The following is a review of the Ethical and Professional Standards principles designed to address the learning outcome statements set forth by CFA Institute®. This topic is also covered in:

CFA Institute Code of Ethics and Standards of Professional Conduct

Study Session 1

CFA Institute Code of Ethics

Members of CFA Institute shall:

1. Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members.

2. Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession.

3. Strive to maintain and improve their competence and the competence of others in the profession.

4. Use reasonable care and exercise independent professional judgment.

Standards of Professional Conduct[1]

I. Fundamental Responsibilities

I(A) Know the laws and rules.

I(B) Don't break or help others break the law.

II. Relationships With and Responsibilities To the *Profession*

II(A) Use of professional designation: Use the CFA® mark in a dignified manner.

II(B) Professional misconduct: Don't do anything that reflects adversely on the profession.

II(C) Plagiarism: Don't use others' work without reference and permission.

III. Relationships With and Responsibilities To the *Employer*

III(A) Inform your employer of the Code and Standards.

III(B) Duty to employer: Obtain your employer's written permission to consult.

III(C) Disclose conflicts between you and your employer to your employer.

III(D) Disclose additional compensation from outside the firm to your employer.

III(E) Supervisors are responsible for supervising their subordinates.

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IV. Relationships With and Responsibilities To *Clients and Prospects*

IV(A) The investment process:

IV(A.1) Have a reasonable basis and representation:
- a. Exercise diligence and thoroughness.
- b. Have a reasonable basis for your recommendation.
- c. Avoid misrepresentations.
- d. Keep appropriate records.

IV(A.2) Research reports:
- a. Use reasonable judgment.
- b. Distinguish between fact and opinion.
- c. Indicate the basic characteristics of the investment.

IV(A.3) Maintain independence and objectivity.

IV(B) Interaction with clients and prospects:

IV(B.1) Fiduciary duties: Place your clients' interests before your own.

IV(B.2) Portfolio investment recommendations and actions:
- a. Know your client.
- b. Consider the appropriateness and suitability of the investment for your client.
- c. Distinguish between fact and opinion.
- d. Disclose the investment process to clients and prospects.

IV(B.3) Fair dealing: Disseminate investment *recommendations* fairly.

IV(B.4) Priority of transactions: Client trades have priority over you or your firm's trades.

IV(B.5) Preservation of confidentiality: Don't talk about your clients' business.

IV(B.6) Prohibition against misrepresentation: Don't guarantee an investment return.
- a. Don't say you can do what you can't.
- b. Don't lie about your qualifications.
- c. Don't lie about your academic or professional credentials.

IV(B.7) Disclosure of conflicts to clients: Disclose things that would bias your recommendations.

IV(B.8) Disclosure of referral fees.

V. Relationships With and Responsibilities To the *Investing Public*

V(A) Prohibition against use of material nonpublic information.

V(B) Performance presentation.

The following is a review of the Ethical and Professional Standards[1] principles designed to address the learning outcome statements set forth by CFA Institute®. This topic is also covered in:

STANDARDS OF PRACTICE HANDBOOK

Study Session 1

EXAM FOCUS

Your performance in the Ethics section can have a significant impact on whether you pass the Level 1 exam. In addition to reading this review of the ethics material, Schweser Study Program strongly suggests that all candidates for the 2005 CFA® examination *purchase* and *read* their own copy of the original *Standards of Practice Handbook.* As a registered candidate, it is your responsibility to own an original copy of the *Standards* and comply with the *Standards*. You will likely have to read this topic review and the Handbook multiple times to prepare for this area of the exam.

CFA INSTITUTE PROFESSIONAL CONDUCT PROGRAM

CFA Institute's mission is to serve its members and, through them, to serve investors as a global leader in educating and examining investment managers and analysts and in sustaining high standards of professional conduct.

CFA Institute's primary efforts in the area of ethics and professional conduct are to:

- Promote high standards of ethical and professional conduct globally.
- Educate members on day-to-day ethical issues.
- Increase ethical awareness within the investment profession.
- Illustrate how to apply the Code and Standards in daily investment practice.
- Provide global leadership in the development of a code of ethics and standards of professional conduct.
- Bring disciplinary action against members who violate the Code and Standards.

THE CODE OF ETHICS

LOS 1: State the four components of the Code of Ethics.

Members of CFA Institute shall:

1. *Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members.*

2. *Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession.*

3. *Strive to maintain and improve their competence and the competence of others in the profession.*

4. *Use reasonable care and exercise independent professional judgment*

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Standards of Professional Conduct

LOS 2: Each category contains multiple concepts for which the candidate is responsible. The candidate should be able to identify the ethical responsibilities required by the Code and Standards in these areas:

I. Fundamental Responsibilities.
II. Relationships with and Responsibilities to the Profession.
III. Relationships with and Responsibilities to the Employer.
IV. Relationships with and Responsibilities to Clients and Prospects.
V. Relationships with and Responsibilities to the Investing Public.

LOS 3: Candidates should focus on 1) "the purpose and scope of the standard" for each standard, 2) the "application of the standard" for each standard, and 3) "procedures for compliance" with each standard.

LOS 3.a: Demonstrate a thorough knowledge of the Standards of Professional Conduct by recognizing and applying the Standards to specific situations.

LOS 3.b: Distinguish between conduct that conforms to the Code and the Standards and conduct that violates the Code and the Standards.

Standard I: Fundamental Responsibilities

Members shall:

I(A) *Maintain knowledge of and comply with all applicable laws, rules, and regulations (including CFA Institute's Code of Ethics and Standards of Professional Conduct) of any government, government agency, regulatory organization, licensing agency, or professional association governing the members' professional activities.*

I(B) *Not knowingly participate or assist in any violation of such laws, rules, or regulations.*

CFA Institute believes that a minimum level of professional responsibility and conduct dictates that members be aware of and comply with laws, rules, and regulations governing their conduct. This includes the Code and Standards as well as the laws and regulations of foreign jurisdictions.

International Application of the Code and Standards

Members who practice in multiple jurisdictions may be subject to varied securities laws and regulations.

Rule of Thumb for members, CFA Charterholders, and candidates in the CFA program: If the applicable laws are *more strict* than the requirements of the Code and Standards, they must adhere to the applicable laws. If there are *no laws* or the applicable laws are *less strict* than the Code and Standards, they must adhere to the Code and Standards.

Application to the Standard (refer to page 13 of CFA Institute's 1999 *Standards of Practice Handbook*)

- **Situation:** An analyst *feels* that a standard or law has been violated.

  The analyst must seek the advice of the firm's counsel. If the analyst feels that the attorney is competent and unbiased and follows the counsel's advice, Standard I has not been violated. Example: receiving information contradictory to a registration statement.

- **Situation:** An analyst *knows* that a standard or law has been violated.

  (1) Discovering a client has knowingly misstated information on a prospectus. (2) An analyst acting on an outside board of directors learns that a standard or law has been violated.

  The analyst should report the finding to the appropriate supervisory person in the analyst's firm. If the situation is not remedied, then the analyst should disassociate from the situation. The analyst should also seek legal advice to see what other actions, such as notifying the proper regulatory agency, should be taken.

- **Situation:** An analyst lives or works in a foreign country, or works with foreign firms outside of the analyst's own country.

  The analyst is covered by the stricter of the following laws and rules: their own country, the foreign country, or CFA Institute's Code and Standards.

  (1) An analyst mistakenly believes that only her own nation's less strict laws apply to her behavior when dealing with clients living in more strict countries. (2) An analyst living in a country without laws specifically regulating certain types of professional behavior is subject to the Code and Standards of CFA Institute. Remember, a member cannot engage in conduct that constitutes a violation of the Code and Standards even though the conduct is legally acceptable in the member's home or work country.

Procedures for Compliance

I(A) Members can acquire and maintain knowledge about applicable laws, rules, and regulations in the following ways:

- Maintain current files on applicable statutes, rules, and regulations.
- Keep informed.
- Review written compliance procedures on a regular basis.

I(B) When members suspect a client or a colleague of planning or engaging in ongoing illegal activities, members should take the following actions:

- Consult counsel to determine if the conduct is, in fact, illegal.
- Disassociate from any illegal or unethical activity. When members have reasonable grounds to believe that a client's or employee's activities are illegal or unethical, the members should dissociate from these activities and urge their firm to attempt to persuade the perpetrator to cease such activity.

Professor's Note: Members may disassociate themselves from illegal or unethical activities by reporting the activities to the appropriate authorities. Inaction combined with continued association with those involved in illegal conduct may be construed as participation in the illegal conduct.

Professor's Note: The Code and Standards do not require that members report legal violations to the appropriate governmental or regulatory organizations, but such disclosure may be prudent in certain circumstances.

Standard II: Relationships With and Responsibilities to the Profession

Standard II(A): Use of Professional Designation

II(A.1) *CFA Institute members may reference their membership only in a dignified and judicious manner. The use of the reference may be accompanied by an accurate explanation of the requirements that have been met to obtain membership in these organizations.*

II(A.2) *Those who have earned the right to use the Chartered Financial Analyst designation may use the marks "Chartered Financial Analyst" or "CFA®" and are encouraged to do so, but only in a proper, dignified, and judicious manner. The use of the designation may be accompanied by an accurate explanation of the requirements that have been met to obtain the right to use the designation.*

II(A.3) *Candidates in the CFA Program, as defined in the CFA Institute Bylaws, may reference their participation in the CFA Program, but the reference must clearly state that an individual is a candidate in the CFA Program and cannot imply that the candidate has achieved any type of partial designation.*

II(A) limits the use of the CFA designation to those who have passed all three levels of the CFA Program, have received their charters, and are dues-paying charterholders in good standing. There is no designation for someone who has passed one or more levels of the exam. Candidates may state that they have completed one or more of the levels, but to say they are candidates, they must be registered to take the next scheduled CFA exam.

Application of the Standard (page 19)

- **Situation:** Advertisements *relating to CFA Charterholders*.

  Advertisements announcing that employees have been awarded the CFA designation should be limited to a statement of facts regarding the designation. Advertisements cannot mention that an individual has passed all three exams on the first try, that the individual has accomplished what few others have done, or that the designation implies superior performance capabilities.

- **Situation:** Advertisements *relating to CFA Candidates.*

  To indicate that an individual is a candidate for the CFA designation, the individual must be enrolled to take the next scheduled exam. Candidates who have successfully passed one or more levels of the exam may state so, but the candidate cannot imply they hold any partial designation, such as CFA II.

Procedures for Compliance

- Only the mark CFA or the words Chartered Financial Analyst should appear after the charterholder's name.

Professor's Note: This means that you can't say things like "CFA 2005," or "CFA with scores over 70% in all areas" because these are not dignified and judicious uses of the CFA designation.

- The designation cannot be listed in a type set larger than that used for the charterholder's name.
- Any description or explanation of the designation should be limited to a concise description of the requirements and/or organization conferring the designation. The CFA designation or CFA Institute membership should not be used in any way to mislead employers, clients, prospects, or the public.
- Candidates may state that they are Level I (II or III) candidates if they are registered for the next exam. If you are not registered, you may say, "I passed Level I (II or III) of the CFA Program in (year)." A candidate without work experience who has passed Level III may say, "I have passed all three levels of the exam and will be eligible for the CFA Charter upon completion of the required work experience."
- The designation "CFA" should be used only as an adjective and never as a noun. You may not say you are a CFA, rather you must say you are a CFA charterholder. The CFA designation should not be used as part of a firm's name.
- CFA Institute imposes the following requirements to use the CFA designation. You must complete the CFA Program, abide by CFA Institute's Professional Conduct Program, and maintain active membership in CFA Institute. If you stop paying your dues to CFA Institute, you must stop using the CFA designation. You can, however, indicate that you were awarded the CFA charter on a specific date since this is a statement of fact and not an indication of current membership.

