(B) requires that members and candidates give the interests of their clients and employers priority over their personal financial interests. This standard is designed to prevent any potential conflict of interest or the appearance of a conflict of interest with respect to a member's or candidate's personal transactions. Conflicts between the client's interest and an investment professional's personal interest may occur. Client transactions must take precedence over transactions made on behalf of the member's or candidate's firm or personal transactions.

### Personal Investments

The objective of the standard is to prevent personal transactions from adversely affecting the interests of clients or employers. A member or candidate having the same investment positions or being co-invested with clients does not always create a conflict. Some clients in certain investment situations require members or candidates to have aligned interests. Personal investment positions or transactions of members or candidates or their firm should never, however, adversely affect client investments.

Although conflicts of interest exist, nothing is inherently unethical about individual managers, advisers, or mutual fund employees making money from personal investments as long as (1) the client is not disadvantaged by the trade, (2) the member or candidate does not benefit personally from trades undertaken for clients, and (3) the member or candidate complies with applicable regulatory requirements. Transactions for clients must have priority over transactions in securities or other investments for which a member or candidate is the beneficial owner.

Sometimes, members and candidates may need to enter a personal transaction that runs counter to current recommendations or strategies they are pursuing for client portfolios. For example, a member or candidate may be required at some point to sell an asset for personal financial reasons, and the sale may be contrary to the recommendations or advice the member or candidate is currently providing to clients. In such situations, members and candidates may be justified in acting counter to their advice to clients.

Standard VI(B) covers the activities of members and candidates who have knowledge of pending transactions that may be made on behalf of their clients or employers. Members and candidates are prohibited from benefiting from or conveying information about client transactions.

## Impact on Accounts with Beneficial Ownership

Members or candidates may undertake transactions in accounts for which they are a beneficial owner only after their clients and employers have had adequate opportunity to act on a recommendation. Members and candidates are beneficial owners if they ultimately own, control, have the power to direct, or have a material interest in a security or investment. Personal transactions include those made for the member's or candidate's own account, for the accounts of immediate family members, and for accounts in which the member or candidate has a direct or indirect financial interest. Family accounts that are client accounts should be treated like any other firm account and should neither be given special treatment nor be disadvantaged because of the family relationship.

## Compliance Practices

Complying with an employer's policies and procedures that are designed to prevent potential conflicts of interest and even the appearance of a conflict of interest with respect to personal transactions is critical to establishing investor confidence in the investment industry. Because investment firms vary greatly in assets under management, types of clients, number of employees, and so on, members and candidates must carefully consider the policies regarding personal investing that are applicable to their situation. Members and candidates should then prominently disclose these policies to clients and prospective clients.

While the specific provisions of each firm's approach will vary, many firms adopt certain basic procedures to address the conflict areas created by personal investing. Members and candidates must comply with their employer's personal investing policies, which could include the following:

- *Limited participation in equity IPOs:* Some eagerly awaited IPOs rise significantly in value shortly after the issue is brought to market. Because the new issue may be highly attractive and sought after, the opportunity to participate in the IPO may be limited. Purchases of IPOs by investment personnel create conflicts of interest in two principal ways. First, participation in an IPO may have the appearance of taking away an attractive investment opportunity from clients for personal gain—a clear breach of the duty of loyalty to clients. Second, personal purchases in IPOs may have the appearance that the investment opportunity is being bestowed as an incentive to make future investment decisions for the benefit of the party providing the opportunity. Members and candidates can avoid these conflicts or appearances of conflicts of interest by not participating in IPOs.

When participation in IPOs is permitted by a firm's policies, members and candidates should preclear their participation in IPOs, even in situations without any conflict of interest between a member's or candidate's participation in an IPO and the client's interests. Members and candidates should not benefit from the position that their clients occupy in the marketplace—through preferred trading, the allocation of limited offerings, or oversubscription.

