Achievement of Market-Friendly Initiatives and Results Program
(AMIR 2.0 Program)

Funded by U.S. Agency for International Development

Ethical and Professional Standards and Portfolio Presentation Standards
CFA Level III 2003

Review Notes

Study Sessions 1, 2 & 17

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Contract No. 278-C-00-02-00210-00

2003

ETHICAL AND PROFESSIONAL STANDARDS
&
PORTFOLIO PRESENTATION STANDARDS

CFA LEVEL III B 2003

REVIEW NOTES

STUDY SESSIONS 1, 2 &17

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Note to CFA Level III Candidates: These study notes are intended to be a supplement to, and not a substitute for, the assigned readings in Ethical and Professional Standards and Portfolio Presentation Standards. Please read the assigned candidate readings carefully and take notes for future reference. .

Ethical and Professional Standards

Note for 2003 Level III CFA Exam Format in Ethical and Professional Standards:

For the 2003 Level III CFA Exam, the format for testing in Ethical and Professional Standards again will consist of one or more item sets. Each item set will consist of a multi-paragraph vignette or mini-case situation and several multiple choice questions based on the vignette. A sample item set is provided in the 2003 Level III Study Guide (see pp.10-12 of the Study Guide).

Ethical and professional standard have become an increasingly important part of the CFA program and the CFA Level III Study Guide indicates that approximately 10% of the questions on the 2003 Level III exam will come from this area. The 2003 Study Guide allocates two study sessions to the topics of ethical and professional standards, and the volume of reading is significant. For questions covering this topic, candidates should be able to anticipate potential professional conduct problems that may arise and to create procedures to resolve or adequately address those problems, especially in such areas as fiduciary duties, portfolio investment recommendations and actions, fair dealing, priority of transactions, preservation of confidentiality, misrepresentation, disclosure of referral fees, disclosure of conflicts to clients and prospects, inside information, performance presentation and soft dollars, among others.

Candidates should develop and in-depth appreciation of the AIMR=s *Code of Ethics, Standards of Professional Conduct, Standards of Practice, and AIMR Global Investment Performance Standards,* as well as an understanding of the three primary aspects of fiduciary duty. The depth of knowledge expected of candidates in these areas increases as they progress through the CFA program. Since this is the highest level, candidates are expected to have a manager=s knowledge of these areas.

Standards of Practice Handbook

The AIMR *Standards of Practice Handbook* contains the AIMR *Code of Ethics* and *Standards of Professional Conduct.* The Handbook also addresses the application of the Code and Standards by discussing the purpose and scope of each standard, and provides practical illustrations describing their application to factual situations, and provides examples of compliance procedures. Developing an understanding of the Code and Standards will enable securities analysts to make ethical decisions and to accept responsibility on behalf of the investment profession. This conduct is crucial for maintaining the public trust.

Code of Ethics

The AIMR Code of Ethics consists of four statements describing the conduct of the ethical analyst. Members of the Association for Investment Management and Research shall:

- Act with integrity, competence, dignity, and in an ethical manner when dealing with the public, clients, prospects, employers, employees, and fellow members.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on members and their profession.
- Strive to maintain and improve their competence and the competence of others in the profession.
- Use reasonable care and exercise independent judgment.

The AIMR has built its reputation with strong support of an ethical code and virtually all CFAs believe that ethical behavior is an essential requirement for a successful market. Investors must trust the fairness of the market and the fairness of their investment professional if they are to repeatedly invest in the market. Therefore, an ethical marketplace serves the best interests of everyone.

Standards Of Professional Conduct

The Standards of Professional Conduct embrace the ideals of the Code of Ethics and provide guidance to achieve the behaviors embodied in the Code. The five standards cover: (1) Fundamental Responsibilities; (2) Relationships with and Responsibilities to the Profession; (3) Relationships with and Responsibilities to the Employer; (4) Relationships with and Responsibilities to Clients and Prospects; and (5) Relationships with and Responsibilities to the Investing Public.

Candidates should read the Handbook completely and outline the details. Exam questions from this material can be quite demanding. The Standards of Professional Conduct are the central building blocks of professional ethics for CFAs. They represent qualities that CFA candidates should possess so that they can perform their duties in a manner that will reflect positively upon the profession and, therefore, will help the investment profession retain its position of trust in the investment community. The usefulness in knowing these qualities lies in helping candidates understand how they should approach ethical dilemmas. On the 2003 Level III exam, the most probable questions you will be asked will focus on a case situation in which ethical violations have occurred. A Level III candidate is expected to know the Standards intimately and to be able to identify the specific standard(s) that fit various ethical situations. You must be able to identify the violations and to cite specific standards. You will need to identify one or more of the five Standards listed above. With the change in question format to an item set, this may be easier than on past exams.

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The Standards are summarized below in a format that should facilitate your study of them.

Standard I: Fundamental Responsibilities
A - Knowledge
B - Honor Code Responsibilities

Standard II: Relationships with and Responsibilities to the Profession
A - Designation
- 1 - dignified manner
- 2 - encourage use
- 3 – candidate's participation

B - Professional Misconduct
C - Prohibition of Plagiarism

Standard III: Relationships with and Responsibilities to the Employer
A - Obligation to Inform
- 1 - in writing
- 2 - provide copy

B - Duty
C - Disclosure of Conflicts
- 1 - disclose ownership interests
- 2 - comply with prohibitions

D - Disclose Additional Compensation
E - Supervisory Responsibilities

Standard IV: Relationships with and Responsibilities to Clients and Prospects
A - Investment Process
- 1 - representations
  - a - diligence & thoroughness
  - b - reasonable & adequate basis
  - c - no misrepresentations
  - d - maintain records
- 2 - research reports
  - a - reasonable judgment
  - b - fact vs. opinion
  - c - investment characteristics
- 3 - independence & objectivity