Standard II(B): Professional Misconduct

II(B.1) *Members shall not engage in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation or commit any act that reflects adversely on their honesty, trustworthiness, or professional competence.*

II(B.2) *Members and candidates shall not engage in any conduct or commit any act that compromises the integrity of the CFA designation or the integrity or validity of the examinations leading to the award of the right to use the CFA designation.*

Standard I addresses the overall obligation to comply with the laws and rules governing your professional activities. Standard II(B) extends beyond technical compliance. Standard II(B) addresses your personal integrity and prohibits individual behavior that reflects adversely on the entire profession.

Standard II(B) includes felony convictions punishable by more than one year in prison and misdemeanors involving moral turpitude (lying, cheating, stealing, or other dishonest conduct) whether or not the offense relates to your professional activities. Repeated convictions for misdemeanors reflect poorly on your professional conduct. Standard II(B) also includes dishonest activities that reflect negatively on professional competence even if they do not result in criminal convictions.

Application of the Standard (page 25)

- **Situation:** Poor personal behavior.

  The standard applies to any personal behavior that reflects poorly on your competence and the profession. This includes excessive lunchtime drinking and being intoxicated at work.

- **Situation:** Misdemeanor convictions.

  Multiple minor convictions suggest a gross disregard for the law. They reflect poorly on your competence, judgment and performance. This application includes minor drug-related offenses.

- **Situation:** Unprosecuted behavior.

  Any activity that involves dishonesty, fraud, or misrepresentation is a violation of Standard II(B), even in the absence of a criminal conviction. This type of behavior includes: altering receipts, fudging expense accounts, taking kickbacks, and arranging for unrecognized fee-splitting.

- **Situation:** Cheating on the CFA exam or helping someone else cheat on the exam.

  By giving or accepting information the integrity and validity of the exam is compromised.

Procedures for Compliance

Members should encourage their employers to:

- Make clear that dishonest personal behavior reflects poorly on the profession.
- Adopt a code of ethics to which every employee must subscribe.
- Conduct background checks on potential employees to ensure that they are of good character and eligible to work in the investment industry.

Standard II(C): Prohibition Against Plagiarism

II(C) *Members shall not copy or use, in substantially the same form as the original, material prepared by another without acknowledging and identifying the name of the author, publisher, or source of such material. Members may use, without acknowledgment, factual information published by recognized financial and statistical reporting services or similar sources.*

The most flagrant example of plagiarism is taking a research report or study done by another firm or person, changing the names, and releasing the material as one's own original analysis.

Other violations of Standard II(C) are:

- Using excerpts from reports prepared by others without acknowledgment.
- Citing quotes attributable to "investment experts" without specific reference.
- Presenting statistical forecasts prepared by others with the source identified but without qualifying statements or caveats that may have been used.
- Using charts and graphs without stating their source.
- Copying proprietary computerized spreadsheets or algorithms without seeking authorization from their creators.

Application of the Standard (page 31)

- **Situation:** The analyst adds to or improves on an existing report from outside the firm.

  The analyst must reference the original report, even if the revised report is only being used internally. This standard also applies to the situation (frequently used on past exams) where the analyst is told to "use the XYZ report, change a few words, sign your name, and get it out." Being ordered to act by your boss does not exempt you from ethical behavior. Note several rules are broken: breaking copyright laws is a violation of Standard IB and using material nonpublic information is a violation of Standard V(A).

- **Situation:** The analyst tweaks and adds new bells and whistles to another analyst's mathematical, computerized, or quantitative model.

  Adjusting someone else's model does not make it a new model. The revising analyst can take credit for the improvements, but must cite the original source of the model.

- **Situation:** How do you present the firm's own research?

  When reporting the findings and methodology of one's own research staff, the firm's owner, representative or spokesperson need not attribute the source to the firm's research staff. But, in a professional witness situation, the source of the findings, data, and methodology must be properly credited to the firm's research staff.

Procedures for Compliance

In preparing research reports, members should:

- Maintain copies of materials that were relied on in preparing the research report.
- Attribute quotations (and projections, tables, statistics, models, and methodologies) used other than recognized financial and statistical reporting services.
- Attribute paraphrases and summaries of material prepared by others.

Standard III: Relationships With and Responsibilities to the Employer

Definition: An employee is someone in the service of another. The employer has the power to control and direct the employee in the details of how work is to be performed. A written contract may or may not exist between the employer and the employee. Also, the actual receipt of monetary compensation is not required for an employer-employee relationship to exist.

Standard III(A): Obligation to Inform Employer of Code and Standards

Members shall:

III(A.1) *Inform their employer in writing, through their direct supervisor, that they are obligated to comply with the Code and Standards and are subject to disciplinary sanctions for violations thereof.*

III(A.2) *Deliver a copy of the Code and Standards to their employer if the employer does not have a copy.*

CFA Institute considers the responsibility required by III(A) to be an integral part of professional practice. III(A) requires that members take steps to notify their employer *in writing* of the Code and Standards that control members' professional practices. "In writing" includes any form of communication that can be documented, even e-mail. "Employer" means immediate (direct) supervisor. Members should not assume that someone else will take care of it. New employees need to be alerted to the expectation that their conduct will meet high ethical standards.

Application of the Standard (page 38)

- **Situation:** An analyst's boss tells her to do something that will violate the Code and Standards.

  Subordinates should not assume that their supervisors, even though they may be CFA Institute members, are aware of their obligation to obey the Code and Standards. Most exam questions dealing with III(A) involve a subordinate member being unknowingly asked to violate the Code or Standards by a superior. This superior may even be a member. If you are asked to explain what standards are being violated on the exam, the answer will be the standard under discussion plus III(A), if the subordinate member does not inform his or her superior that the Code and Standard applies to the situation.

Procedures for Compliance

Members should notify their supervisors in writing of the Code and Standards and the member's responsibility to follow them. The member should also suggest that their employers adopt the Code and Standards and disseminate it throughout the firm. If the employer has publicly acknowledged, in writing, that they have adopted CFA Institute's Code and Standards as part of the firm's policies then the member need not give the formal written notification as required by III(A).

Standard III(B): Duty to Employer

III(B) *Members shall not undertake any independent practice that could result in compensation or other benefit in competition with their employer unless they obtain written consent from both their employer and the persons or entities for whom they undertake independent practice.*

An employee of a firm must protect the firm's interests by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the advantage of the employee's skill and ability. III(B) does not stop you from entering into an independent business or consulting agreement. However, it does require you to secure written permission from both your employer and the outside firm to whom you will sell your services. The services covered by III(B) are any services that your employer currently makes available for a fee. Note that although Standard III(B) applies to activities that could result in compensation, actual compensation is not required for III(B) to apply.

Standard III(B) covers competing with your employer, not preparing to compete. If you plan to leave your current employment, however, you have a duty to act in the employer's best interest and not to engage in any activities that would conflict with your duties until your resignation becomes effective.

Activities that might constitute a violation of III(B) are:

- Misappropriation of trade secrets.
- Misuse of confidential information.
- Conspiracy to bring about a mass resignation of other employees.
- Solicitation of the employer's clients prior to your termination of employment.
- Self-dealing, that is taking the employer's property or information.
- Misappropriation of clients or client lists.

Application of the Standard (page 44)

- **Situation:** You consult on your own time.

  This does not relieve you from the requirement to get your employer's and your client's written consent.

- **Situation:** You are an independent investment advisor and get hired by a brokerage firm. You want to keep your existing clients for yourself.

  To do this, you must obtain your employer's written consent and disclose the new job in writing to your clients.

- **Situation:** You get caught setting up an independent deal but claim you have not violated III(B) because you have not been compensated.

  You have violated III(B)! Why? Because you would have been compensated had you not been caught.

- **Situation:** You start your own firm (or get a new job). Before leaving your current job, you: (1) solicit your employer's clients; (2) take home client lists, investment statements, marketing presentations, and buy lists; (3) copy your employer's computer models and other property.

  If you do any of these, you are in violation of III(B).

- **Situation:** You are an independent contractor.

  Your responsibilities are determined by the terms of the written or oral agreement between yourself and your client.

Procedures for Compliance

Members who plan to engage in independent practice for compensation should provide written statements to their employer describing the types of services they will perform, the expected duration of the services, and the compensation they will receive. Members should not proceed until they receive written consent from their employer.

Members should also disclose to their prospective clients the identity of their employer, the fact that they are performing independently of the employer, and what their employer would charge for similar services. Members should not render any services until the client provides a written statement that they have read and understood the member's disclosure statement.

Members seeking new employment should not contact existing clients or potential clients prior to leaving their employer. In addition, members should not take records or files to their new employer without the written permission of the previous employer.

Standard III(C): Disclosure of Conflicts to Employer

III(C.1) *Members shall disclose to their employer all matters, including beneficial ownership of securities or other investments, that reasonably could be expected to interfere with their duty to their employer or ability to make unbiased and objective recommendations.*

III(C.2) *Members shall comply with any prohibitions on activities imposed by their employer if a conflict of interest exists.*

Standard III(C) deals with conflicts of interest between members and their employers. Standard IV(B7) deals with conflicts of interest between members and their clients.

Many investment firms restrict their employees' investment actions to avoid conflicts between the employees' interest and the client's interest. Standard III(C) requires that members obey the firm's internal directives and that members use their own judgment concerning conflicts that are not covered by their employer's guidelines. Members should always render unbiased investment advice and always act in the employer's best interest. Remember, the mere appearance of a conflict of interest may damage your or the firm's reputation.

Application of the Standard (page 52)

- **Situation:** An analyst makes personal trades in violation of existing company policy.
- **Situation:** An analyst doesn't tell her employer about actions that may conflict with her employer's interest. For example, acting as a trustee of a foundation or charity.
- **Situation:** An analyst is directing trades to her husband's small, noncompetitive brokerage firm.

  This action is in conflict with the employer's interest and/or client's interest.

Procedures for Compliance

Members should report to their employers any beneficial interest and any special relationships, such as corporate directorships, that may reasonably be considered a conflict of interest with their responsibilities. Members should also discuss the situation with their firm's compliance officer before taking any action that could lead to a conflict of interest.

Standard III(D): Disclosure of Additional Compensation Arrangements

III(D) *Members shall disclose to their employer in writing all monetary compensation or other benefits that they receive for their services that are in addition to compensation or benefits conferred by a member's employer.*

Compensation and benefits include direct compensation by the client and any indirect compensation or other benefits received from third parties.

Members must disclose in writing outside compensation/benefits to employers because such arrangements may affect loyalties and objectivity and create potential conflicts of interest.

Application of the Standard (page 55)

- **Situation:** In an attempt to increase portfolio performance a firm's client offers the portfolio manager an incentive, such as a free vacation.

  Incentives such as this establish potential conflicts of interest between this client's portfolio and the manager's other portfolios, so the employer must be informed. Note: Standard IV(A.3) allows accepting this gift, so the purpose of this example is to show you that you must inform your employer in writing before you accept. You should recognize, however, the employer will probably reject the manager's request to prevent the appearance of a conflict between the client's portfolio and the manager's other portfolios.