- *Restrictions on private placements:* Employers may place strict limits on investment personnel acquiring securities in private placements. Participation in private placements raises conflict-of-interest issues that are similar to issues surrounding IPOs. Investment personnel should not be involved in transactions, including (but not limited to) private placements, that could be perceived as favors or gifts that seem designed to influence future judgment or to reward past business deals.
- *Blackout/restricted periods:* Investment personnel involved in the investment decision-making process should comply with established blackout periods so that managers cannot take advantage of their knowledge of client activity by "front-running" client trades (trading for one's personal account before trading for client accounts).
- *Reporting requirements:* Members and candidates must comply with employer reporting policies, including disclosure of personal holdings/beneficial ownerships, confirmations of trades to the firm and the employee, and preclearance procedures. Reporting requirements may include the following:
  - *Disclosure of holdings in which the employee has a beneficial interest.* Firms may require disclosure upon commencement of the employment relationship and periodically thereafter.
  - *Providing duplicate confirmations of transactions.* Firms may require employees to direct their brokers to supply to their employer duplicate copies or confirmations of all their personal securities transactions and copies of periodic statements for all securities accounts. The duplicate confirmation requirement has two purposes: (1) The requirement sends a message that there is independent verification, which reduces the likelihood of unethical behavior, and (2) it enables verification of the accounting of the flow of personal investments that cannot be determined from merely looking at holdings.
  - *Preclearance procedures.* Firms may require employees to disclose all planned personal trades so that they may identify possible conflicts prior to the execution of the trades. Preclearance procedures are designed to identify possible conflicts before a problem arises.
- *Disclosure of policies:* Upon request, members and candidates should fully disclose to investors their firm's policies regarding personal investing. The information about employees' personal investment activities and policies will foster an atmosphere of full and complete disclosure and address

concerns about the conflicts of interest posed by personal trading. The disclosure must provide helpful information to investors; it should not be simply boilerplate language, such as “investment personnel are subject to policies and procedures regarding their personal trading.”

## Application of the Standard

### Example 1 (Personal Trading)

Long, a research analyst, does not recommend purchase of a common stock for his employer’s pension account, because he wants to purchase the stock personally and does not want to wait until the recommendation is approved and the stock is purchased by his employer.

*Comment:* Long violated Standard VI(B) by taking advantage of his knowledge of the stock’s value before allowing his employer to benefit from that information.

### Example 2 (Trading for a Family Member’s Account)

Baker, the portfolio manager of an aggressive growth mutual fund, maintains an account in her husband’s name at several brokerage firms with which the fund and a number of Baker’s other individual clients conduct a substantial amount of business. Whenever a hot issue becomes available, she instructs the brokers to buy it for her husband’s account. Because such issues normally are scarce, Baker often acquires shares in hot issues but her clients are not able to participate in them.

*Comment:* Baker violated Standard VI(B). To comply with the standard, Baker must acquire shares for her mutual fund first before acquiring them for her husband’s account. She also must disclose the trading for her husband’s account to her employer because this activity creates a conflict between her personal interests and her employer’s interests.

### Example 3 (Family Accounts as Equals)

Toffler, a portfolio manager at Esposito Investments, manages the retirement account established with the firm by her parents. Whenever IPOs become available, she first allocates shares to all her other clients for whom the investment is appropriate; then, she places any remaining portion in her parents’ account, if the issue is appropriate for them. She adopted this procedure so that no one can accuse her of favoring her parents.

*Comment:* Toffler violated Standard VI(B) by breaching her duty to her parents by treating them differently from her other accounts simply because of the family relationship. As fee-paying clients of Esposito Investments, Toffler’s parents are entitled to the same treatment as any

other client of the firm. If Toffler has beneficial ownership in the account, however, and Esposito Investments has preclearance and reporting requirements for personal transactions, she may have to preclear the trades and report the transactions to Esposito.

#### Example 4 (Personal Trading and Disclosure)

Michaels is an entry-level employee who works for both the research department and the investment management department of an active investment management firm. George, the director of the investment management department, who has responsibility for monitoring the personal stock transactions of all employees, discovers that Michaels has made substantial investment gains by purchasing stocks just before they were put on the firm's recommended "buy" list. Michaels regularly declined to complete the firm's quarterly personal transaction form.

*Comment:* Michaels violated Standard VI(B) by placing personal transactions ahead of client transactions. In addition, George violated Standard IV(C) Responsibilities of Supervisors by not requiring Michaels to complete the quarterly personal transaction form.

#### Example 5 (Trading Prior to Report Dissemination)

Wilson, a brokerage's insurance analyst, makes an internal video conference presentation to her firm's branches around the country. During the broadcast, she includes negative comments about a major company in the insurance industry. The following day, Wilson's follow-up written report is printed and distributed to the sales force and public customers. The report recommends that both short-term traders and intermediate investors take profits by selling the insurance company's stock. Seven minutes after the video conference, however, Riley, the head of the firm's trading department, closed out a long "call" position in the stock. Shortly thereafter, Riley established a sizable "put" position in the stock. When asked about her activities, Riley claimed she took the actions to facilitate anticipated sales by institutional clients.

*Comment:* Riley violated Standard VI(B) by not giving customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Riley's firm may have depressed the price of the calls and increased the price of the puts. Riley should have avoided the conflict of interest by waiting to trade for the firm's own accounts until its clients had an opportunity to receive and assimilate Wilson's recommendations.