B - Interactions with Clients & Prospects
- 1 - fiduciary duties
- 2 - portfolio recommendations & actions
  - a - client=s objectives
  - b - evaluate suitability
  - c - fact vs. opinion
  - d - disclose process
- 3 - fair dealing
- 4 - priority of transactions
  - a - direct or pecuniary interest
  - b - voting power
  - c - disposition
- 5 - preservation of confidentiality
- 6 - no misrepresentations
  - a - capabilities
  - b - qualifications
  - c - credentials
- 7 - conflicts
- 8 - referral fees

Standard V: Relationships with and Responsibilities to the Investing Public

A - Material Nonpublic Information

B - Performance Presentation
- 1 - misrepresentations
- 2 - fair, accurate & complete information

Fiduciary Responsibility

The ethics portion of the CFA material relies heavily on the concept of **fiduciary duty**. The three basic parts of fiduciary duty are:

- Responsibility to Client
- Knowledge, Care and Diligence
- Administrative Responsibilities

The concept of fiduciary duty is central to all of the professional ethics material. Ethical behavior is required because of a CFA=s fiduciary responsibility. At Level III, candidates must be able to explain these issues and also be able to operationalize them as supervisors and leaders of their organizations.

The evolution of fiduciary duty has been a long process and it should be understood by exam candidates. Years ago, when the managers first became responsible for finances of others, English courts codified the responsibility of a prudent caretaker. This responsibility evolved over many years and through many court cases into the present day concept of fiduciary duty. The three basic concepts cited above represent the current evolution of this basic tenet. Each should be understood separately, and candidates should be able to explain why each part supports the whole concept.

The three essential elements of fiduciary duty are outlined below in a study format:

Fiduciary Duty
- Client First
- Knowledge, Care and Diligence
- Administrative Responsibilities

Fiduciary Duty - Responsibility to Client

The first fiduciary duty, *responsibility to client*, has been highlighted by court cases, actions of the Securities and Exchange Commission, and the AIMR. AIMR has used the phrase *client first* to describe this concept, and it stands as the central precept of the CFA profession. The first and overriding responsibility any financial professional has is to the participants of the market B the client. This primary obligation is required in order to maintain the perception and reality that the market is a fair game and thus encourage the widest possible participation in the capital allocation process. The premise of the U.S. capital market is that the widest possible participation in the market will result in the most efficient allocation of financial resources and, therefore, lead to the best operation of the world-wide economy. Putting the Aclient first@ actually protects and promotes the best interests of the entire financial community, and, therefore, society as a whole.

The concept is operationalized by requiring that financial professionals place the interests of their clients ahead of all other concerns. Responsibilities to employers, colleagues and selves are all placed in a descending order of importance so that the financial markets can be best served. All relevant information must be disclosed to clients and all decisions made with their interests first in mind. The standards support and amplify this basic concept.

Insider trading is also specifically precluded by this guideline. Insider trading is the use of information not available to the general public in a manner which will secure an unfair advantage for some specific party. Since the objective of the financial market is to incorporate all information toward the efficient allocation of resources, the use of nonpublic information to gain an unfair advantage is counter to the general objective. Insider trading is an area of specific concern to AIMR, and candidates should be able to define such activity, identify situations in which it is described and provide remedies to prevent it from occurring in the future.

Fiduciary Duty - Knowledge, Care and Diligence

The second fiduciary responsibility, *knowledge, care and diligence*, concerns the technical and behavioral responsibilities of the financial professional. *Knowledge* requires that investment managers and researchers have the necessary skills to discharge their duties. Financial professionals cannot be experts in all aspects of the complex financial markets that exist, and they should not try to represent themselves as such. However, CFAs and CFA candidates should strive to expand their expertise in areas which will best serve their clients. A lack of knowledge or expertise is, in itself, not a violation of ethical guidelines; however, continuing to do business in areas where expertise is required or not disclosing a lack of knowledge is definitely an ethical violation. CFAs must only make decisions and give advice in areas in which they fully understand all implications of the technical implications involved.

Care is the quality that financial professionals must exercise when making financial decisions and taking actions on those decisions. The concept of prudence or the Aprudent man rule@ is key to this responsibility. Financial professionals must act in a manner in which their decisions and actions are in the best interests of their client=s requirements. The Aprudent man rule@ also refers to the obligation of Aclient first,@ but in this context it highlights the responsibility of principal retention of the client=s portfolio, and now also includes modern portfolio diversification. Care, or prudence, therefore, provides the guidelines in which financial professional are required to know the investing characteristics and desires of their clients, and act in a manner which best promotes those concerns.

Diligence requires financial professionals to discharge their duties in a timely manner and to maintain full records of decisions and actions. Timeliness is necessary so that opportunities will not be lost due to inaction. Violations of ethical behavior can actually be caused by inaction when action would have been required. This responsibility also requires full disclosure of all actions undertaken by financial professionals. Full disclosure means that all information necessary for investors to make the best decision is publicly available. On a more individualized basis, full disclosure means that financial professionals must inform clients and potential clients of all information which affects or could affect the client=s reliance on the actions of the financial professional (such as conflicts of interest, referral fee arrangements and the process by which investment decisions are made).

Fiduciary Responsibility - Administrative Responsibilities

The third aspect of financial responsibility, administrative responsibilities, is of particular interest to Level III candidates. Level III candidates are considered to be in positions where they currently assume or will soon assume supervisory responsibilities. Such responsibilities are specifically covered by Standard III E. Controlling and monitoring client expenses, internal control and the establishment of proxy voting rules are all examples of administrative responsibilities for which a CFA needs to be prepared.

Controlling costs and soft-dollar rules are basic applications of the administrative responsibilities of a financial professional. Since a financial professional has the objective of putting the client=s interests first, it is obvious that any costs passed on to clients must be spent wisely. This does not mean that the least expensive alternative must always be used, but does mean that a cost-benefit analysis must be considered for each expense. If certain brokerage fees are higher with one broker than with another broker, but the services provided by the more expensive broker more than compensate for the increased fees, the more expensive basic fee may be in the best long-term interest of the client. Soft dollar considerations include the assessment of how considerations received by an investment professional should be used. Again, the client=s interest come first and any considerations received should be used in the best interests of the client.