- **Situation:** An investment manager gets free membership to a club, on whose board of directors she sits, for her financial advice.

  While no monetary compensation is received, she is in violation of III(D) if she does not disclose the relationship to her employer.

Procedures for Compliance

Members should make an immediate written report to their employer specifying any compensation or benefits they receive or propose to receive for services in addition to what their employer is to give them. This written report should state the terms of any oral or written agreement, the amount of compensation, and the duration of the agreement.

Standard III(E): Responsibilities of Supervisors

III(E) *Members with supervisory responsibilities, authority, or the ability to influence the conduct of others shall exercise reasonable supervision over those subject to their supervision or authority to prevent any violation of applicable statutes, regulation, or provisions of the Code and Standards. In so doing, members are entitled to rely on reasonable procedures designed to detect and prevent such violations.*

Members with supervisory responsibility exercise reasonable supervision by establishing and implementing written compliance procedures and ensuring that these procedures are followed through periodic review. Supervisors must make a reasonable effort to detect violations. If a member adopts reasonable procedures and takes steps to institute an effective compliance program, then the member may not be in violation of III(E) if the member was unable to detect violations. Supervisory members are expected to understand what an adequate compliance system for their firm is and see that the system is established and followed.

It is important to know for the exam that even though members may delegate supervisory duties, such delegation does not relieve members of the supervisory responsibilities.

A supervisory member should bring an inadequate compliance system to the attention of the firm's senior managers and recommend corrective action. If the member cannot discharge supervisory responsibilities because of a poor or nonexistent compliance system, the member should decline in writing to accept supervisory responsibility until the firm adopts an adequate system.

Application of the Standard (page 59)

- **Situation:** Lack of control. A supervisor does not exercise adequate supervision.

  How? The supervisor fails to establish or disseminate reasonable procedures. The supervisor, because of time pressures, does not check to see if an analyst's investment recommendations are supported by a "reasonable and adequate basis Standard IV(A.1)."

- **Situation:** Conflicts between the supervisor's (or firm's) self-interest and supervisory responsibility.

  How? (1) Proper supervision is not exercised because the supervisor's income is partially based on unsupervised or improper trading activity. (2) Poor procedures allow a portfolio manager to designate a trade to an account or portfolio after the outcome of the trade is known. (3) Procedures are not followed, allowing fraudulent bids designed to circumvent the securities laws.

Standard III(E) problems usually occur in conjunction with other violations. Why? Because of poor supervision, some other violation occurs.

Procedures for Compliance

Adequate compliance procedures should:

- Be easy to understand.
- Designate a compliance officer and define the officer's authority and responsibility.
- Outline the scope of the procedures.
- Outline permissible conduct.
- Outline procedures for reporting violations and sanctions.

The supervisor and the compliance officer should:

- Disseminate the compliance procedures to the covered staff.
- Periodically update the procedures so that they comply with the law.
- Continually educate the staff and issue periodic reminders.
- Incorporate a professional conduct evaluation into the employee's performance review.
- Review employee actions to ensure compliance and identify violators.
- Promptly initiate procedures once a violation has occurred.

Once a violation is discovered, a supervisor should:

- Respond promptly to the violation.
- Conduct a thorough investigation.
- Place appropriate limitations on the wrongdoer until the investigation is complete.

Standard IV: Relationships With and Responsibilities to Clients and Prospects

Standard IV(A): Investment Process

Standard IV(A.1): Reasonable Basis and Representations

IV(A.1) *Members shall:*

> a. *Exercise diligence and thoroughness in making investment recommendations or in taking investment actions.*
> b. *Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions.*
> c. *Make reasonable and diligent efforts to avoid any material misrepresentation in any research report or investment recommendation.*
> d. *Maintain appropriate records to support the reasonableness of such recommendations or actions.*

Members must establish a reasonable basis for every investment recommendation; exercise diligence in avoiding any material misrepresentation; and maintain such records and documentation as are appropriate to support their recommendations.

Members are in compliance if they recommend an investment transaction on the basis of their firm's research; the research of another party or firm that has exercised diligence and thoroughness; or a quantitatively oriented process designed to rank securities. Members must also make a reasonable and diligent effort to ensure that any research report finding is accurate.

With respect to an individual investment transaction, a member has the obligation to consider the transaction within the context of a client's entire portfolio. This includes the client's needs and preferences.

Application of the Standard (page 67)

- **Situation:** Inappropriate investments.

  A manager fails to follow the obligation to consider each specific investment within the context of the entire portfolio.

- **Situation:** Turning optimism into certainty.

  (1) An analyst attends an optimistic company meeting and then writes a research report *misrepresenting* the optimism by turning it to certainty. (2) An analyst does a statistical study over a short time period. The analyst then attributes greater significance to the findings than the data warrants.

- **Situation:** Poor research.

  (1) Due to time pressures, the analyst guesstimates or averages the data to get a report out in time. (2) The analyst overhears a conversation and bases a recommendation on this information. (3) The analyst extrapolates backwards to get an earnings estimate from the stock's price, then turns around and uses the earnings estimate to justify the stock's price.

Procedures for Compliance

Members can comply with Standard IV(A.1) by addressing the following areas:

- Analyze the investment's basic characteristics. Records must show the characteristics of the investment and the basis for the recommendation.
- Analyze the needs of the portfolio. This includes the client's needs, as well as the needs of the total portfolio.
- Maintain files to support investment recommendations.

Standard IV(A.2): Research Reports

IV(A.2)*Members shall:*

> a. *Use reasonable judgment regarding the inclusion or exclusion of relevant factors in research reports.*
> b. *Distinguish between facts and opinions in research reports.*
> c. *Indicate the basic characteristics of the investment involved when preparing for public distribution a research report that is not directly related to a specific portfolio or client.*

A report need not be in written form. It could be given: in person, over the phone, or even by computer. If the recommendation is in capsule form, the clients should be notified that additional information and analysis is available. Any limitations of the analysis should be outlined and all investment risks mentioned.

Standard IV(A.2.b) requires that opinions be separated from fact. The most common violation is the failure to separate the past from the future. When using the past to forecast the future, you must state that your opinions are subject to future events.

Application of the Standard (page 75)

- **Situation:** Investment characteristics are not included in the report.

  (1) The analyst leaves out the complications of the evaluation process to simplify his report. This is a violation because the client needs to fully understand the process and logic behind the recommendation to implement the recommendation effectively. (2) An analyst issues a report stressing only the upside potential of an investment strategy. This is a violation because the analyst's report must adequately describe the basic characteristics of the investment strategy and include a balanced discussion of the risks involved. (3) An analyst issues a report promoting her firm's investment strategy without describing the strategy. A report must describe the basic characteristics of the investment strategy.

- **Situation:** (1) The analyst uses sloppy language in a report. The analyst estimates a sales figure and then in her report uses language such as, "based on the *fact* that sales are such and such." This is a violation because the analyst must always separate fact from opinion. (2) The analyst asks someone to review and revise her report. The revision contains inaccuracies. The analyst should have checked the accuracy of the changes.

Procedures for Compliance

Members should consider including the following information in research reports:

- Expected annual rates of return, calculated on a total return basis.
- Annual income expectations.
- Current rate of return or yield.
- The degree of uncertainty associated with the cash flows and other risk factors.
- The investment's marketability or liquidity

Standard IV(A.3): Independence and Objectivity

IV(A.3) *Members shall use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment actions.*

Every member should endeavor to avoid situations that might cause, or be perceived to cause, a loss of independence or objectivity in recommending investments or taking investment action.

External sources may try to influence the investment process by offering investment managers a variety of "perks." The handbook specifically mentions perks offered in the form of shares in oversubscribed IPOs to investment managers for their personal accounts.

Gifts from clients can be distinguished from gifts given by entities seeking to influence a member to the possible detriment of clients.

Professor's Note: Gifts from clients in excess of US$100 may be accepted but must be disclosed to the member's employer. See Standard (IIID), Disclosure of Additional Compensation Arrangements.

Application of the Standard (page 80)

- **Situation:** Expenses. A client company pays all the travel expenses for an out-of-the-way site visit.

  Since the trip was all business and out of the way, payment is acceptable. If the location had been accessible by normal means, or if the analyst's objectivity or integrity could have been perceived as being influenced, the analyst should have paid for her own travel accommodations.

- **Situation:** Client/analyst conflicts.

  (1) An analyst should not provide favorable recommendations to secure a client's business. (2) An analyst should not be subject to pressures from above to write favorable reports to satisfy an existing client. (3) An analyst should not be asked to recommend securities to help dispose of the firm's inventory.

- **Situation:** Integrity of opinions.

  An analyst is given a security to review, but told not to change the current "buy" recommendation. The analyst's recommendation should be his or her own independent and objective view. If the analyst does not concur with the buy recommendation, she should not cover the security.

- **Situation:** Perks.

  (1) An analyst receives a vacation gift from a firm to which he directed trades. (The analyst did not notify his supervisor.) This is a triple violation: the value of the gift exceeds U.S. $100, the gift came from a non-client, and the giver is trying to influence the analyst's behavior. (2) An analyst receives a vacation gift from a client for good performance. The analyst discloses the gift to her supervisor and receives permission to accept the vacation. Under III(D) this is not a violation.

  Professor's Note: Clients are considered to be different from entities trying to gain influence over the analyst.

Procedures for Compliance

- Protect integrity of opinions. Reports should reflect the analyst's unbiased opinion.
- Disclose all corporate relationships (i.e., directorships, underwriting arrangements, or acting as a market maker).
- Disclose personal holdings and beneficial ownerships.
- Create a restricted list. Firms that pose a conflict should be put on a restricted list.
- Restrict special cost arrangements. Members should pay for their commercial transportation and hotel charges.
- Limit gifts. U.S. $100 is the maximum acceptable value for a gift or gratuity.
- Restrict investments. Strict limits should be imposed on private placements.
- Review procedures. Supervise the personal investment activities of the employees

Standard IV(B): Interactions with Clients and Prospects

IV(B.1): Fiduciary Duties

IV(B.1) *In relationships with clients, members shall use particular care in determining applicable fiduciary duty and shall comply with such duty as to those persons and interests to whom the duty is owed. Members must act for the benefit of their clients and place their clients' interests before their own.*

A fiduciary is someone who acts for the benefit of someone else. The duty required in a fiduciary relationship exceeds that of other business relationships because the fiduciary is in a position of trust. Fiduciaries owe undivided loyalty to their clients and must place clients' interests before their own. Extra care must be taken if the fiduciary has direct control or access to the client's assets. Any pooling of funds must be done in strict accordance to the trust documents.

Fiduciaries work for a wide variety of clients and are subject to multiple laws.

When working with individuals, care must be taken to insure that the goals of the investment firm and manager do not conflict with those of the client.

Trusts are subject to the Prudent Man Rule. The Prudent Man Rule states that "a fiduciary shall exercise the judgment and care, under the circumstances then prevailing, which men of prudence, character and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital."

Charitable organizations and public pension plans are subject to the Uniform Management of Institutional Funds Act. Fiduciaries are held to a standard of ordinary business care and prudence prevailing at the time of their actions.