## Standard VI(C) Referral Fees

Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

### Guidance

Members and candidates must inform their employer, clients, and prospective clients of any benefit received for referrals of customers and clients. Such disclosures allow clients and employers to evaluate (1) any partiality shown in any recommendation of products or services and (2) the full cost of the services. Members and candidates must also disclose when they pay a fee or provide compensation to others who have referred prospective clients to the member or candidate.

Appropriate disclosure means that before entry into any formal agreement for services, members and candidates must inform the client or prospective client of any benefit given or received for the recommendation of any services provided by the member or candidate. The member or candidate must disclose the nature of the consideration or benefit—for example, flat fee or percentage basis, one-time or continuing benefit, benefit based on performance, benefit in the form of provision of research, or other noncash benefit—together with the estimated dollar value. Consideration includes all fees, whether paid in cash, in soft dollars, or in kind.

### Compliance Practices

Members and candidates should encourage their employers to develop procedures related to referral fees. Employers may completely restrict such fees or outline the appropriate steps for requesting approval of a referral fee arrangement. Members and candidates who participate in approved referral fee programs should provide to their employer regular (at least quarterly) updates on the amount and nature of compensation received through referral fee arrangements.

## Application of the Standard

### Example 1 (Disclosure of Referral Arrangements and Outside Parties)

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment management firm. In this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral accounts to Brady Securities.

White, a partner at Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities are US\$200,000 annually. Referrals from Brady Securities last year resulted in fee income of US\$1.8 million for Lewis Brothers, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of US\$100,000.

Branch, the chief financial officer of Maxwell Inc., is seeking an investment manager for Maxwell's profit-sharing plan and contacts White about Lewis Brothers' investment management services. She tells White that her friend at Brady Securities, Hill, recommended Lewis Brothers without qualification. White secures Maxwell as a new client but does not disclose his firm's referral arrangement with Brady Securities.

*Comment:* White violated Standard VI(C) by failing to inform the prospective customer of the referral fee arrangement with commissions paid to Brady Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

### Example 2 (Disclosure of Interdepartmental Referral Arrangements)

Handley works for the trust department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage department and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement at Central Trust to his clients.

*Comment:* Handley violated Standard VI(C) by not disclosing the referral arrangement at Central Trust Bank to his clients. Standard VI(C) does not distinguish between referral payments paid by a third party for referring clients to the third party and internal payments paid within a firm to attract new business to a subsidiary. Members and candidates must disclose all such referral fees. Therefore, Handley is required to disclose, at the time of referral, any referral fee agreement in place among Central Trust Bank's departments. The disclosure must include the nature and the value of the benefit.

### Example 3 (Disclosure of Referral Arrangements and Informing Firm)

Roberts is a portfolio manager at Katama Investments, an advisory firm specializing in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients. Roberts asks the trading desk to direct a large portion of its commissions to Naushon, Inc., a small broker/dealer run by one of Roberts's business school classmates. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research to be not especially useful. Nevertheless, the traders do as Roberts asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment services of Roberts and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

*Comment:* Roberts is violating Standard VI(C) by failing to inform her employer and clients of the referral arrangement.

### Example 4 (Disclosure of Referral Arrangements and Outside Parties)

The state employee pension plan is seeking to hire a firm to manage the pension plan's emerging market allocation. To assist in the review process, the plan hires Arronski as a consultant to solicit proposals from various advisers. Arronski is contracted by the plan to represent its best interest in selecting the most appropriate new manager. The process runs smoothly, and Overseas Investments is selected as the new manager.

The following year, it comes to light that Arronski charges fees to investment managers that he recommends if they are awarded new pension allocations. Although the plan is happy with the performance of Overseas since it has been managing the plan's emerging market funds, the plan still decides to have an independent review of the proposals and the selection process to ensure that Overseas is the appropriate firm for its needs. This review confirms that, even

though Arronski was paid by both the plan and Overseas, the recommendation of Overseas appeared to be objective and appropriate.

*Comment:* Arronski violated Standard VI(C) because he did not disclose the fee being paid by Overseas. Withholding the information that firms pay Arronski once they are awarded business based on his recommendations implies a potential lack of objectivity in the recommendation of Overseas by Arronski.

# STANDARD VII: RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

## Standard VII(A) Conduct as Participants in CFA Institute Programs

Members and Candidates 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 CFA Institute programs.