Investment firms must also establish proxy voting procedures to ensure their administrative responsibilities. Avoiding voting in proxy fights is an error of omission that is not in the best interest of the client. Proxy votes are required so that the clients investment goals and objectives can best be attained. Making informed proxy vote decisions requires that the investment professional carefully considers the options available and then takes actions to help ensure the best outcome for the client.

Separation of information in an investment firm (Fire Walls) is required so that confidentiality is not breached. An investment professional is required not to attain insider information which can be used to give any parties an unfair advantage. Therefore, propriety information that is necessary to perform investment services must be isolated within the investment banking portion of an investment firm.

Fire Walls
- Control communication
- Review/control employee trades
- Disseminate procedures
- Maintain records

International Concerns

Ethical responsibilities do not change with unfamiliarity. When an analyst makes investment decisions in foreign (non-U.S.) markets, care must be taken to be sure that the country=s accounting standards are understood and that the fundamentals of the foreign investment market are considered. The same care must be taken with respect to the ethical environment present outside of the U.S. In this regard, the sophistication of the foreign market, the development of the regulatory bodies involved in overseeing the market, and any other pertinent factors must be identified and assessed.

The essentials factors to consider when evaluating the ethical environment present in a non-U.S. market are as follows:

International Aspects
- Market
. sophistication, size, control
- Government
. taxes, support, restrictions
- Environment
. disclosure, GAAP, legal, culture

Compliance Programs

Compliance programs have become an important topic at Level III of the CFA exam. Level III Candidates are expected to understand the responsibilities of supervision and leadership and should be able to devise policies which will promote an ethical environment. These policies should relate the theoretical aspects of ethics with the practical problems of operating in the Areal world@ and should result in an ethical framework that promotes professionalism in the work place.

Creating and maintaining an ethical environment within a financial organization is an important responsibility of CFAs. As leaders in the profession and senior persons in their organizations, CFAs must take responsibility to set the Atone at the top.@ This responsibility includes adequately supervising subordinates and developing an ethical atmosphere within their firms. Level III candidates are assumed to be in these leadership positions, and the questions asked at this level of the exam will require that candidates can demonstrate those qualities. Compliance programs are the final step in the ethical administration of a firm. These programs help promote good ethics!

The establishment of a compliance program requires the support of all senior management of a firm, as well as the firm=s directors. Writing a list of expectations and procedures will clearly communicate to all employees the general support of ethics as well as provide guidelines that establish acceptable employee behavior. Employees must be required to read and understand the established guidelines, and the administration must support the program in reality as well as in theory. The best illustration of administrative support is the appointment of a compliance officer who has the authority to monitor and change, if necessary, a firm=s behavior. The compliance officer must monitor employee behavior and take an active part in communicating the ethical objectives of the firm. The AIMR=s objective in supporting and enforcing sound ethical behavior is not based on retribution against wrongdoers, but educational goals. Penalties that are unreasonably severe are considered as bad as no penalties. The objective of AIMR is to reinforce the awareness that an ethical environment is the best interest of all parties.

The essentials to remember in building a compliance program are detailed below:

Compliance Programs
- Tailor to organization
- Broad support
- Educational vs. Punitive
- Review often

Global Investment Performance Standards

Study Session 17 in the 2002 CFA Level III Study Guide covers Global Investment Performance Standards (GIPS) guidelines as part of the candidate readings on Portfolio Management. These standards provide AIMR=s policies for the fair disclosure of information by firms to their clients and prospects (potential clients). In prior years, including 2002, Level III candidates were also responsible for the information in the AIMR Presentation Performance Standards (PPS) as well as several related candidate readings. This aspect of performance presentation has been dropped from the 2003 Level III exam, indicating the growing importance of global standards to the investment industry. Therefore, Global Investment Performance Standards (GIPS) are a high probability topic on the 2003 Level III exam.

GIPS are divided into five areas. They are:

- Input data
- Calculation methodology
- Composite construction
- Disclosures
- Presentation and reporting

An outline of each of these area is included in the abstract section of the review notes. Please read them carefully.

Both the *Standards of Practice* and the *GIPS* have many details for which Level III Candidates are responsible. There is no substitute for committing to memory the subheadings of the five Standards of Practice and the detailed requirements of GIPS. At Level III, candidates must also be able to read hypothetical situations, recognize violations of the Standards and/or GIPS which have occurred; and identify **and** recognize how to correct the violations.

Summary

In summary, candidates must be able to master the five following aspects of AIMR material:

1. Know the *Standards of Professional Conduct.*
2. Know the requirements of the AIMR *Global Investment Performance Standards.*
3. Understand the need for and importance of the fiduciary duties of investment professionals.
4. Understand the need for and use of compliance programs.
5. Be able to use the above knowledge to assess real-world ethical situations and to write guidelines which would reduce the possibility of unethical behavior.

SELF-TEST QUESTIONS

Question 1: A CFA is responsible to many people. **List** the order of priority.

Question 2: Explain the concept of confidentiality and **discuss** why it is a necessary ethical consideration.

Question 3: List three responsibilities a CFA has to his/her employer.

Question 4: List three requirements a CFA must meet when making an investment recommendation.

Question 5: Explain what plagiarism is and how it can be avoided.

Question 6: Explain why ethical conduct is necessary for CFAs.

Questions 7: Explain what **steps** a CFA must take if he/she encounters an unethical situation.

Question 8: List the differences in global pension management practices..

Question 9: Explain the shift in international sources of capital over the last twenty years..

Question 10: Explain the responsibilities of supervisors according to the Code of Conduct.

Question 11: Explain why a proxy voting procedure is necessary for a firm which manages equity shares.

Question 12: Write a memo that establishes a proxy voting procedure.

Question 13: List and **explain** the step necessary for a good compliance program.

Question 14: In order to establish a compliance program a firm must attain the approval and support of many people. **List** three different groups of people and **explain** the role each group has in a compliance program.

Question 15: Define insider trading and **list** the steps a CFA must take if he/she becomes aware of such an activity.

Question 16: Proxy voting, soft-dollar rules and creating a corporate culture were all the topics of various readings in this study session. **Explain** how each is part of the general fiduciary responsibility of a financial manager.