Corporate pension plans are governed by Employee Retirement Income Security Act (ERISA). ERISA requires the fiduciary to:

- Act solely in the interest of the plan participants and beneficiaries.
- Act with the care, skill, prudence, and diligence of a prudent person.
- Diversify the plan's investments to protect it from the risk of substantial loss.
- Act within the provisions of the plan documents.
- Refrain from engaging in prohibited transactions.

Under the rules of corporate governance, fiduciaries are obligated to vote proxies in an informed and responsible manner for the benefit of the beneficiaries.

Soft dollars: Whenever managers direct client trades to obtain goods or services that benefit the managers' firm or other clients, managers must disclose to their clients the policies followed in addressing the potential conflict. Managers must follow the laws of the country involved when directing trading activity. Brokerage is an asset of the client, so directed brokerage (where trades are directed to provide goods and services for the client) is not a violation of the standards.

Application of the Standard (page 92)

- **Situation:** Loyalty.

  A manager acts in a way that benefits the pension plan's sponsor rather than the beneficiaries of the plan. For example: (1) Buying the sponsoring company's stock with the pension's funds to support the stock's price. (2) Voting proxies in the support of management rather than the support of the beneficiaries. (3) Not accepting a reasonable tender offer during a hostile take over bid to support management.

- **Situation:** Directing Brokerage Services.

  (1) A manager receives benefits from the brokerage firm doing the pension's trading. Obtaining non-research services that do not directly benefit the client is a breach of the Standards. (2) A manager receives research that does not directly benefit the account being traded. This action is permitted by law, as long as the best prices and executions are received and the practice is disclosed to the client. (3) A manager receives favorable treatment on her personal transactions for directing trades to a specific brokerage house.

  Professor's Note: It is the manager's obligation to obtain the best price and executions for his clients.

Procedures for Compliance

- Follow all applicable rules and laws.
- Establish the investment objectives of the client.
- Diversify.
- Deal fairly with all clients with respect to investment actions.
- Disclose all possible conflicts of interest.

- Disclose compensation arrangements.
- Preserve the confidentiality of client information.
- Maintain loyalty to the plan beneficiaries.

Standard IV(B.2): Portfolio Investment Recommendations and Actions

IV(B.2) *Members shall:*

a. Make a reasonable inquiry into a client's financial situation, investment experience, and investment objectives prior to making any investment recommendations and shall update this information as necessary, but no less frequently than annually, to allow the members to adjust their investment recommendations to reflect changed circumstances.
b. Consider the appropriateness and suitability of investment recommendations or actions for each portfolio or client. In determining appropriateness and suitability, members shall consider applicable relevant factors, including the needs and circumstances of the portfolio or client, the basic characteristics of the investment involved, and the basic characteristics of the total portfolio. Members shall not make a recommendation unless they reasonably determine that the recommendation is suitable to the client's financial situation, investment experience, and investment objectives.
c. Distinguish between facts and opinions in the presentation of investment recommendations.
d. Disclose to clients and prospects the basic format and general principles of the investment processes by which securities are selected and portfolios are constructed and shall promptly disclose to clients and prospects any changes that might significantly affect those processes.

Members must carefully consider the appropriateness and suitability of an investment action to the needs and circumstances of their client. The client must be made fully aware of policies, strategies, and selection procedures being applied to their funds.

Perhaps the most important factor to be considered in matching appropriateness and suitability of an investment with a client's needs and circumstances is measuring the client's risk tolerance.

Application of the Standard (page 102)

- **Situation:** Investment-related topics.

  (1) The analyst should acquaint the client with the downside risks, as well as the upside potential. (2) When determining the suitability of an investment, the primary focus should be on the characteristics of the entire portfolio, not on the specific issue under study.

- **Situation:** Disclosure.

  Before a portfolio changes its scope, focus, or valuation methodology, existing clients must be made aware of the change.

Procedures for Compliance

In formulating an investment policy for the client, take the following into consideration:

- Know the basic nature of your client.

- Determine your client's objectives.
  a. Return objectives.
  b. Risk tolerances.

- Determine your client's constraints.
    a. Liquidity needs.
    b. Time horizon.
    c. Tax considerations.
    d. Regulatory and legal circumstances.
    e. The client's preferences, circumstances, and unique needs.

Standard IV(B.3): Fair Dealing

IV(B.3) *Members shall deal fairly and objectively with all clients and prospects when disseminating investment recommendations, disseminating material changes in prior investment recommendations, and taking investment action.*

The term "fairly" implies that members should take care not to discriminate against a client when disseminating investment recommendations. The standard does not require "equally" because of the impossibility of contacting all clients simultaneously.

There are two primary groups of analysts:

1. The first group consists of members whose primary function is the preparation of investment recommendations to be disseminated to the public or firm to aid in the investment decision–making process.

   IV(B3) addresses the manner in which investment recommendations or material changes in prior recommendations are disseminated to clients. You should note that a material change is anything that would cause an investor to change his mind. The most common material change is changing an investment recommendation from buy to sell.

   Material changes should be communicated to:

   - Clients known to have purchased the security or who are known to hold it.
   - Persons placing orders contrary to the current recommendation.

2. The second group consists of members whose function is taking investment action based on research recommendations prepared by others.

   Under IV(B.3) it is the obligation of members to ensure that all clients and prospective clients are treated fairly. New issues and secondary offerings should be allocated to all on a pro rata basis.

Application of the Standard (page 110)

- **Situation:** Dissemination of recommendations.

  (1) An analyst announces to a client or group of clients that he will be issuing a buy or sell recommendation in the next few days. IV(B.3) requires that the analyst send the information out to everyone first, then discuss it with clients. (2) A broker receives a large buy order for XYZ stock. She has recently changed her buy recommendation on XYZ to a sell. She should inform the client of the recommendation change before she accepts the order.

- **Situation:** Order placement.

  (1) A manager trades for her primary or discretionary accounts before issuing trades for her regular accounts. The manager must execute orders on a systematic basis that is fair to all her clients. (2) An underwriter allocates a client a portion of a new issue in anticipation of receiving future business from the client. IV(B.3) prohibits members from benefiting from the positions their clients occupy in the market. (3) A manager

purchases shares for his firm's inventory account before the firm's buy recommendation is released. IV(B.3) prohibits trading ahead of research reports.

- **Situation:** An analyst goes along with a firm's lowball earnings forecast when she really believes the true number to be higher. She, however, passes on her real estimate (the whisper number) to her larger customers.

  This is a violation to Standard IV(B.3), Fair Dealing.

Procedures for Compliance

Consider the following when establishing fair dealing compliance procedures:

- Limit the number of people privy to recommendations and changes.
- Shorten the time frame between initiation and dissemination.
- Publish personnel guidelines for pre-dissemination.
- Simultaneous dissemination.
- Establish rules about employee trading activities.
- Establish procedures for determining material changes.
- Maintain a list of clients and their holdings.
- Develop trade allocation procedures.
- Make sure one account is not being used to bail out other accounts.
- If the firm offers differing levels of service, to discretionary and regular accounts, for example, this fact should be disclosed to all clients.

Standard IV(B.4): Priority of Transactions

IV(B.4) *Transactions for clients and employers shall have priority over transactions in securities or other investments of which a member is the beneficial owner so that such personal transactions do not operate adversely to their clients' or employer's interests. If members make a recommendation regarding the purchase or sale of a security or other investment, they shall give their clients and employer adequate opportunity to act on the recommendation before acting on their own behalf. For purposes of the Code and Standards, a member is a "beneficial owner" if the member has:*

a. a direct or indirect pecuniary interest in the securities.
b. the power to vote or direct the voting of the shares of the securities or investments.
c. the power to dispose or direct the disposition of the security or investment.

Standard IV(B.4) covers the activities of all members who have knowledge of pending transactions that may be made on behalf of their clients or employers. This standard also applies to members who have access to information being prepared for research reports or investment actions. These people are called *access persons*.

A member may undertake transactions in accounts for which the member is a beneficial owner only after the member's clients and employer have had an adequate opportunity to act on the recommendation. Personal transactions include those made for the member's own account, family accounts, and accounts in which the member has a direct or indirect pecuniary interest.

Professor's Note: Family accounts that are client accounts should be treated like any other firm account and should not be given special treatment or disadvantage.

Application of the Standard (page 120)

- **Situation:** Non-action.

  (1) An analyst does not change a recommendation from buy to sell so he can sell the stock.
  (2) An analyst does not make a buy recommendation so she can buy the stock personally.

- **Situation:** Deceit.

  (1) An analyst informs her father of a fixed-sized tender offer, holding off trading the firm's shares until she knows her father's offer has gone ahead. (2) An analyst maintains an account in his wife's name at another firm so that he can trade hot new issues, many of which he is unable to get for his own clients. (3) An analyst buys stocks just before they are put on the firm's recommended buy list.

- **Situation:** Fast action.

  Firm members wait to trade until after the firm's buy/sell recommendations are announced but before their clients have time to act.

- **Situation:** Excess caution.

  A firm member's mother has an account with the firm that is managed as a client account. Trades are not made for this account until all other accounts with the firm are traded. The standard states that personal client accounts should be treated like other accounts.

Procedures for Compliance

The firm's compliance procedures should:

- Define personal transactions.
- Define covered investments.
- Limit the number of access persons. "Fire walls" should be built to prevent the flow of information from one group or department to other groups within the firm.
- Define prohibited transactions. The text specifically mentions equity-based IPOs.
- Establish reporting procedures and prior-clearance requirements.
- Ensure that procedures will be enforced and establish disciplinary procedures.

Standard IV(B.5): Preservation of Confidentiality

IV(B.5) *Members shall preserve the confidentiality of information communicated by clients, prospects, or employers concerning matters within the scope of the client-member, prospect-member, or employer-member relationship unless the member receives information concerning illegal activities on the part of the client, prospect, or employer.*

Standard IV(B.5) is applicable when: (1) The member receives information on the basis of his or her special ability to conduct a portion of the client's business. (2) The member receives information that arises from that portion of the client's business that is the subject of the special or confidential relationship.

If the information concerns illegal activities by the client, however, the member may have an obligation to report the activities to the appropriate authorities.

A member may not hold back confidential client information concerning the member's activities from an CFA Institute Professional Conduct Program (PCP) investigation into the member's behavior. Why? Since CFA Institute will keep the client's information confidential, the member is not violating the standard.

Application of the Standard (page 128)

- **Situation:** Requests for confidential information.

  An analyst working with a charitable organization receives a request for the trust's financial information from an individual who claims to be a potential contributor.

- **Situation:** Use of confidential information.

  A financial advisor knows that a client is thinking about a contribution to charity. The advisor tells a charity to solicit the client.

- **Situation:** CFA Institute PCP investigations.

  To keep CFA Institute from discovering his behavior, an analyst claims he cannot divulge his client trading records to the PCP committee.

Procedures for Compliance

The simplest and most effective way to comply with Standard IV(B.5) is to avoid discussing any information received from a client except to colleagues working on the same project.

Standard IV(B.6): Prohibition Against Misrepresentation

IV(B.6) *Members shall not make any statements, orally or in writing, that misrepresent:*

> *a. the services that they or their firms are capable of performing;*
> *b. their qualifications or the qualifications of their firm;*
> *c. the member's academic or professional credentials.*
>
> *Members shall not make or imply, orally or in writing, any assurances or guarantees regarding any investment except to communicate accurate information regarding the terms of the investment instrument and the issuer's obligations under the instrument.*

Members should avoid misrepresentation of their services or qualifications and not make inappropriate assurances or guarantees about an investment or its return. Misrepresentation can be defined as giving a false or misleading impression about something.