### Guidance

Standard VII(A) covers the conduct of CFA Institute members and candidates involved in any CFA Institute program. There is an array of CFA Institute programs beyond the earning the CFA designation that provide additional educational and credentialing opportunities. Standard VII(A) holds members and candidates to high ethical conduct while they are participating in or involved with any CFA Institute program so as not to undermine the public's confidence in the integrity of those programs. This standard does not require participants in a CFA Institute program to comply with the Code and Standards unless they are a member or candidate otherwise subject to the Code and Standards.

Prohibited conduct includes but is not limited to

- giving or receiving assistance (cheating) on any CFA Institute examinations;
- violating the rules, regulations, and testing policies of CFA Institute programs;
- providing confidential program or exam information to candidates or the public;
- disregarding or attempting to circumvent security measures established for any CFA Institute examinations;
- improperly using an association with CFA Institute to achieve personal or professional goals; and
- misrepresenting information to CFA Institute regarding any CFA Institute program.

## Confidential CFA Institute Information

CFA Institute is vigilant about protecting the integrity of the content and examination processes of all CFA Institute programs. Participants in these programs are prohibited from disclosing confidential material gained during participation in any program or any exam process. Examples of information that cannot be disclosed by candidates or members include but are not limited to

- specific details of questions appearing on an exam and
- broad topical areas and formulas tested or not tested on an exam.

All aspects of an exam for any CFA Institute program are considered confidential until such time as CFA Institute elects to release them publicly. This confidentiality requirement allows CFA Institute to maintain the integrity and rigor of exams for future candidates. Standard VII(A) does not prohibit candidates from discussing nonconfidential information or material with others or in study groups in preparation for an exam.

Many candidates for the CFA designation use online services as part of their exam preparations. CFA Institute actively polices blogs, forums, and related social networking groups for dissemination of confidential information. The organization works to promptly address or remove any and all material that violates exam or other rules, laws, or regulations. Candidates, members, and the public are encouraged to report suspected violations to CFA Institute.

The rules, regulations, and policies for CFA Institute programs define additional allowed and disallowed actions concerning the programs and examinations. Violating any of the testing policies constitutes a violation of Standard VII(A). The policies for CFA Institute programs are posted on the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)).

## Volunteers with CFA Institute Programs

Members participating as volunteers in CFA Institute programs are often exposed to confidential material. Standard VII(A) prohibits members from offering, soliciting, or disclosing confidential material gained while volunteering to unauthorized personnel or those outside the organization.

Examples of information that must not be shared by members involved in developing, administering, or grading exams include but are not limited to

- questions appearing on an exam or under consideration,
- deliberation related to an exam process, and
- information related to the scoring of questions.

## Expressing an Opinion

Standard VII(A) does *not* cover expressing opinions regarding CFA Institute or its programs. Members and candidates are free to disagree and express their disagreement with CFA Institute on its policies, its procedures, or any advocacy positions taken by the organization. When expressing a personal opinion, a candidate is prohibited from disclosing confidential information about exam content, including any actual exam questions and information about subject matter covered or not covered in an exam.

## Application of the Standard

### Example 1 (Sharing Exam Questions)

Nero, a candidate for the CFA designation, recently found what appears to be a copy of the Level II CFA exam. Although he is not sure whether it is authentic, he posts some of the questions in an online chatroom frequented by other candidates for the CFA designation. Two other Level II candidates in the chatroom ask Nero to post more questions, which he does. All three use the questions to prepare for their upcoming exam.

*Comment:* Nero and the two candidates violated Standard VII(A). By giving information about the CFA exam questions to two candidates, Nero provided an unfair advantage to the two candidates and undermined the integrity and validity of the Level II CFA exam as an accurate measure of the knowledge, skills, and abilities necessary to earn the right to use the CFA designation. By soliciting and accepting the information, the two other candidates also compromised the integrity and validity of the Level II CFA exam and undermined the ethical framework that is a key part of the designation.

### Example 2 (Filing a Fraudulent Deferral Request to Postpone Exam Date)

Chiu is a candidate for the CFA designation and is registered to take the Level I CFA exam during the upcoming open exam window. As the date gets closer, Chiu realizes that she is not prepared to take the exam. According to CFA Institute policies in effect at the time, Chiu can request a Paid Deferral, but she notices that the Emergency Deferral option is free, so she files an Emergency Deferral request claiming that her uncle died. CFA Institute denies her request since the death of an uncle is not a valid basis for an Emergency Deferral under the current rules. In response, Chiu files a second request claiming that her mother died. The death certificate she submits with her new request is identical to her first request, except the name of the deceased has been changed. Later, Chiu admits that there had been no deaths and that the documentation was altered in an attempt to obtain an Emergency Deferral to save money.