Suggested Answers to Self-Test Questions

Question 1: Client first, then employer, colleagues and finally self.

Question 2: Confidentiality means the maintenance of silence about a client=s financial information. Such silence is necessary to avoid possible charges of spreading insider information.

Question 3: Obligation to abide by AIMR=s Code of Conduct, disclosure of conflicts and disclosure of additional compensation arrangements.

Question 4: A CFA must form a reasonable basis for a decision, must rely upon their own research, and must maintain independence and objectivity.

Question 5: Plagiarism is the use of research other than one=s own without attribution. An easy way to avoid plagiarism is to cite sources of information used during the decision making process. An exception to this rules makes citing information from universally know sources not necessary.

Question 6: Ethical conduct increases investor confidence and participation in the market, thus increasing market efficiency.

Question 7: A CFA should first confront the person who is participating in any unethical conduct. If the activity does not cease the CFA must discuss the matter with his or her supervisor and keep pursuing the matter up the chain of command of their organization. If the situation is not satisfactorily resolved the CFA should finally contact AIMR=s ethics hotline. At all steps in such a process the CFA should maintain written records of the actions they take.

Question 8: The degree of governmental supervision, governance practices, the structure of the capital market, tax rules, restrictions on investments, legal structure of the pension funds, availability of reliable performance data and cultural attitude all differ in global pension management.

Question 9: Old sources of foreign aid and World Bank loans have been significantly replaced by direct capital market investments.

Question 10: CFAs are responsible for not only their own actions but also for the actions of those they supervise.

Question 11: Fiduciary responsibilities require proxy voting procedures so that the client=s best interests can be maintained.

Question 12: The guidelines should include procedures that identify the individuals responsible for making the decision, a format for reporting the findings to the Board of Trustees and an assertion of the Trustees responsibility. Good decisions include basis financial analysis and sensitivity analysis to resolve conflicting courses of action (sell decisions if the vote goes contrary to desires).

Question 13: Obtaining Board support, a review of the firm=s characteristics, a review of competitor=s programs, the drafting of a program, the implementation of the program and the periodic review of the established program are the six steps of developing a compliance program.

Question 14: The Board of Directors - ethics Astarts at the top@ so it is imperative for the Board to establish and visibly support a compliance program to establish an ethical atmosphere within any firm. Supervisors - monitoring and amending the program is a constant requirement that requires the attention of managers on an every-day basis. Employees - must take the cue of upper level management and strive to develop a personal attitude of ethical behavior.

Question 15: Insider trading is the improper use of non-publicly known information in making investment decisions. As opposed to the development of a trading strategy using the mosaic theory (the putting together of small bits of public information to develop a buy, hold or sell strategy), insider information is non-public in nature. When such information is learned, a CFA must refrain from trading on such information and encourage the wide spread dissemination of such information.

Question 16: Fiduciary responsibilities require financial managers to act in the best interests of the beneficiaries of the funds they manage. Managers must identify all beneficiaries and discuss with them their investment aims. Maximization of returns are not always appropriate goals, but rather, the maximum returns for the appropriate level of risk should be determined. Beneficiaries who need to build wealth over a long period of time can often accept higher levels of risk than beneficiaries who must depend upon the funds for annuities to fund current living expenses. Financial managers should be sure to carefully communicate with beneficiaries and act in their best interests.

In order to best serve beneficiaries, financial managers must follow the **prudent man** rule by acting with due diligence in attending to their responsibilities, taking **care** that their decisions are appropriate for the investment aims of the beneficiaries, and exercising professional **competence** in choosing investment strategies that will minimize risks and maximize returns to the level appropriate to the fund's aims.

Prudent care and competence can often be attained through a portfolio diversification strategy. Financial managers should evaluate all investment options and use a combination of investments which, when evaluated together, will provide for a maximum return for the appropriate level of risk determined by the beneficiary.

Finally, in carrying out their responsibilities, financial managers should limit administrative expenses so that the beneficiaries retain as much of the returns as possible. Expenses can and should include all necessary expenditures necessary for the financial manager to make the best investment selections. However, financial managers should not benefit from such expenditures nor should other beneficiaries of other funds managed by the manager.

Soft-dollar rules involve the last issue discussed above. Financial managers must be very careful when choosing research services to employ when evaluating investment opportunities. Ample research is necessary for the financial manager to maintain a professional competence, but such services should not be priced so as to include side benefits that accrue to the manager. Investment seminars held in airport convention centers at locations easy to travel to are good examples of appropriate research expenses, but seminars held at plush hotels near golf resorts may be in violation of soft-dollar rules.

Proxy voting and the creation of a responsible environment are examples of the **professional care** and **due diligence** that financial managers must exercise if they are to carry out their fiduciary duties. The requirement of **care** requires managers to research investment opportunities before adding those options to a portfolio. The **care** responsibility does not stop once a security is purchased. If the security includes an ownership interest, the financial manager is bound to continue actively participating in that business organization to insure that it continues to be a good portfolio investment. Careful and considered proxy voting is an excellent example of such active participation. The creation of an ethical organization is part of the **due diligence** process. Financial managers must operate in organizations which are equally ethical as themselves. Establishing such an environment allows the financial professional to insure that all his fiduciary responsibilities will be supported.

Study Session 1: Ethical and Professional Standards

Abstract B AIMR Code of Ethics

The *Code of Ethics* is reproduced on page one the *Standards of Practice Handbook.* The code indicates that dealings between members of the AIMR and the public, clients, prospects, employers, employees and fellow members should follow the ethical guidance provided. Integrity, competence, dignity, professionalism, and independence are all qualities which the *Code* indicates should be observed in these relationships. Along with these qualities, the *Code* calls for analysts to be ethical professionals and to maintain their professional competence in all business and personal dealings.