IV(B.6) prohibits statements or assumptions that an investment is "guaranteed" or that superior returns can be expected in the future based on the member repeating past success.

Professor's Note: This standard applies to e-mail and web pages as well as written and oral statements.

Application of the Standard (page 132)

- **Situation:** Range of services.

  An analyst says, "My firm can perform all the services you need," when, in fact, the firm can't.

- **Situation:** Misstating one's qualifications.

  An analyst calls herself a portfolio management specialist when, in fact, she is just a trainee.

- **Situation:** Promising or misstating performance.

  (1) Promising performance. An analyst says an investment is guaranteed to give you a 100 percent gain. (2) Misstating performance. An analyst says you can increase your yield by buying money market funds instead of buying municipal bonds. He fails to tell you that, on an after-tax basis, this statement is false. (3) Misrepresenting an investment. An analyst tells you that IO strips are guaranteed by the US government.

Procedures for Compliance

Firms can provide guidance to employees who make written or oral presentations to clients or prospects by providing a written list of the firm's available services and a description of the firm's qualifications.

Standard IV(B.7): Disclosure of Conflicts to Clients and Prospects

IV(B.7) *Members shall disclose to their clients and prospects all matters, including beneficial ownership of securities or other investments, that reasonably could be expected to impair the member's ability to make unbiased and objective recommendations.*

Members must be aware of and disclose to their clients the members' (or their firm's) material ownership of securities, market-making and underwriting activities, corporate finance relationships, and directorships.

Members should disclose to their clients, with the approval of their employer, any special compensation arrangements they have with their employer (like bonuses based on short-term performance) that might conflict with the interests of the client.

Application of the Standard (page 137)

- **Situation:** Failure to disclose.

  An analyst recommends a stock but does not disclose that: (1) he is on the company's board, (2) his firm is acting as the company's underwriter, (3) the recommended company owns an interest in the firm he works for, (4) his wife owns a significant amount of the stock. Note: He is considered a beneficial owner.

- **Situation:** Self-dealing.

  (1) A manager wants her firm's analyst to recommend a company's stock in hopes of getting the management contract for the company's pension fund. (2) An underwriter wants one of its affiliated companies to purchase shares for its client's pension plans that the underwriter has been unable to sell. (3) A manager is under pressure from firm XYZ that is considering hiring her to manage its pension account. XYZ wants her to vote the XYZ stock proxies held in other pension accounts she manages in favor of XYZ's current management.

- **Situation:** Changing conditions.

  An analyst recommending a stock just inherited a sizable number of shares in the company's stock. Solution: in the next stock report, he should disclose his holdings.

- **Situation:** Failure to disclose a performance-based bonus plan.

  A manager gets a bonus from her employer based on the performance of the pension accounts she manages. One of her clients asks her why his pension plan seems to be weighted in favor of high beta stocks. She says nothing about the bonus plan.

Procedures for Compliance

Members should report to their employers, clients, and prospects any material beneficial interest they may have in securities, corporate directorships, or other special relationships they may have with the companies they are recommending. Members should make the disclosures before they make any recommendations or take any investment actions regarding these investments.

Standard IV(B.8): Disclosure of Referral Fees

IV(B.8) *Members shall disclose to clients and prospects any consideration or benefit received by themember or delivered to others for the recommendation of any services to the client or prospect.*

Appropriate disclosure means telling the client or prospect, before agreeing to perform services, of any benefit given or received for recommending the member's services.

Application of the Standard (page 143)

- **Situation:** XYZ has an agreement with ABC that XYZ will recommend prospective pension and endowment clients to ABC. For this service, ABC will give XYZ free research and direct all trades generated by the referrals back to XYZ for execution.

Procedures for Compliance

- Disclose all agreements in writing to any client or prospect who has been referred.
- Describe in the disclosure the nature of the consideration and the estimated dollar value of the consideration.
- Consult a supervisor and legal counsel concerning any prospective arrangement regarding referral fees.

Standard V: Relationships With and Responsibilities to the Investing Public

Standard V(A): Prohibition Against Use of Material Nonpublic Information

V(A) *Members who possess material nonpublic information related to the value of a security shall not trade or cause others to trade in that security if such trading would breach a duty or if the information was misappropriated or relates to a tender offer. If members receive material nonpublic information in confidence, they shall not breach that confidence by trading or causing others to trade in securities to which such information relates.*

Members shall make reasonable efforts to achieve public dissemination of material nonpublic information disclosed in breach of a duty.

Standard V(A) prohibits a member from taking investment action on the basis of information that the member knows was disclosed by a person (tipper) conveying the information in violation of a confidence or in *breach of a duty*. Furthermore, even if no duty is breached, a member violates this standard by taking investment action or passing on material nonpublic information that the member knows has been *misappropriated*. In no instance may a member trade or cause others to trade in a security while the member possesses material nonpublic information relating to a *tender offer* regarding that security. Regarding tender offers, mere possession of material nonpublic information triggers trading restrictions.

Information is "material" if its disclosure would be 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. Material is "nonpublic" until it has been disseminated to the marketplace in general and investors have had an opportunity to react to the information.

The test for determining if a tipper is breaching a fiduciary duty is whether the tipper personally benefits directly or indirectly from the disclosure. There are three types of personal benefits:

1. Pecuniary benefit or a reputational benefit that will translate into future earnings for the tipper.

2. A quid pro quo relationship between the insider and the recipient of the information.

3. A gift of confidential information to, for example, a relative.

A member should evaluate the materiality of any nonpublic information received to determine whether the disclosure of that information violates the communicator's fiduciary duty. If the member determines that the information is material and has been disclosed in breach of a duty, the member should make reasonable efforts to achieve public dissemination of the information. This effort usually means encouraging the issuing company to make the information public. If public dissemination is not possible, the member should communicate the information only to designated supervisory and compliance personnel within the member's firm and should take no investment action on the basis of this information.

A good analyst may be able to predict a corporate action or event based on a perceptive assembly and analysis of material public information or nonmaterial nonpublic information. (This is called the *mosaic theory.*) The analyst may use this information to make investment decisions. Securities professionals must be able to profit from their research efforts.

To sum up the rules of information: (1) If you receive it through your employment, you are an insider and have a fiduciary duty not to use or disclose it. (2) If you receive it from someone else, who is breaching her fiduciary duty, you should make a reasonable effort to have it disclosed. You cannot trade on it. (3) Information received on a selective basis from an insider, who is not breaching his fiduciary duty, may be traded but you do so at your own risk. (4) If you receive the information in a public forum, it has been disseminated, and you can trade on it. (5) If you figure the information out on your own, via the mosaic method, you can use it.

Application of the Standard (page 47)

- **Situation:** Loose conversations.

  (1) A passenger in an elevator overhears a comment made by the CEO of a publicly traded company. The loud-mouthed CEO breached no duty, so no violation occurred. (2) A passenger in an elevator overhears a comment made by the CEO of a publicly traded company about a tender offer. Based on this information, the passenger trades the stock. Since the comment that elicited the trade concerned a tender offer, a violation would have occurred. (3) An analyst fails to provide privacy during a conference call where nonpublic information is discussed. Firm members, who overheard the conversation, subsequently trade for their client's accounts. The analyst has violated V(A) due to lack of adequate procedures.

- **Situation:** Tender offers.

  (1) A CEO tells her brother that she will accept a high-priced tender offer to buy out her firm. The brother tells his daughter, who tells her husband, who tells his broker, who buys the stock. Everyone along the way has said, "don't tell anyone about this." The broker had no reason to believe a duty was breached in the transmission of the information, so he didn't break Standard V(A) for that reason. However, he broke the standard because the trade involved nonpublic information *concerning a tender offer.* (2) Mrs. A asks Mrs. B to cover her volunteer work because Mrs. A's husband (the CEO of a large company) was having problems at work (non-public information). Mrs. B tells her husband, who trades the stock of Mr. A's company. There was no breach of duty, so no violation took place. However, if the information concerned a tender offer a violation would have taken place.

- **Situation:** Misappropriated information.

  (1) You overhear someone say they sneaked a peek into the CEO's briefcase and discovered information about a pending tender offer. You can't trade on this information for two reasons: (a) it was misappropriated, and (b) it concerns nonpublic information concerning a tender offer. (2) A magazine employee trades on information contained in one of the magazine's weekly investment columns that has not yet been published. This is a violation of V(A).

Professor's Note: The information is not nonmaterial nonpublic information (that type of information comes from within the company whose stock is being traded). The violation here is the misappropriation of information.

Professor's Note: Ask these five questions before trading on information under Standard V(A):

1. *Is the information public?*
   *If yes, you **can** trade on it.*
2. *If no to 1, is the information material?*
   *If no, you **can** trade on it.*
3. *If yes to 2, is the information related to a tender offer?*
   *If yes, you **cannot** trade on it.*
4. *If no to 3, is the information misappropriated?*
   *If yes, you **cannot** trade on it.*
5. *If no to 4, did the informant breach a fiduciary duty?*
   *If yes, you **cannot** trade on it.*
   *If no, you **can** trade on it.*

Procedures for Compliance

Members and their firms should adopt written compliance procedures designed to prevent trading while in the possession of material nonpublic information. The most common and widespread approach to prevent insider trading by employees is an information barrier or "fire wall" to prevent the flow of information.

The following are the minimum elements of a fire wall:

- Control over interdepartmental communications.
- Review employee trading against "watch," "restricted," and "rumor" lists.
- Restrict proprietary trading while the firm is in possession of material nonpublic information.

Additional procedures, typically used with an information barrier include:

- Restrict personal and proprietary employee trading.
- Place securities on a restricted list when the firm has material nonpublic information.
- Disseminate material nonpublic information only to those with a need to know.

Designate a supervisor who decides when information is sufficiently public so that the securities can be recommended and traded.

Standard V(B): Performance Presentation

1. *Members shall not make any statements, orally or in writing, that misrepresent the investment performance that they or their firms have accomplished or can reasonably be expected to achieve.*
2. *If members communicate individual or firm performance information directly or indirectly to clients or prospective clients, or in a manner intended to be received by clients or prospective clients, members shall make every reasonable effort to assure that such performance information is a fair, accurate, and complete presentation of such performance.*

Members are encouraged to adopt CFA Institute's Performance Presentation Standards (PPS) for reporting investment results. The PPS are voluntary standards that a member or firm may adopt in compiling and presenting performance figures. The PPS are intended to promote full disclosure and fair representation in the reporting of investment results.

Professor's Note: Firms are not required to comply with the Standards but are encouraged to do so. To claim compliance, however, the firm must comply on a firm–wide basis and satisfy the Standards on all material aspects.

A member must give a fair and complete presentation of performance information whenever communicating data with respect to the investment performance history. Misrepresentation of past performance or expected performance is prohibited.

CFA Institute's PPS consist of the following four sections: (1) the construction and maintenance of composites; (2) the calculation of returns; (3) the presentation of investment results; and (4) disclosures.

Application of the Standard (page 156)

- **Situation:** Misleading statements.

  Based on the recent performance of one trust account, the manager tells prospective clients that they should be able to expect a certain return. A misstatement occurs for two reasons: (1) Current performance results were used rather than long term results, and (2) Performance was based on only one account rather than a composite of all similarly managed accounts.

- **Situation:** Erroneous PPS claims.