*Comment:* By filing a fraudulent request for an Emergency Deferral, Chiu violated rules of the CFA Program and compromised the integrity of the CFA exam. As a result, her conduct violated Standard VII(A), in addition to Standard I(C) Misrepresentation.

### Example 3 (Disruptive Conduct at Test Center)

Hermosa is a candidate for the CFA designation and is registered to take the Level III CFA exam at a test center in his city. On his scheduled exam day, he arrives at the test center. During the check-in process, he refuses to cooperate with the proctor when asked to show that his pants pockets are empty. He becomes agitated, shouts profanity, throws his passport at the proctor, and threatens her with bodily harm. Several other CFA candidates in the test center at the time complain that the incident interrupted their testing experience and that they were concerned for their safety as a result of Hermosa's conduct.

*Comment:* Hermosa's conduct violated Standard VII(A) because he violated testing rules and compromised the integrity and security of the CFA exam.

### Example 4 (Bringing Written Material into Computer-Based Testing Centers)

Yu is a candidate for the CFA designation and is registered to take the Level I CFA exam. She has difficulty remembering formulas, so prior to entering the computer-based testing (CBT) center, she writes several formulas on a piece of paper and hides it in one of her shirt sleeves. During the exam, a proctor notices Yu removing the paper from her sleeve. The proctor approaches Yu and confiscates the paper.

*Comment:* Because Yu took written information into the CBT exam room, her conduct violated the testing rules and compromised the security and integrity of the CFA exam and the validity of her exam performance. Therefore, she violated Standard VII(A).

### Example 5 (Looking at Other Workstation Screens during CBT Exams)

Sharma is a candidate for the CFA designation. He is at a CBT center taking the Level II CFA exam. The testing rules prohibit looking at other candidates' screens. Sharma's mind wanders during the exam, and he briefly reminisces about the past—when the exams were on paper instead of on a computer. He wonders if his test is the same as that of the test taker sitting next to him, who is also taking the Level II CFA exam. He looks multiple times at the computer screen of the test taker next to him. His conduct is observed by a CBT proctor and is captured by video surveillance.

*Comment:* Sharma's conduct violated Standard VII(A) because he violated testing rules and compromised the validity, integrity, and security of the CFA exam.

### Example 6 (Sharing Exam Content)

After completing the Level II CFA exam, Rossi posts online about her experience. Her post reads, "Level II is complete! I think I did fairly well on the exam. It was really difficult but fair. I think I did especially well on the derivatives questions. And there were tons of them! I think I counted 18! The ethics questions were really hard. I'm glad I spent so much time on the Code and Standards. I was surprised to see there were no questions at all about IPO allocations. I expected there to be a couple. Well, off to celebrate getting through it. See you tonight?"

*Comment:* Rossi did not violate Standard VII(A) when she wrote about how difficult she found the exam or how well she thinks she may have done. By revealing portions of the exam content covered on the exam and areas not covered, however, she did violate Standard VII(A). Depending on the time frame in which the comments were posted, Rossi not only may have assisted future candidates but also may have provided an unfair advantage to candidates yet to sit for the same exam, thereby undermining the integrity and validity of the exam.

### Example 7 (Sharing Exam Content)

Level I candidate Gagne has been a frequent visitor to an internet forum designed specifically for candidates for the CFA designation. The week after completing the Level I CFA exam, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.

*Comment:* Gagne violated Standard VII(A) by providing confidential exam information, which compromises the integrity of the exam process. In trying to determine correct answers to specific questions, the group's discussion included question-specific details considered to be confidential.

### Example 8 (Sharing Exam Content)

CFA4Sure is a company that produces test-preparation materials for CFA Program candidates. Many candidates register for and use the company's products. The day after the CFA exam, CFA4Sure sends an email to all its customers asking them to share with the company the hardest questions from the exam so that CFA4Sure can better prepare its customers for the next exam administration. Pena emails a summary of the questions she found most difficult on the exam.

*Comment:* Pena violated Standard VII(A) by disclosing exam questions. The information provided is considered confidential until publicly released by CFA Institute. CFA4Sure is likely to use such feedback to refine its review materials for future candidates. Pena's sharing of the specific questions undermined the integrity of the exam while potentially making the exam easier for future candidates.

If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also violated Standard VII(A).

### **Example 9 (Discussion of Exam Grading Guidelines and Results)**

As a condition of participating in grading CFA exams, Whitcomb agrees not to reveal or discuss the exam materials with anyone except CFA Institute staff or other graders. Several weeks after the conclusion of the CFA exam grading process, Whitcomb tells several colleagues who are candidates for the CFA designation which question he graded. He also discusses the guideline answer and adds that few candidates scored well on the question.