LO 1: *State components of the Code of Ethics.*

Abstract B AIMR Standards of Professional Conduct (pp. 2B7), ***Standards of Practice Handbook***

The Standards are summarized below:

Standard I: Fundamental Responsibilities
A.) Maintain Knowledge and Comply with all Applicable Laws, Rules and Regulations
B.) Not Knowingly Participate or Assist in any Violations of Laws, Rules and Regulations

Standard II: Relationships with and Responsibilities to the Profession
A.) Use of Professional Designation
1. Use in a dignified and judicious manner
2. Encouragement of use
3. Candidates refer to participation in program
B.) Professional Misconduct
C.) Prohibition Against Plagiarism

Standard III: Relationships with and Responsibilities to the Employer
A.) Obligation to Inform Employer of Code and Standards
1. Inform supervisor of obligation to comply with Code and Standards
2. Provide employer with copy of Code and Standards
B.) Duty to Employer
C.) Disclosure of Conflicts to Employer
1. Disclose ownership interests which could interfere with independence
2. Comply with prohibitions imposed by employer if conflict of interest exists
D.) Disclosure of Additional Compensation Arrangements
E.) Responsibilities of Supervisors

Standard IV: Relationships with and Responsibilities to Clients and Prospects

A.) Investment Process
  1. Reasonable basis and representations
     a. diligence and thoroughness
     b. reasonable and adequate basis
     c. avoid material misrepresentations
     d. maintain appropriate records
  2. Research reports
     a. use reasonable judgment
     b. distinguish between fact and opinion
     c. indicate basic characteristics of investment when distributing reports
  3. Independence and objectivity

B.) Interactions with and Responsibilities to Clients and Prospects
  1. Fiduciary duties
  2. Portfolio investment recommendations and actions
     a. determine client=s investment objectives
     b. evaluate portfolio selections
     c. distinguish between fact and opinion
     d. disclose investment processes
  3. Fair dealing
  4. Priority of transactions (first to owners who have)
     a. direct or indirect pecuniary interest
     b. power to vote
     c. power to dispose of security
  5. Preservation of confidentiality
  6. Prohibition against misrepresentation
     a. of services capabilities
     b. of qualifications
     c. of credentials
  7. Disclosure of conflicts to clients and prospects
  8. Disclosure of referral fees

Standard V: Relationships with and Responsibilities to the Investing Public

A.) Prohibition Against Use of Material Nonpublic Information

B.) Performance Presentation
  1. Prohibition against misrepresentations
  2. Fair, accurate and complete presentations

LO 2: *Identify ethical responsibilities in five areas of Standards.*

Abstract B AIMR Standards of Practice Handbook, 8th edition (Preface and pp. 9B264)
This candidate reading contains much of the material upon which past Level III exam questions have been based. Candidates should concentrate their ethics study on a thorough reading of the entire handbook, taking notes for exam review. The following brief review summarizes the material. Close and careful reading of all the individual Standards and the supplementary material included with each Standard is **strongly** recommended (This material is concise and makes for a hard reading assignment, but you must master it in order to complete the CFA program).

On pages 9 through 159, the handbook provides sections that expand on each of the standards, explaining the purpose and scope of the standard, providing applications of the standard, and listing procedures for compliance. Topical studies on Corporate Governance, Soft Dollar Standards, Fiduciary Duty, Insider Trading, and Personal Investing are provided on pages 161 through 243. The last section of the Handbook is a self-administered exam (pages 245 through 264), which provides an excellent overall review for the candidate.

Since the AIMR has its headquarters in America, and U.S. security laws predominate in the CFA curriculum, the international section (page 10B15) is very important. CFA candidates from other countries should know that the Standards require U.S. analysts to abide by a higher code of conduct than what is required under U.S. securities laws. It is the intention of AIMR that CFAs be more critically judged than ordinary analysts and non-U.S. CFAs are required to adhere to the same high standards. The *Code of Ethics* is not normal practice for all financial analysts, but it is the code for CFAs.

LO 3: *Interpret and apply Code and Standard; identify violation; interpret topical studies; identify disciplinary procedures and sanctions.*

Study Session 2: Ethical and Professional Standards

Abstract B AIMR *Standards of Practice Casebook B* AIntroduction@

The AIMR Standards of Practice Casebook begins with a general description of material provided and how to use the material in the casebook in an effective manner. Candidates should be aware, however, that the Standards of Professional Conduct listed on pages 5 through 9 have been ***superseded by the 8th edition of the Standards of Practice Handbook, so the references to Standard sections should be updated by the candidate.***

The four cases that are assigned as candidate readings provide good examples of the types of issues that candidates should expect to see on the Level III exam. AIMR has developed these **examples and discussions** in an attempt to provide better illustrations of the thought processes that candidates should follow when analyzing ethical situations. Candidates should approach the assigned cases as follows. First, quickly read through the case (but not the discussion material). Then carefully read the requirements - - this is the material in ***bold italic print*** that appears at the end of the case narrative, but before the "case discussion" material. Decide what is necessary to meet these requirements. Often you are directed to identify the ethical problems presented, develop solutions to each problem, and write a company policy that would have helped avoid the situation. Once you have done this, return to the case and read it slowly and carefully, and begin your analysis. As you read the case a second time, make notes and circle key words that can be referred to later when you develop your answer.

You should write an answer to each case **before** you read the case discussion. Be sure to read the requirement carefully and decide how you should analyze the case. Then proceed to develop your answer along those guidelines. In the abstracts provided below, an outline of the requirements is first presented. Then a review of the ethical material of each case is included. Candidates should stop reading the review notes at this point and read the case and requirements from the casebook. Once you have developed an outline of the solution to the case, return to this material to see if you have understood the requirements and have developed a format that fully analyzes the case.

Abstract B Hughes, "Tore & Associates"

Requirements: The requirements for this case indicate that your answer should include three basic steps: Adiscuss the violations,@ Astate what actions Waah should recommend@ and Acreate short policy statements.@ Since the requirements list three areas to address, your analysis should identify at least three violations. Three parts are a minimum; you should really structure your answer around four, or even five areas. Notice that the case discussion centers around five areas: the three memo points; Asoft dollars;@ Aproxy voting@ and Adiversification;@ and then includes two other areas of concern: Afiduciary duties@ and Aprocess versus performance.@ You do not need to cover both of these areas, but the general area of fiduciary duty should have come to mind while you read the case.