  A manager says returns were calculated in accordance with CFA Institute Standards, except: (1) The composite's returns were equally-weighted rather than size-weighted. (2) A manager's past performance in XYZ fund is imputed to a new fund, ABC, which the manager is now managing. A manager's performance at one fund cannot be combined with the performance at another fund. (3) A manager presents simulated results as actual or combines simulated results with actual results. (4) Composites must be clearly defined and contain all similar portfolios under management. This is a violation of the Standards, as a firm cannot claim partial compliance of CFA Institute–PPS.

Professor's Note: CFA Institute's Performance Presentation Standards (CFA Institute-PPS®) are now part of Global Investment Performance Standards (GIPS®), which are reviewed in the next section of this book. Based upon the principles of fair representation and full disclosure that underlie the GIPS standards, the CFA Institute-PPS standards provide North America with consistent and comparable means of evaluating investment performance.

Procedures for Compliance

Misrepresentation about the investment performance of the firm can be avoided if the member maintains data about the firm's investment performance in written form. Investment accounts should be combined into composites by investment class and risk groups.

CFA Institute Rules of Procedure for Proceedings Related to Professional Conduct

LOS 3.c: Explain the Rules of Procedure for Proceedings Related to Professional Conduct and distinguish among the various sanctions that may be imposed.

Professor's Note: Very specific questions on these rules, such as how long the waiting period is before seeking reinstatement or how long does a review panel have to report their findings, would not surprise me on the exam. Don't let them surprise you!

These rules determine how cases of alleged and actual misconduct are handled, how penalties are imposed, how findings may be appealed, and how records of findings made are to be kept. The rules are organized as follows:

- *Rule 1:* Preamble—defines who is subject to the rules.
- *Rule 2:* Discipline—defines who is charged with the imposition of discipline, grounds for discipline, potential sanctions that can be handed out, and how any sanctions handed out will be announced.
- *Rule 3:* Investigation—defines how an investigation of alleged misconduct will be handled.
- *Rule 4:* Action—defines what actions may be taken following an investigation.
- *Rule 5:* Hearing—outlines procedures for appeal in the event that covered person does not accept the action (as proposed under Rule 4) in writing.
- *Rule 6:* Summary Suspension—defines situations for which a summary suspension may be imposed on covered persons. In effect, this means that the procedures outlined under rules 3– 5 are bypassed.
- *Rule 7:* Review of Summary Suspension—outlines procedures for appeal of a summary suspension.
- *Rule 8:* Reinstatement Following Timed Suspension—details steps required for reinstatement following a suspension for a specific period of time.
- *Rule 9:* Reinstatement Following Revocation—details steps required for reinstatement following the revocation of membership and/or CFA designation.
- *Rule 10:* Waiver of All Rights and Proceedings—permits a covered person to tender a conditional admission of misconduct.
- *Rule 11:* Confidentiality—outlines when proceedings will be kept confidential and when they will not.
- *Rule 12:* Records—defines how long records will be kept.

Summary Details of the Rules of Procedure

Rule 1: Preamble

1.1 Individuals identified as "covered persons" are required to adhere to the Code and Standards and will be held accountable for any violations thereof. Covered persons include CFA Institute members, CFA charterholders, and candidates in the CFA program.

Rule 2: Discipline

2.1 The Professional Standards and Policy Committee (PSPC) is empowered to conduct investigations and to impose sanctions. The PSPC may exercise its disciplinary authority via a subcommittee called the Disciplinary Review Subcommittee (DRS), formed under PSPC direction.

2.2 Disciplinary action may be imposed upon covered persons for a variety of reasons. These include violations of the Code and Standards; sanctions are imposed by another recognized supervisory authority (such as a governmental securities regulatory body); a felony conviction; permanent disbarment under securities laws; failure to complete, sign, and return the required annual professional conduct statement; falsification of information to CFA Institute; failure to cooperate with an CFA Institute investigation or other "good cause" so deemed by CFA Institute.

2.3 Sanctions comprise a variety of potential actions. These include (broadly, but not strictly, in the order of severity): private censure, public censure, timed suspension of membership, timed suspension of the right to use the CFA designation, revocation of membership, revocation of the right to use the CFA designation, summary suspension, suspension or revocation from further participation in the CFA professional designation study and examination program.

2.4 Requires that notice containing the appropriate information shall be provided when a disciplinary action occurs and sanctions are warranted.

2.5 Stipulates that sanctions shall be announced pursuant to the rules.

2.6 Covered persons will be deemed to have been provided with sufficient notice if the relevant documents are mailed to the covered person's address of record with CFA Institute (i.e., the onus for insuring that CFA Institute has the correct address lies with the covered person).

Rule 3: Investigation

3.1 The designated officer may appoint others to act on his or her behalf in conducting an inquiry.

3.2 The designated officer is empowered to convene an investigation.

3.3 Any person who files a complaint (a.k.a. the complaining party) concerning a covered person's conduct will be requested to furnish a statement of circumstances or other supporting documentation relating to the allegation. The identity of the complaining party may be kept confidential at the complaining party's request.

3.4 The designated officer shall provide the covered party with a notice of inquiry explaining the nature of the investigation. The covered person has 30 days to respond to such notice and will be subject to a summary suspension for failure to respond.

3.5 All communications must be directed to the designated officer.

3.6 Resignation of CFA Institute membership, the CFA designation, or affiliate organizations will not terminate an investigation if its continuance appears warranted.

Rule 4: Action by the Designated Officer and the Disciplinary Review Subcommittee (DRS)

4.1 The designated officer may terminate an inquiry lacking sufficient evidence and must notify the covered person of the termination. This does not preclude reopening the matter at a future date.

4.2 Private censure will be imposed for minor violations of the Code and Standards. The covered person subject to private censure has 30 days within which to request an appeal to a hearing panel as defined under Rule 5.

4.3 When examined conduct warrants actions that are more severe than private censure, the designated officer may propose to enter into a stipulation agreement with the offending covered person. By agreeing to enter into such an agreement, the covered person waives the right to further appeals concerning the matter.

4.4 An accepted stipulation agreement must be signed by the covered person, describe the misconduct, and state the recommended sanction. The DRS will review accepted stipulation agreements and can impose the recommended sanction, a lesser sanction, or refer the matter back for further review.

4.5 The covered person has 30 days within which to accept or reject the proposed stipulation agreement. If the proposal is rejected, the covered person may request an appeal to a hearing panel as defined under Rule 5. Failure of the covered person to either accept or reject a stipulation proposal will result in the matter being referred to a hearing panel as defined under Rule 5.

Rule 5: Request for Hearing

5.1 The PSPC chair shall designate a hearing panel upon receipt of a statement of charges. No member of the hearing panel shall have a conflict of interest relating to the investigation.

5.2 Hearings will be held by telephone unless otherwise requested by the covered person. The hearing must be held within 120 days of the request. The covered person has the right to be heard in his or her own defense, legal counsel, present witnesses and evidence, and to cross-examine any witness. All evidence and written information must be submitted a fixed minimum number of days prior to the hearing.

5.3 The hearing will proceed as follows: the chair will make a statement summarizing the purpose of the hearing, and the procedures that will be followed; the designated officer will present the charges; the covered person will be given the opportunity to present a defense; the designated officer will be given the opportunity to respond to the defense; the hearing panel will make a determination based upon the preponderance of the evidence. The panel is not bound by rules of evidence typical of courts of law. The findings of the hearing shall be recorded.

5.4 The hearing panel must provide a report of its findings and determination within 30 days. Any sanctions recommended by the panel will be imposed unless the covered person requests a review by the PSPC (see item 5.5 below).

5.5 The covered person can request a review by the PSPC. Such a review will be granted in cases of exceptional or unusual circumstances. The findings of such a review panel are final and conclusive.

Rule 6: Summary Suspension

6.1 Summary suspension means revocation of: CFA Institute membership, membership in affiliated organizations, use of the CFA designation, and/or participation in the CFA program.

6.2 Summary suspension may be imposed on a covered person in cases where the covered person is subject to (a) a felony conviction (so defined, or punishable by more than 1 year in prison); (b) permanent disbarment under securities laws; (c) failure to cooperate with an CFA Institute investigation; or (d) failure to complete, sign, and return the required annual professional conduct statement.

6.3 A summary suspension imposed based upon categories A or B, as defined under 6.2, above, will be automatic following the verification of the final ruling. The covered person can request a review of the summary suspension within 30 days of notification. Further requests for review will not be accepted until one year has lapsed.

6.4 A summary suspension imposed based upon Category C, as defined under 6.2, above, will become effective after the covered person has been furnished with notification. The covered person can request a review of the summary suspension within 30 days of notification. Further requests for review will not be accepted until 1 year has lapsed.

6.5 A summary suspension imposed based upon Category D, as defined under 6.2, above, will become effective after the covered person has been furnished with notification. If the covered person files back copies of the required annual statements, the designated officer will review the matter. The designated officer may require the covered person to demonstrate professional competence and may terminate the suspension. If the suspension is not terminated by the designated officer, the covered person can request a review of the summary suspension within 30 days of notification. Further requests for review will not be accepted until 1 year has lapsed.

Rule 7: Request for Review by Summary Suspension Review Panel

7.1 Upon receipt of request, the PSPC chair shall form a review panel. No member of the review panel shall have a conflict of interest relating to the investigation.

7.2 The review will be held by telephone. The review must be held within 90 days of the request. The covered person has the right to be heard in his or her own defense, legal counsel, present witnesses and evidence, and to cross-examine any witness. All evidence and written information must be submitted a fixed minimum number of days prior to the review.

7.3 The review will proceed as follows: the designated officer may present the charges; the covered person will be given the opportunity to present a defense; the designated officer will be given the opportunity to respond to the defense; the review panel will terminate the suspension only in the case of exceptional or unusual circumstances. The panel is not bound by rules of evidence typical of courts of law.

7.4 The review panel shall prepare a report of its findings and determination and deliver these to the PSPC chair and the covered person within 30 days. The findings of the panel are final and conclusive and do not preclude further investigation of the covered person.

Rule 8: Reinstatement Following Timed Suspension

8.1 A covered person subject to a timed suspension will be automatically reinstated at the end of the term providing that the person completes and files a professional conduct statement confirming that no further actionable violations have occurred during the suspension.

Rule 9: Reinstatement Following Revocation

9.1 A covered person may seek reinstatement of revoked privileges. Conditions required for reinstatement include (a) waiting five years, (b) demonstration of fitness to practice, and (c) adherence to any other conditions reasonably required by the PSPC.

9.2 The designated officer will receive requests for reinstatement. The covered person must cooperate with the investigation. The designated officer shall submit a report with a recommendation.

9.3 Covered persons must wait at least two years following an unsuccessful request for reinstatement prior to submitting a new request.

Rule 10: Waiver of All Rights and Proceedings

10.1 A covered person may tender a conditional admission of misconduct. If accepted by the designated officer, the practical effect of such admission is likely to be to terminate the proceedings underway.

Rule 11: Confidentiality of Proceedings

11.1 It is a matter of policy that all proceedings and records will remain confidential, subject to limited exceptional cases is outlined under 11.2.

11.2 Proceedings and records will be excepted from the confidentiality policy in cases where (a) failure to disclose the findings has the potential to cause serious harm to the profession, (b) criminal activity is uncovered, (c) such confidentiality is waived by the covered person, or (d) disclosure is required by law.