*Comment:* Whitcomb violated Standard VII(A) by disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

### **Example 10 (Compromising CFA Institute Integrity as a Volunteer)**

Ramirez is an investor relations consultant for several small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute local society in the city where he works. Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies.

*Comment:* By using his volunteer position at CFA Institute to benefit himself and his clients, Ramirez is compromising the reputation and integrity of CFA Institute and thus is violating Standard VII(A).

### **Example 11 (Compromising CFA Institute Integrity as a Volunteer)**

Warrenski is a member of the CFA Institute GIPS Standards Technical Committee, which provides technical oversight and guides development of the GIPS standards. As a member of the committee, she has advance knowledge of confidential information regarding the GIPS standards, including any new or revised standards the committee is considering. She tells her clients that her committee membership will allow her to better assist them in keeping up with changes to the GIPS standards and facilitating their compliance with the changes.

*Comment:* Warrenski used her association with the GIPS Standards Technical Committee to promote her firm's services to clients and potential clients. In stating that her volunteer position at CFA Institute provides a strategic business advantage over competing firms and implying to clients that she would use confidential information to further their interests, Warrenski compromised the reputation and integrity of CFA Institute and thus violated Standard VII(A). She may factually state her involvement with the committee but cannot infer any special advantage to her clients from such participation.

## Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

### Guidance

Standard VII(B) is intended to assure factual representations relating to CFA Institute and prohibit members and candidates from making unsupported statements promising competence or performance that are tied to CFA Institute membership, the CFA designation, or candidacy in the CFA Program.

Standard VII(B) is not intended to prohibit factual statements related to the positive benefits of earning the CFA designation. The benefits of CFA Institute membership and holding the CFA designation are evident. Statements referring to CFA Institute, the CFA designation, or candidacy for the CFA designation that overstate the competency of an individual or assert or imply that superior performance can be expected from someone with the CFA designation are prohibited by the standard.

Statements that highlight or emphasize the commitment of CFA Institute members, CFA charterholders, and CFA candidates to ethical and professional conduct or mention the thoroughness and rigor of the CFA exams are appropriate. Members and candidates may make claims about the relative merits of CFA Institute, the CFA exams, or the Code and Standards as long as those statements are implicitly or explicitly stated as the opinion of the speaker. Statements that do not express opinions must be supported by facts.

Standard VII(B) applies to any form of communication, including but not limited to communications made in electronic or written form (such as communications on firm letterhead, business cards, professional biographies, directory listings, printed advertising, LinkedIn pages, email signatures, websites, or personal resumes) and in oral statements made to the public, clients, or prospects.

### CFA Institute Membership

Use of the CFA designation by a CFA charterholder is governed by the terms and conditions of the CFA Institute Membership Agreement and applicable laws.

The term “CFA Institute member” refers to “regular” and “affiliate” members of CFA Institute who have met the membership requirements as defined in the CFA Institute Bylaws. Membership requirements include satisfying the following requirements on an annual basis:

- complete a CFA Institute Membership Agreement,
- remit to CFA Institute a completed Professional Conduct Statement, which renews the commitment to abide by the requirements of the Code and Standards and the CFA Institute Professional Conduct Program, and
- pay applicable CFA Institute membership dues.

If a CFA Institute member fails to meet any membership requirement established by CFA Institute, the individual is no longer considered a member. Until membership is reactivated, individuals must not present themselves to others as members and must remove all references to CFA Institute membership from social media profiles, business communications, reports, and anywhere else membership is referenced. Former members may state, however, that they were CFA Institute members in the past or refer to the years when they met the requirements of CFA Institute membership.

## Using the CFA Designation

Charterholders are encouraged to use the designation but, in doing so, must state their charterholder status in a manner that is accurate and does not exaggerate the benefits of the charter. The use of the designation may be accompanied by an accurate explanation of the requirements that have been met to earn the right to use the designation.

“CFA charterholders” are those individuals who have earned the right to use the CFA designation granted by CFA Institute. Once granted the right to use the designation, individuals must also satisfy CFA Institute annual membership requirements to maintain their right to use the designation.

If a CFA charterholder fails to meet any membership requirement, he or she forfeits the right to use the CFA designation. Until membership is reestablished, individuals must not present themselves to others as CFA charterholders and must remove all references to the CFA designation from social media profiles, business communications, reports, and anywhere else the designation is referenced. Former members may state, however, that they were charterholders in the past.

On social media, where individuals may anonymously express their opinions, pseudonyms or online profile names created to hide a member’s identity must not be tagged with the CFA designation.