"Violations:" In the discussion of soft dollars in the memo, most of the firm=s use of such resources are appropriate. The two problem areas are the lack of clear guidelines and policies and the use of soft dollars to pay for spreadsheet and word-processing software. The memo notes on proxy voting are much more of a problem. In this area, Tore generally disregards the requirements that his firm act responsibly in voting proxies. The firm needs to change its entire attitude in this matter. The firm=s diversification seems to generally be sound, but two clients have plan documents that are clear violations of the principles of diversification, and this area must be addressed. Generally, the firm needs a review of fiduciary responsibility and of general procedures. Perhaps the most telling part of the Acase facts@ was the statement that explained that John Tore did not like dealing with administrative matters. This is often true of analysts who desire to spend most of their efforts on substantive market analysis. However, AIMR and the investment profession require more attention to details. This will be stressed in these cases time after time.

Primary Points: Fiduciary duties begin this case discussion. Notice that a general definition is used, and that both applicable standards are cited. Candidates need to identify the point (fiduciary duties), make a statement of actions required, and that write a policy statement. In this first area the action Arequired@ and Apolicy statement@ are very general in nature - - candidates should note that, and copy it on their exam answers. The next three areas are more specific. The discussion of soft dollars requires a statement of what is allowed and what is not allowed. Firms can use soft dollars if they are used for the direct benefit of their clients. Safe harbor provisions allow soft dollar expenditures for research seminars where firm analysts will become better able to determine the best opportunities for their clients. These soft dollars cannot be used for general firm expenses, such as office software. Tore needs to establish clear guidelines in this matter and be certain the requirements are followed carefully. The proxy voting requirements of ERISA dictate that proxies are an asset of the client and should be taken seriously. In this case, Tore & Associates needs to rethink its entire policy and then establish a program of careful consideration and record keeping. Finally, the lack of diversification for two client portfolios is a direct violation of ERISA guidelines, despite the requirements of the plan documents. In this case Tore must take action to inform its client of the violation. Despite the good returns of recent years, the plan provisions are not in the long-term best interests of the policy holders - - Tore=s true clients. The plan provisions need to be changed or Tore needs to resign from the engagement. Generally Tore needs to spend more effort on the administration of its fiduciary duties. Working to provide excellent returns is an important part of Tore=s responsibility, but the fiduciary duties also require attention to other details that Tore seems not to value. Tore must be made to realize this shortcoming and begin a process of more vigorous ethical management.

AIMR Guidance: Standards I and IVB1 provide most of the guidance for this case. A general definition of fiduciaries and of ERISA requirements would also help in demonstrating a candidates knowledge of the guidance available to analyze this material. This case is an excellent example of AIMR=s concern for Aprocess.@ Many ethical cases brought to AIMR=s attention are not the result of dishonest people; they are the result of individuals of firms not completing the administrative details that are required of fiduciary responsibility. This case demonstrates that fact.

Abstract B Huot, AThe Consultant@

Requirements: ADiscuss the actions Vernley could have taken@ and Acreate a plan@ are the two steps needed to answer this problem. A good answer needs to identify the important points of the case and then communicate a specific set of guidelines that should be adopted.

AActions:@ Avoidance and disclosure are the keys to this case. In the first instance, Vernley wants to be sure to avoid conflicts in the future. To do this, he must completely disclose all facts to all parties concerned and then let the various parties decide which facts are important to them. Specifically in this case, Vernley should either avoid investing in energy-related stocks or establish a blind-trust to administer his personal investments. If he does this and communicates his potential conflicts to clients, they will then be able to assess his position and determine for themselves whether he is impartial.

Primary Points: The primary points needed in the plan Vernley needs to create are: the communication of firm policies to employees and clients, the training of ethics needed by employees, and the establishment of a compliance procedure. Remember AIMR is very serious about having members establish complete compliance procedures. If you can demonstrate that you know what steps should be taken to establish and maintain a good compliance program you should be able to select the correct response.

AIMR Guidance: The Acase discussion@ for this case is a bit different in that no specific AIMR Standards are cited, *per se.* Instead, candidates should be certain that they can communicate the basic requirements of a complete compliance program.

Abstract B Holden, APearl Investment Management (A), (B), and (C)

Requirements: AIdentify violations,@ Astate what actions,@ and Amake a short policy statement@ are the key requirements for all three parts of this case. Candidates should evaluate each part in full before proceeding to the next part. You should read through the case and identify each potential violation. Do not merely list all of the violations B develop actions and a policy statement for each violation identified.

AActivities:@ In all three parts of the case, Peter Sherman is too busy to consider carefully the results of his actions. At the start of Part A, Peter needs to take more time with the firm=s policy manual and the CFA material on ethics, and consider his fiduciary responsibilities to his clients and employer. Not considering the implications of one=s actions can lead a person into a complex ethics violation. One of the primary objectives of the AIMR yearly ethical review statement is so that CFAs will stop and consider the actions they have taken in the past year. Often, individuals can correct inappropriate actions more effectively if they take time to reflect on their responsibilities.

In Part A, Peter made the mistake of reading the firm=s policy manual too quickly. He and his supervisor should have discussed the contents thoroughly. Peter also discussed potentially confidential information with his friends in his enthusiasm for his new job. His supervisor should have explained to him the concept of confidentiality. Finally, Peter opened a personal trading account without following compliance procedures. This created a situation in which he could violate insider trading and front running provisions, and breach his fiduciary duties.

In Part B, Peter did not understand fully the tasks he was performing when he reconciled the block trades, and he failed to consult the client=s investment policy statements. These actions indicate that he is not as knowledgeable as he should be in order to fulfil his fiduciary duties. (Knowledge of the skills needed to complete one=s duties properly is an important aspect of an analyst=s duties. Block trades may create problems with front running or soft dollar rules violations.