Rule 12: Records

12.1 A record of all investigations and actions will be preserved for six years.

The following is a review of the Ethical and Professional Standards principles designed to address the learning outcome statements set forth by CFA Institute®. This topic is also covered in:

Global Investment Performance Standards

Study Session 1

Exam Focus

This topic review covers the key features of the Global Investment Performance Standards® as adopted by CFA Institute in 1999. Do not take this material lightly. Investment performance presentation is an area of constantly growing concern in the investment management field and an important part of the CFA® curriculum. Repeated exposure is the best way to learn this material. So, study the material in this review now, then study it again closer to the exam date. The performance presentation material appears to be relatively easy, but still requires a reasonable amount of time for it to sink in. Questions pertaining to the acceptable presentation of investment performance will inevitably be on the exam—so don't miss out on these relatively easy points!

Warm Up: The Global Investment Performance Standards[1]

The Global Investment Performance Standards (GIPS®) contain ethical and professional standards for the presentation of investment performance results. *The GIPS standards are a voluntary set of standards.* They are based on the fundamental principles of full disclosure and fair representation of performance results. When investment management firms comply with the GIPS standards, clients, prospective clients, and consultants are better equipped to fairly assess historical investment performance.

The GIPS standards are by no means all-encompassing. There is no practical way for a set of standards to address every possible situation that any firm may face. GIPS should be viewed as a minimum set of investment performance presentation requirements. Investment management firms should always include additional information in their performance presentations that would help prospective clients better understand the reported performance results.

Why GIPS?

LOS 5.a: Explain why the GIPS® standards were created.

Recognizing the need for one globally accepted set of investment performance presentation standards, CFA Institute sponsored and funded the Global Investment Performance Standards Committee to develop and publish a single global standard by which all firms calculate and present performance to clients and prospective clients. As a result of this initiative, CFA Institute formally endorsed GIPS on February 19, 1999, as the worldwide standard. Akin to the CFA Institute-PPS standards, GIPS is based on the underlying principles of fair representation and full disclosure and has been designed to meet the needs and capabilities of a broad range of global markets. As countries adopt the GIPS standards, competition in the global investment industry is enhanced because clients and potential clients can make fair and unambiguous comparisons among investment advisory firms.

1. Copyright, 2005, CFA Institute. Reproduced and republished from CFA Institute *Global Investment Performance Standards* (GIPS, April 1999) with permission from CFA Institute. All Rights Reserved.

Professor's Note: CFA Institute-PPS standards are incorporated in the GIPS standards. In fact, the CFA Institute-PPS standards that are used in practice are called "CFA Institute-PPS standards, the U.S. and Canadian version of GIPS."

LOS 5.b: Explain what parties the GIPS standards apply to and who the standards serve.

The GIPS standards *apply to investment management firms*. They are intended to *serve prospective and existing clients of investment firms and consultants* who advise these clients. Firms claiming GIPS compliance provide investors with assurance that performance is reported completely and fairly. GIPS compliance gives investors confidence in the integrity of performance presentations and facilitates the comparison of performance presentations among firms that claim GIPS compliance.

LOS 5.c: State the objectives and key characteristics of the GIPS standards.

Objectives

The objectives stated in the *Introduction to GIPS* (Section I) are presented below:

- To obtain worldwide acceptance of a standard for the calculation and presentation of investment performance in a fair, comparable format that provides full disclosure.
- To ensure accurate and consistent investment performance data for reporting, record keeping, marketing, and presentation.
- To promote fair, global competition among investment firms for all markets without creating barriers to entry for new firms.
- To foster the notion of industry self-regulation on a global basis.

Key Characteristics

Also included in the *Introduction to GIPS* are several key characteristics. These consist of the following:

- GIPS are ethical standards for investment performance presentation to ensure fair representation and full disclosure of an investment firm's performance history.
- GIPS exist as a minimum worldwide standard where local or country-specific law, regulation, or industry standards may not exist for investment performance measurement and/or presentation.
- GIPS require managers to include all actual fee-paying, discretionary portfolios in composites defined according to similar strategy and/or investment objective and require firms to show GIPS-compliant history for a minimum of five years, or since inception of the firm or composite if in existence less than five years.

Definition: A *composite* is a set of portfolios that all follow the same investment style. For example, your company manages high net worth portfolios for individual clients. Four of your client portfolios follow an *international growth* style philosophy. For reporting purposes, the performance of these four portfolios would be reported together in the *international growth composite*.

Professor's Note: This is an important tenet of GIPS. It prevents firms from presenting only the results of their best-performing portfolios.

- GIPS require firms to use certain calculation and presentation methods and to make certain disclosures along with the performance record.
- GIPS rely on the integrity of input data. The accuracy of input data is critical to the accuracy of the performance presentation. For example, benchmarks and composites should be created/selected on an *ex ante* basis, not *ex post*.
- GIPS consist of guidelines that firms are required to follow in order to claim compliance. The adoption of other elements of GIPS is recommended for firms to achieve best practice in performance presentation.
- GIPS apply to the presentation of investment performance of assets managed on behalf of a third party.

- GIPS should be applied with the goal of full disclosure and fair representation of investment performance. Meeting the objective of full and fair disclosure is likely to require more than compliance with the minimum requirements of GIPS. If an investment firm applies GIPS in a performance situation that is not addressed specifically by the standards or is open to interpretation, disclosures other than those required by GIPS may be necessary. To fully explain the performance included in a presentation, firms are encouraged to present all relevant supplemental information.
- In cases in which applicable local or country-specific law or regulation conflicts with GIPS, the Standards require firms to comply with the local law or regulation and make full disclosure of the conflict. Note how this differs from candidate requirements as they relate to the Standards of Professional Conduct. If a candidate or Charterholder faces a *more strict/less strict* conflict between local laws and the Standards of Professional Conduct, the *more strict* standard prevails (either local law or SOP). However, with respect to the GIPS, if the local law is *less strict*, then the local law prevails and the candidate or Charterholder must simply disclose the conflict between GIPS and the local law.
- GIPS do not address every aspect of performance measurement, valuation, attribution, or cover all asset classes. GIPS will evolve over time to address additional aspects of investment performance. Certain recommended elements in GIPS may become requirements in the future.

LOS 5.d: State the scope of the GIPS standards with respect to definition of firm, historical performance record, and compliance.

Definition of Firm

In order for an investment firm to claim GIPS compliance, GIPS must be applied on a firmwide basis. The key here is the definition of a firm, because what is defined as the *firm* defines the boundaries for firm assets and the set of *all* portfolios that must be included in at least one composite (i.e., portfolio for performance measurement—discussed below). According to GIPS, a firm may define itself for the purpose of claiming GIPS compliance using one of the following three options:

- An entity registered with the appropriate national regulatory authority overseeing the entity's investment management activities.
- An investment firm, subsidiary, or division held out to clients or potential clients as a distinct business unit. This means that a subsidiary or division of a firm can claim compliance with GIPS even if the parent company is not GIPS-compliant.
- All assets managed to one or more base currencies. This option pertains to firms managing global assets and is available until January 2005.

Whenever an investment management firm presents investment performance in compliance with GIPS, it *must state how it defines itself as a "firm."*

Historical Performance Record

In order to claim GIPS compliance, a firm must present at least five years of annual investment performance that complies with GIPS. If a firm or composite is less than five years old, the performance since the inception of the firm or composite must be presented. After five years of compliant history has been achieved, firms must add an additional year of performance each year until a 10-year performance record has been established.

Regardless of the 5-year minimum compliance history requirement, a firm may link non-GIPS-compliant performance to their compliant history as long as *only GIPS-compliant performance is presented for periods after January 1, 2000*, and the firm discloses the periods of noncompliance with an explanation of why the presentation is not GIPS-compliant.

Example: Historical performance requirements

Assume it is January 1, 2003, and a 20-year-old firm with no GIPS-compliant performance history wishes to claim compliance with the GIPS standards. What options are available to this firm?

Answer:

Since the firm is more than five years old, it must report at least five years of GIPS-compliant performance history. Thus, the firm must comply, retroactively, for the 5-year period beginning on January 1, 1998. With regard to its investment performance record prior to January 1, 1998, the firm has the following options listed.

- Retroactively comply for the 5-year period January 1, 1993, through December 31, 1997, giving the firm a 10-year GIPS-compliant performance history.
- Not retroactively comply and include noncompliant performance over the 5-year period from January 1, 1993, through December 31, 1997, along with the five years of GIPS-compliant performance results, for a 10-year total performance history. Under this option, the firm must disclose why the non-GIPS-compliant years are not in compliance.
- Present only the 5-year GIPS-compliant performance history for the period January 1, 1998, through December 31, 2002.

Compliance

A firm must be in full compliance with the GIPS standards in order to claim GIPS compliance. There is no such thing as partial GIPS compliance!

Once a firm has met all of the required elements of GIPS, the firm may use the following *Compliance Statement* to indicate that the performance presentation is in compliance with GIPS:

> *[Insert name of firm] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS).*

If the performance presentation does not meet *all* of the requirements of GIPS, firms *cannot* represent that the performance presentation is "in compliance with the Global Investment Performance Standards *except for* . . ."

Also note that only investment management firms may claim compliance with GIPS, because they actually manage the assets for which performance is reported. This means that parties such as plan sponsors and consultants may not claim GIPS compliance.

LOS 5.e: Identify the requirements and recommendations of each of the five main topics of the GIPS standards, i.e., input data, calculation methodology, composite construction, disclosures, and presentation and reporting.

Professor's Note: To address this LOS, Section 2 of GIPS has been reproduced here. As you will note, Section 2 is divided into five areas that reflect the essential elements associated with presenting performance information. Study these five topics and be prepared to identify situations that represent violations of the GIPS requirements. Be sure to know the recommendations in each section, as well.

Section 1: Input Data

1.A. *Requirements*

1.A.1. All data and information necessary to support a firm's performance presentation and to perform the required calculations must be captured and maintained.

1.A.2. Portfolio valuations must be based on market values (not cost basis or book values).

1.A.3. Portfolios must be valued at least quarterly. For periods beginning January 1, 2001, portfolios must be valued at least monthly. For periods beginning January 1, 2010, it is anticipated that firms will be required to value portfolios on the date of any external cash flow.

1.A.4. Firms must use trade-date accounting for periods beginning January 1, 2005.

1.A.5. Accrual accounting must be used for fixed-income securities and all other assets that accrue interest income.

1.A.6. Accrual accounting must be used for dividends (as of the ex dividend date) for periods beginning January 1, 2005.

1.B. *Recommendations*

1.B.1. Sources of exchange rates should be the same for the composite and the benchmark.

Section 2: Calculation Methodology

2.A. *Requirements*

2.A.1. Total return, including realized and unrealized gains plus income, must be used.

2.A.2. Time-weighted rates of return that adjust for cash flows must be used. Periodic returns must be geometrically linked. Time-weighted rates of return that adjust for daily-weighted cash flows must be used for periods beginning January 1, 2005. Actual valuations at the time of external cash flows will likely be required for periods beginning January 1, 2010.

2.A.3. In both the numerator and the denominator, the market values of fixed-income securities must include accrued income.

2.A.4. Composites must be asset weighted using beginning-of-period weightings or another method that reflects both beginning market value and cash flows.

2.A.5. Returns from cash and cash equivalents held in portfolios must be included in total-return calculations.

2.A.6. Performance must be calculated after the deduction of all trading expenses.