## Referring to Candidacy for the CFA Designation

Candidates for the CFA designation may reference their candidacy, but such references must clearly state that an individual is a *candidate* for the CFA designation. Candidates must not state or imply that they have achieved any type of partial designation in a manner not authorized or permitted by CFA Institute. A person is a candidate for the CFA designation if (1) CFA Institute has accepted the person's application to be a candidate for the designation, as evidenced by issuance of a notice of acceptance, and (2) the person is enrolled to sit for a specified examination or the person has sat for a specified examination but exam results have not yet been received.

If an individual declines to sit for an exam for which they have enrolled or otherwise does not meet the definition of a candidate as described in the CFA Institute Bylaws, then that individual is no longer considered a candidate. Once the person is enrolled to sit for a future examination, his or her candidacy resumes.

Except and only to the extent as authorized or permitted by CFA Institute, candidates for the CFA designation must never state or imply that they have a partial designation as a result of passing one or more levels of the CFA exam. Candidates also must not cite an expected completion date for earning the charter. Final award of the charter is subject to meeting the requirements for the designation established by CFA Institute and approval by the CFA Institute Board of Governors.

If a candidate passes each level of the exam in consecutive sittings and states that he or she did so, that is not a violation of Standard VII(B), because it is a statement of fact. If the candidate then goes on to claim or imply superior ability as a result of obtaining the designation and not failing any of the exams, however, he or she is in violation of Standard VII(B).

**Exhibit 1** provides examples of proper and improper references to the CFA designation.

## Exhibit 1. Proper and Improper References

Proper References	Improper References
"Becoming a charterholder has enhanced my portfolio management skills."	"CFA charterholders achieve better performance results."
"John Smith passed all three CFA exams in three consecutive sittings."	"John Smith is among the elite, having passed all three CFA exams in three consecutive attempts."
"The CFA designation is globally recognized and attests to a charterholder's success in a rigorous and comprehensive study program in the field of investment management and research analysis."	"As a CFA charterholder, I am the most qualified to manage client investments."
"The credibility that the CFA designation affords and the skills the CFA Program cultivates are key assets for my future career development."	"As a CFA charterholder, Jane White provides the best value in trade execution."
"I enrolled as a candidate for the CFA designation to obtain the highest set of credentials in the global investment management industry."	"Enrolling as a candidate for the CFA designation ensures one of becoming better at valuing debt securities."
"I passed the Level II CFA exam."	"CFA, Level II"
"I am a 20XX Level III candidate for the CFA designation."	"CFA, Expected 20XX"
"I passed all three levels of the CFA exam and will be eligible for the CFA charter upon completion of the required work experience."	"CFA, Expected 20XX" "John Smith, Charter Pending"

## Compliance Practices

Members and candidates should disseminate written information about Standard VII(B) and the accompanying guidance to their firm's legal, compliance, public relations, and marketing departments.

For materials that refer to employees' affiliation with CFA Institute, members and candidates should encourage their firms to create templates that are consistent with Standard VII(B). This practice promotes consistent and accurate references to CFA Institute membership, the CFA designation, and candidacy for the CFA designation.

## Application of the Standard

### Example 1 (Passing Exams in Consecutive Attempts)

Zonder drafts and publishes an advertisement for her firm, AZ Investment Advisers, which states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.

*Comment:* Zonder may state that all AZ principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try may be more successful than those who do not violates Standard VII(B).

### Example 2 (Right to Use CFA Designation)

Five years after receiving his CFA charter, Vasseur resigns his position as an investment analyst and spends the next two years traveling abroad. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. As a result, his CFA Institute membership has lapsed. At the conclusion of his travels, Vasseur becomes a self-employed analyst accepting assignments as an independent contractor. Without reinstating his CFA Institute membership, he prints business cards that display "CFA" after his name.

*Comment:* Vasseur violated Standard VII(B) by misrepresenting his status as a charterholder because he is no longer a CFA Institute member with the right to use the CFA designation. Therefore, he no longer is able to state or imply that he is a CFA charterholder. If he wants to reinstate his membership, he needs to complete the appropriate process and meet the requirements for reinstatement established by CFA Institute.

### Example 3 ("Retired" CFA Institute Membership Status)

After a 25-year career, Simpson retires from his firm. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. Simpson designs a plain business card (without a corporate logo) to hand out to friends with his new contact details, and he continues to put "CFA" after his name.

*Comment:* By misrepresenting his status as a charterholder, Simpson violated Standard VII(B). Because he failed to meet the requirements for membership established by CFA Institute, his membership lapsed and he has given up the right to use the CFA designation. CFA Institute has procedures, however, for reclassifying a member and charterholder as “retired” and reducing the annual dues. If he wants to obtain retired status, he needs to complete the appropriate process and meet the requirements for retired status established by CFA Institute.