In Part C of the case, Peter lacked knowledge in the area in which he was working when he developed his research report. He plagiarizes the work of another and does not cite the source of his material. In this instance, Peter is taking credit for work he did not do; he is essentially stealing ideas from another person. He compounds this violation by presenting incomplete material to potential clients. A complete report must contain all information necessary for a complete analysis of the situation Peter and Champa were too hurried to take the care and diligence required of them by their fiduciary duties to their clients.

Primary Points: Part A focuses on the responsibilities of employees and supervisors. Part B is concered with the required knowledge that should be possessed by an investment analyst, both within his area of expertise and the necessary familiarity with a client=s investment strategy. Part D addresses plagiarism and the incomplete work that can result when deadlines necessitate reports to be released before they are complete. In each of these instances, the concept of fiduciary duty is of paramount importance.

AIMR Guidance: Fundamental responsibilities, supervisors= responsibilities, responsibilities of candidates, fiduciary duty, fair dealing, priority of transactions, confidentiality, insider information, using the work of others, having a reasonable basis, distinguishing between fact and opinion, and misrepresentation of services and performance presentation are the issues addressed in the three parts of this case.

Abstract B Van Schyndel, "International Investment Advisors"

Requirements: "Explain what violations,@ Aindicate a proper course of action@ and Aprovide short policy statements@ are the three steps required to solve this case. These steps are consistent requirements, and the most difficult part for candidates should only be the identification of key violations.

"Violations:" Rules governing the use of soft dollars are the key issue in this case, but a thorough analysis good answer will break down the case into multiple points to be considered. The primary issue concerning whether it is appropriate to use soft dollars for research conferences sounds like the Asafe-harbor@ provisions available to firms. However, attendance at conferences by marketing personal makes the use much more suspect and probably indicates that the funds would not be spent towards the clients= best interests. The clients= best interests - fiduciary duty - then becomes the central focus of this case. It is then apparent that the use of soft dollars for the education of marketing personal is inappropriate, as is the use of commissions in the manner that Turbot Fisheries wishes to use its soft dollars.

Primary Points: A general consideration of fiduciary duties is a good way to start the analysis of the case. The answer should then include an evaluation of allowable soft dollar expenditures and development of a general policy about how these expenditures are decided upon. The Turbot situation should include consideration of Aaiding and abetting@ as well as a determination of the advisability of continuing relations with a client that lacks ethical standards. Finally, because the case discusses the concerns of Laura Manning, who is the president of IIA, supervisory responsibilities should be addressed in the solution. Typically, whenever a firm=s top management is introduced in a case, some of the case discussion should revolve around supervisory responsibilities.

AIMR Guidance: Standards I and IIIE provide most of the guidance for this case. Standard IIIE on supervisory responsibilities will probably be an AIMR Standard that can be applied in any CFA III ethics case.

LO 1: *Identify violations of and compliance with the Code and Standards; indicate appropriate action to be taken; identify compliance procedures.*

Abstract B Case Study: ASuitability@

This case involves SEC sanctions against a broker for unsuitable recommendations and excessive trading. The broker used his influence over clients to pursue aggressive, short-term trading strategies that were inconsistent with the clients= investment objectives. The clients involved were unsophisticated, inexperienced, and of limited means. Their objectives were safe, income-producing securities. The broker=s specific actions included investing in U.S. Treasury strips that did not produce the income sought by the clients, inappropriate use of margin accounts (whose interest on the margin loan added to account maintenance costs), excessive concentration of principal in particular securities; and extremely high turnover rates. AIMR Standards require members to consider the appropriateness and suitability of investment recommendations and actions for each portfolio or client, which requires the member to obtain information on client circumstances, investment objectives, and time horizon (to be updated at least annually); consider a client=s risk tolerance; diversify the client=s portfolio when appropriate; and ensure that the client understand the basic characteristics of each investment considered and how that investment will meet the client=s objectives.

LO 2: *Explain noncompliance with Code and Standards and identify compliance procedures.*

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Study Session 17: Portfolio Management B Performance Presentation Standards

Abstract B GIPS Handbook, Edition 1, CFA Candidate Version, pp 1-116 & 146-148 (2002) and Global Investment Performance Standards – Level III Workbook (2002)

These two readings should be considered together when studying this material.

The *need for performance presentation standards* centers on comparability of information among investment management firms. Firms that choose only to present the results of their best performers, exclude accounts terminated because of poor performance, include manager=s performance from a prior firm, or vary the time period of the return to show superior returns are not providing information which allows clients to correctly assess their performance. The two major constituencies benefiting from GIPS are investment management firms and their current and prospective clients.

The AIMR sponsored the development of GIPS to address these issues and to provide a common, accepted set of standards for the calculation and presentation of firms= performance results. The standards are voluntary, but compliance is encouraged. GIPS were adopted by the AIMR Board of Governors in April 1999. GIPS make the presentation of performance easier to satisfy outside the U.S. on a global basis. An overriding objective was to develop and implement a common, accepted set of ethical principles ensuring fair representation and full disclosure in the presentation of performance results globally. Adoption of global standards will facilitate comparisons of investment performance results worldwide and improve the services offered to clients of multi-national firms.

Since the AIMR Global Investment Performance Standards (GIPS) are the only reading for this topic in the 2003 Study Guide, GIPS represent *a high probability source of a question on the 2003 Level III CFA Exam!!* Candidates should read the standards closely and carefully and make detailed notes for future reference.

Global standards were needed for the following reasons:

X Globalization of financial markets and the investment management industry and corresponding need for global standardization for presentation of investment performance.
X Benefit of global standards to prospective clients and asset managers.
X Level playing field in all countries.
X Increased confidence in presentation contents; increased worldwide comparability.

The stated *objectives* of GIPS are as follows:

X Worldwide standard for calculation and presentation of investment performance.

X Accurate and consistent investment performance data.
X Promote global competition among investment firms.
X Global industry self-regulation.

GIPS represent ethical standards for investment performance presentation to ensure fair representation and full disclosure of an investment firm=s performance history. They exist as *minimum* worldwide standards where local or country-specific law, regulation, or industry standards may not exist for investment performance measurement and/or presentation. Countries without investment performance standards are encouraged to adopt GIPS. The Investment Performance Council evaluates and endorse translations of GIPS into a country's local language. For those countries that have existing standards, and adopt GIPS and other requirements in addition to GIPS are evaluated by the Investment Performance Council to determine if their country version of GIPS will be endorsed.