2.A.7. If a firm sets a minimum asset level for portfolios to be included in a composite, no portfolios below that asset level can be included in that composite.

2.B. *Recommendations*

2.B.1. Returns should be calculated net of non-reclaimable withholding taxes on dividends, interest, and capital gains. Reclaimable withholding taxes should be accrued.

2.B.2. Performance adjustments for external cash flows should be treated in a consistent manner. Significant cash flows (i.e., 10 percent of the portfolio or greater) that distort performance (i.e., plus or minus 0.2 percent for the period) may require portfolio revaluation on the date of the cash flow (or after investment) and the geometric linking of subperiods. Actual valuations at the time of any external cash flows will likely be required for periods beginning January 1, 2010.

Section 3: Composite Construction

3.A. *Requirements*

3.A.1. All actual fee-paying discretionary portfolios must be included in at least one composite.

3.A.2. Firm composites must be defined according to similar investment objectives and/or strategies.

3.A.3. Composites must include new portfolios on a timely and consistent basis after the portfolio comes under management—unless specifically mandated by the client.

3.A.4. Terminated portfolios must be included in the historical record of the appropriate composites up to the last full measurement period that the portfolio was under management.

3.A.5. Portfolios must not be switched from one composite to another unless documented changes in client guidelines or the redefinition of the composite make switching appropriate. The historical record of the portfolio must remain with the appropriate composite.

3.A.6. Convertible and other hybrid securities must be treated consistently across time and within composites.

3.A.7. Carve-out returns excluding cash cannot be used to create a stand-alone composite. When a single asset class is carved out of a multiple-asset portfolio and the returns are presented as part of a single-asset composite, cash must be allocated to the carve-out returns and the allocation method must be disclosed. Beginning January 1, 2005, carve-out returns must not be included in single asset class composite returns unless the carve-outs are actually managed separately with their own cash allocations.

3.A.8. Composites must include only assets under management and may not link simulated or model portfolios with actual performance.

3.B. *Recommendations*

3.B.1. Separate composites should be created to reflect different levels of allowed asset exposure.

3.B.2. Unless the use of hedging is negligible, portfolios that allow the use of hedging should be included in different composites from those that do not.

Section 4: Disclosures

4.A. *Requirements*

The following disclosures are *mandatory:*

4.A.1. The definition of "firm" used to determine the firm's total assets and firmwide compliance.

4.A.2. Total firm assets for each period.

4.A.3. The availability of a complete list and description of all of the firm's composites.

4.A.4. If settlement-date valuation is used by the firm.

4.A.5. The minimum asset level, if any, below which portfolios are not included in a composite.

4.A.6. The currency used to express performance.

4.A.7. The presence, use, and extent of leverage or derivatives, including a description of the use, frequency, and characteristics of the instruments sufficient to identify risks.

4.A.8. Whether performance results are calculated gross or net of investment management fees and other fees paid by the clients to the firm or to the firm's affiliates.

4.A.9. Relevant details of the treatment of withholding tax on dividends, interest income, and capital gains. If using indexes that are net of taxes, firms must disclose the tax basis of the composite (e.g., Luxembourg based or U.S. based) versus that of the benchmark.

4.A.10. For composites managed against specific benchmarks, the percentage of the composites invested in countries or regions not included in the benchmark.

4.A.11. Any known inconsistencies between the chosen source of exchange rates and those of the benchmark must be described and presented.

4.A.12. Whether the firm has included any non-fee-paying portfolios in composites and the percentage of composite assets that are non-fee-paying portfolios.

4.A.13. Whether the presentation conforms with local laws and regulations that differ from GIPS requirements and the manner in which the local standards conflict with GIPS.

4.A.14. For any performance presented for periods prior to January 1, 2000, that does not comply with GIPS, the period of noncompliance and how the presentation is not in compliance with GIPS.

4.A.15. When a single asset class is carved out of a multiple-asset portfolio and the returns are presented as part of a single-asset composite, the method used to allocate cash to the carve-out returns.

4.B. *Recommendations*

The following disclosures are *recommended:*

4.B.1. The portfolio valuation sources and methods used by the firm.

4.B.2. The calculation method used by the firm.

4.B.3. When gross-of-fee performance is presented, the firm's fee schedule(s) appropriate to the presentation.

4.B.4. When only net-of-fee performance is presented, the average weighted management and other applicable fees.

4.B.5. Any significant events within the firm (such as ownership or personnel changes) that would help a prospective client interpret the performance record.

Section 5: Presentation and Reporting

5.A. *Requirements*

5.A.1. The following items must be reported:

(a) At least five years of performance (or a record for the period since firm inception, if inception is less than five years) that is GIPS compliant. After presenting five years of performance, firms must present additional annual performance up to 10 years. (For example, after a firm presents five years of compliant history, the firm must add an additional year of performance each year so that after five years of claiming compliance, the firm presents a 10-year performance record).

(b) Annual returns for all years.

(c) The number of portfolios and amount of assets in the composite and the percentage of the firm's total assets represented by the composite at the end of each period.

(d) A measure of the dispersion of individual component portfolio returns around the aggregate composite return.

(e) The standard Compliance Statement indicating firmwide compliance with the GIPS.

(f) The composite creation date.

5.A.2. Firms may link non-GIPS-compliant performance to their compliant history so long as firms meet the disclosure requirements of Section 4 and no non-compliant performance is presented for periods after January 1, 2000. (For example, a firm that has been in existence since 1990 that wants to present its entire performance history *and* claim compliance as of January 1, 2000, must present performance history that meets the requirements of GIPS at least from January 1, 1995, and must meet the disclosure requirements of Section 4 for any noncompliant history prior to January 1, 1995.)

5.A.3. Performance for periods of less than one year must not be annualized.

5.A.4. Performance results of a past firm or affiliation can only be linked to or used to represent the historical record of a new firm or new affiliation if:

(a) A change only in firm ownership or name occurs.

(b) Or the firm has all of the supporting performance records to calculate the performance, substantially all the assets included in the composites transfer to the new firm, and the investment decision-making process remains substantially unchanged.

5.A.5. If a compliant firm acquires or is acquired by a noncompliant firm, the firms have one year to bring the noncompliant firm's acquired assets into compliance.

5.A.6. If a composite is formed using single-asset carve-outs from multiple asset class composites, the presentation must include the following:

(a) A list of the underlying composites from which the carve-out was drawn.

(b) And the percentage of each composite the carve-out represents.

5.A.7. The total return for the benchmark (or benchmarks) that reflects the investment strategy or mandate represented by the composite must be presented for the same periods for which the composite return is presented. If no benchmark is presented, the presentation must explain why no benchmark is disclosed. If the firm changes the benchmark that is used for a given composite in the performance presentation, the firm must disclose both the date and the reasons for the change. If a custom benchmark or combination of multiple benchmarks is used, the firm must describe the benchmark creation and rebalancing process.

5.B. *Recommendations*

5.B.1. The following items should be included in the composite presentation or disclosed as supplemental information:

(a) Composite performance gross of investment management fees and custody fees and before taxes (except for non-reclaimable withholding taxes).

(b) Cumulative returns for composite and benchmarks for all periods.

(c) Equal-weighted means and median returns for each composite.

(d) Volatility over time of the aggregate composite return.

(e) And, inconsistencies among portfolios within a composite in the use of exchange rates.

5.B.2. Relevant risk measures—such as volatility, tracking error, beta, modified duration, etc.—should be presented along with total return for both benchmarks and composites.

Professor's Note: No finite set of guidelines can cover all potential situations or anticipate future developments in investment industry structure, technology, products, or practices. When appropriate, firms have the responsibility to include information not covered by the GIPS standards in GIPS-compliant presentations.

VERIFICATION

LOS 5.f: Describe the scope and purpose of verification.

Once a firm claims compliance with the GIPS standards, it is responsible for its claim of compliance and for maintaining its compliance. In doing so, the firm may *voluntarily* hire an independent third party to verify its claim of compliance.

The primary purpose of verification is to increase the level of confidence that a firm claiming GIPS compliance did indeed adhere to the standards. Verification also increases the understanding and professionalism of performance-measurement teams and uniformity of presentation of performance results.

Verification involves the review of an investment management firm's performance-measurement processes and procedures by an independent third-party *verifier*. Upon completion of verification, a verification report is issued that must confirm that:

- The investment firm has complied with all the composite construction requirements of GIPS on a firmwide basis.
- The firm's processes and procedures are designed to calculate and present performance results in compliance with the GIPS standards.

Without such a report from the verifier, the firm cannot claim that its claim of compliance with GIPS has been verified.

Other noteworthy aspects of GIPS verification include the following:

- A single verification report is issued for the entire firm; *GIPS verification cannot be carried out for a single composite*.
- Verification is not a requirement for GIPS compliance, but it is *strongly encouraged* and is expected to become mandatory at some time after 2005.
- The initial minimum period for which verification can be performed is one year of a firm's presented performance. The recommended period over which verification is performed will be that part of the firm's track record for which GIPS compliance is claimed.
- After performing the verification, the verifier may conclude that the firm is not in compliance with GIPS or that the records of the firm cannot support a complete verification. In such situations, the verifier must issue a statement to the firm clarifying why a verification report was not possible.

LOS 5.g: Describe the required verification procedures (including pre-verification procedures).

GIPS contain minimum standards for the recommended third-party verification procedure. Some of these standards are common sense (e.g., verifiers should understand GIPS) and others refer to the verification of firm policies and procedures with respect to the various requirements for GIPS-compliant reporting.

The **pre-verification process** involves the following requirements:

Verifiers must:

- Have knowledge of the firm.
- Have up-to-date knowledge of the GIPS requirements.
- Have knowledge of country-specific performance standards that apply and any differences between these and GIPS.
- Have knowledge of firm policies for establishing and maintaining compliance.

This includes *any policies relevant to the presentation of performance* so it can be a long list. Examples of the relevant policies include policies with respect to: investment discretion, composite definition, timing of the inclusion of new accounts and exclusion of closed accounts, valuation and the accrual of cash flows, computing and presenting composite returns, and the use of leverage and/or derivatives.

This part of the pre-verification procedure includes receiving and reviewing firm policies and definitions in writing.

- Have knowledge of the firm's policies and methods with respect to valuation and performance calculations.

  Here, five specific areas are noted:

  1. Firm policies on classifying cash flows from and to clients, cash flows from securities held in accounts, and cash flows for taxes and fees should produce accurate returns.
  2. The accounting treatment of interest and dividends received is consistent with cash account and cash accrual definitions.
  3. The treatment of taxes and tax accruals is correct and consistent with the firm method, either gross- or net-of-tax returns.
  4. Policies on recognizing purchases and sales will produce accurate results.
  5. Accounting treatment of investments and derivatives is consistent with GIPS.

The **verification procedures** include verifying that:

- The firm is correctly defined.
- The definition and construction of composites and benchmarks are correct and have been consistently applied.
- Discretionary and nondiscretionary accounts are correctly classified (verified by an appropriate sampling procedure).
- Selected accounts have been handled properly in regard to their inclusion in composites, consistency of investment objectives of accounts within a composite, and consistency of account agreement objectives and composite definitions.
- The calculation of performance is consistent with stated firm policy, returns calculations are correct, and composite calculations are correct (by sampling accounts and composite calculations).
- The composite presentations are compliant (by sampling).

Verifiers should also maintain information to support their findings and keep written confirmation from the firm of important representations made during the verification procedure.