#### Example 4 (Stating Facts about the CFA Designation)

Reese has been a CFA charterholder since 2000. In a conversation with a friend who is considering enrolling to be a candidate for the CFA designation, she states that she learned a great deal as a CFA candidate and that many firms require their employees to be CFA charterholders. She would recommend the CFA Program to anyone pursuing a career in investment management.

*Comment:* Reese’s comments comply with Standard VII(B). Her statements refer to facts: Earning her CFA designation enhanced her knowledge, and many firms require the CFA designation for their investment professionals.

#### Example 5 (Use of Fictitious Name)

Glass is the lead quantitative analyst at CityCenter Hedge Fund. Glass is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors’ assets. Glass wants to comment on an article posted on an investor blog. His comment will contain information related to his work that he believes will be helpful to investors. However, he does not want to reveal his identity, so he publishes the comment with the signature line, “Expert, CFA.”

*Comment:* Using a fictitious name or pseudonym to hide one’s true identity while still claiming to be a charterholder is a misrepresentation and an improper use of the designation. By using “Expert, CFA,” Glass violated Standard VII(B).

# DEFINITIONS OF TERMS FOUND IN THE CODE AND STANDARDS

**Appropriate:** Suitable and proper for the circumstances.

**Beneficial Owner:** A person or entity who ultimately owns, controls, has the power to direct, or has a material interest in a security or investment.

**Care:** Acting in a prudent and judicious manner to avoid harm.

**Client:** A person or entity for whom the member or candidate performs a professional service that is of the type usually provided in return for compensation.

**Competence:** Having sufficient knowledge, skills, and abilities to undertake an activity successfully.

**Complete:** Containing all facts and elements necessary to convey the information.

**Conflict of Interest:** Any matter that could reasonably be expected to impair independence and objectivity or raise a question about whether actions, judgment, or decision making is free from bias.

**Diligence:** Careful, consistent, and thorough work or effort.

**Full and Fair Disclosure:** The amount of disclosure necessary to provide accurate and complete information appropriate to the circumstances.

**Independence:** Free of bias; not influenced or controlled in matters of opinion or conduct.

**Intent:** The state of mind to act with a desire, plan, and determination to achieve a particular purpose.

**Investments:** Assets used to build wealth through earned income or appreciation.

**Knowingly:** Acting deliberately with awareness or consciousness.

**Loyalty:** Devotion, support for, or allegiance to a person or entity.

**Material:** Having weight or meaning that is reasonably likely to influence making a decision or taking action.

**Misrepresentation:** Any untrue statement or omission of fact or any statement that is false or misleading.

**More Strict:** Laws, rules, regulations, or practices that place greater restraint on conduct or provide greater protection of client interests.

**Nonpublic:** Information that has not been disseminated or is not available to investors in general.

**Objectively:** Not being influenced by personal feelings or interests or the interests of others when rendering opinions or considering or taking action.

**Plain Language:** Language that is clear, concise, uses common words, and is not dominated by technical or obscure wording or jargon.

**Professional Activities/Professional Conduct:** Any activity or conduct that relates to financial analysis, investment management, securities analysis, stewardship, or other similar professional endeavors and either 1) involves activity or conduct in the workplace, academia, or participation in the investment profession or securities markets OR 2) explicitly or implicitly encompasses use of the CFA charter, or CIPM designation, membership in CFA Institute or CFA Institute societies, or candidacy for a CFA Institute-sponsored designation.

**Professional Responsibilities:** The obligations and duties a member or candidate must fulfill as part of their work.

**Prominent Language:** Language that is placed so that it can be clearly seen or easily accessed by one receiving the information; not formatted to obscure its location or deemphasize its importance relative to other wording in the material (e.g., using a smaller font or relegating the information to a footnote or appendix).

**Prospective Client:** A person or entity that has expressed interest in retaining the services of a member or candidate or their firm or a person or entity to whom the member or candidate or their firm actively solicits or plans to solicit and who has the potential to become a client.

**Prudence:** Using caution and discretion to act with the skill and diligence that a reasonable person acting in a like capacity and familiar with such matters would use.

**Reasonable:** Using sound judgment, understanding, care, and caution appropriate under the circumstances when undertaking an action or making a decision; following a rational and well-considered process that is designed to remedy or address an issue or affect an outcome.

**Relevant:** Closely connected or related to, or having a bearing on, the activity undertaken or subject matter under discussion.

**Securities:** Financial assets that can be traded with the intent to profit from or to raise capital.

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