GIPS are divided into five sections: (1) input data; (2) calculation methodology; (3) composite construction; (4) disclosures; and (5) presentation and reporting. Some of the standards are mandatory and others are recommended. As well, there are transition dates for selected standards.

Candidates should read through the specific requirements and recommendations of GIPS on pages 19 through 24. A straightforward explanation of the standards is included in the GIPS Workbook. An outline of the five GIPS sections is provided below:

Input Data

Requirements:

- Data & information needed to support performance presentation & perform calculations must be captured & maintained
- Use market values for portfolio valuations
- Value portfolios at least quarterly. (Monthly beginning 1/1/2001; as of date of external cash flow beginning 1/1/2010
- Use trade-date accounting beginning 1/12005
- Accrual accounting for fixed-income securities & other assets accruing interest
- Accrual accounting for dividends (ex-dividend) beginning 1/1/2005

Recommendations:

- Use same exchange rate for composite & benchmark

Calculation Methodology

Requirements:

- Use total return (including realized & unrealized gains and income)
- Use time-weighted rates of return adjusted for cash flows; geometrically link periodic returns. Adjust for cash flows beginning 1/1/2005; value assets at time of external cash flow beginning 1/1/2010
- Include accrued income in market value of fixed-income securities
- Use beginning-of-period weightings for composites

- Include cash & cash equivalents in total-return calculations
- Calculate performance after deducting trading expenses
- If minimum asset level for portfolios used, exclude all portfolios below that level from composites

Recommendations:

- Calculate returns net of non-reclaimable withholding taxes on dividends, interest & capital gains
- Consistent treatment of performance adjustments for external cash flows

Composite Construction

Requirements:

- Include all fee-paying discretionary portfolios in at least one composite
- Define firm composites by similar objectives/strategies
- Include new portfolios in composites in timely/consistent manner
- Include terminated portfolios up to last full measurement period under management
- Don't switch portfolios in composites without documented changes in client guidelines or redefinition of composite; leave historical record of portfolio with appropriate composite
- Consistent treatment of convertibles/other hybrid securities
- No stand-alone composites of carve-out returns excluding cash; must allocate cash and disclose allocation methodology
- Include only assets under management in composites; no linking with simulated or model portfolios

Recommendations:

- Separate composites for different levels of asset exposure
- Segregate portfolios allowing significant hedging

Disclosures

Requirements:

- Include definition of firm
- Total firm assets each period
- Available list & description of all composites
- Whether settlement date used
- Minimum asset level for inclusion in composite
- Currency used
- Leverage or derivatives
- Whether performance is gross or net of investment management fees
- Treatment of withholding tax
- If composites managed against benchmark, % invested in countries not in benchmark

- Known inconsistencies between selected exchange rate and benchmark exchange rate
- In non-fee-paying portfolios included in composites and % thereof
- Compliance with local laws & regulations that differ from GIPS
- Lack of compliance before 1/1/2000
- Disclosure of cash allocation method for single asset carve-outs

Recommendations:

- Portfolio valuation sources & methods
- Calculation method
- If presented gross-of-fees, disclose fee schedule
- If net-of-fees, disclose average weighted fees
- Significant changes in firm

Presentation & Reporting

Requirements:

- Five years of GIPS compliant performance, increasing to 10 years
- Number of portfolios & asset amounts in composites & % of firm's total assets in each portfolio
- Dispersion around aggregate composite return
- Standard compliance statement
- Composite creation date
- Linking of non-compliant performance permitted if properly disclosed; no non-compliant performance after 1/1/2000
- Annualize periods of less than one year
- Include results of past firm or affiliation only if change in firm ownership or name & supporting records available; no significant change in investment decision-making
- If compliant firm acquired by non-compliant firm, must bring into compliance within one year
- If single-asset carve-outs from multiple asset class composites used for composites, include list of underlying composites and % of each carve-out in performance
- Present total return for benchmark presented; if benchmark not presented, include explanation; disclose changes in benchmark; describe custom benchmarks

Recommendations:

- Pretax composite performance gross of management & custody fees
- Cumulative returns for composites & benchmarks
- Equal-weighted means & median returns
- Volatility of aggregate composite returns
- Inconsistencies in use of exchange rate among portfolios within composite
- Present relevant risk measures for benchmarks and composites

GIPS represent guidelines that firms must follow if they wish to claim compliance with the standards. For those instances in which local or country-specific law or regulation conflicts with GIPS, the standards require compliance with the local law or regulation, with full disclosure of the conflict included in the report. GIPS will evolve over time to address additional aspects of investment performance, and it is likely that some recommended elements will become requirements in the future. As with PPS, GIPS must be applied on a firm-wide basis.

In order for a firm to claim compliance with GIPS, it must meet *all* of the requirements set forth in the standards. Changes in certain requirements, however, will not become effective until a future date to allow firms time to transition. Earlier application prior to the required date is encouraged. Once a firm has met all the required elements of GIPS, it is permitted to include a ACompliance Statement@ on its report. (A sample presentation, including disclosures, is presented as an Appendix to the GIPS.) Verification of compliance must be performed by an independent third-party Averifier.@ Without a report from the verifier, a firm cannot claim compliance with GIPS.

LO 6: *Know objectives, requirements, and recommendations of GIPS; significance of country versions or translations of GIPS; characteristics of GIPS; definition of firms; compliance requirements; verification requirements; and evaluation, critique and construction of a performance presentation that complies with GIPS.*

Problem Review:

Global Investment Performance Standards:

In addition to studying the sample presentations included in the Candidate Readings, Level II candidates should review the following problems:

Sample questions on pages 15-23 of the GIPS Level III Workbook in the Candidate Readings
Question 30 B 2000 CFA Level III Exam
Question 5 B 2001 CFA Level III Exam
Question 4 – 2002 CFA Level III Exam