

# ETHICAL AND PROFESSIONAL STANDARDS STUDY SESSION

# 1

## Ethical and Professional Standards

**T**his study session introduces ethics, related challenges to ethical behavior, and the role played by ethics in the investment profession. A framework to support ethical decision-making is provided to help guide behavior. The CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards) are examined, with attention given to each standard and its application. The session concludes with coverage of the Global Investment Performance Standards.

### READING ASSIGNMENTS

<b>Reading 1</b>	Ethics and Trust in the Investment Profession by Bidhan L. Parmar, PhD, Dorothy C. Kelly, CFA, and David B. Stevens, CIMC, CFA
<b>Reading 2</b>	Code of Ethics and Standards of Professional Conduct <i>Standards of Practice Handbook</i> , Eleventh Edition
<b>Reading 3</b>	Guidance for Standards I–VII <i>Standards of Practice Handbook</i> , Eleventh Edition
<b>Reading 4</b>	Introduction to the Global Investment Performance Standards (GIPS)
<b>Reading 5</b>	Global Investment Performance Standards (GIPS)



## READING

# 1

## Ethics and Trust in the Investment Profession

by Bidhan L. Parmar, PhD, Dorothy C. Kelly, CFA, and David B. Stevens, CIMC, CFA

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### LEARNING OUTCOMES

<b>Mastery</b>	<b>The candidate should be able to:</b>
<input type="checkbox"/>	a. explain ethics;
<input type="checkbox"/>	b. describe the role of a code of ethics in defining a profession;
<input type="checkbox"/>	c. identify challenges to ethical behavior;
<input type="checkbox"/>	d. describe the need for high ethical standards in the investment industry;
<input type="checkbox"/>	e. distinguish between ethical and legal standards;
<input type="checkbox"/>	f. describe and apply a framework for ethical decision making.

## INTRODUCTION

# 1

As a candidate in the CFA Program, you are both expected and required to meet high ethical standards. This reading introduces ideas and concepts that will help you understand the importance of ethical behavior in the investment industry. You will be introduced to various types of ethical issues within the investment profession and learn about the CFA Institute Code of Ethics. Subsequently, you will be introduced to a framework as a way to approach ethical decision making.

Imagine that you are employed in the research department of a large financial services firm. You and your colleagues spend your days researching, analyzing, and valuing the shares of publicly traded companies and sharing your investment recommendations with clients. You love your work and take great satisfaction in knowing that your recommendations can help the firm's investing clients make informed investment decisions that will help them meet their financial goals and improve their lives.

Several months after starting at the firm, you learn that an analyst at the firm has been terminated for writing and publishing research reports that misrepresented the fundamental risks of some companies to investors. You learn that the analyst wrote the reports with the goal of pleasing the management of the companies that were the subjects of the research reports. He hoped that these companies would hire your firm's investment banking division for its services and he would be rewarded with large bonuses for helping the firm increase its investment banking fees. Some clients bought shares based on the analyst's reports and suffered losses. They posted stories on the internet about their losses and the misleading nature of the reports. When the media investigated and published the story, the firm's reputation for investment research suffered. Investors began to question the firm's motives and the objectivity of its research recommendations. The firm's investment clients started to look elsewhere for investment advice, and company clients begin to transfer their business to firms with untarnished reputations. With business declining, management is forced to trim staff. Along with many other hard-working colleagues, you lose your job—through no fault of your own.

Imagine how you would feel in this situation. Most people would feel upset and resentful that their hard and honest work was derailed by someone else's unethical behavior. Yet, this type of scenario is not uncommon. Around the world, unsuspecting employees at such companies as SAC Capital, Stanford Financial Group, Everbright Securities, Enron, Satyam Computer Services, Arthur Andersen, and other large companies have experienced such career setbacks when someone else's actions destroyed trust in their companies and industries.

Businesses and financial markets thrive on trust—defined as a strong belief in the reliability of a person or institution. In a 2013 study on trust, investors indicated that to earn their trust, the top three attributes of an investment manager should be that it (1) has transparent and open business practices, (2) takes responsible actions to address an issue or crisis, and (3) has ethical business practices.<sup>1</sup> Although these attributes are valued by customers and clients in any industry, this reading will explore why they are of particular importance to the investment industry.

People may think that ethical behavior is simply about following laws, regulations, and other rules, but throughout our lives and careers we will encounter situations in which there is no definitive rule that specifies how to act, or the rules that exist may be unclear or even in conflict with each other. Responsible people, including investment professionals, must be willing and able to identify potential ethical issues and create solutions to them even in the absence of clearly stated rules.

## 2

### ETHICS

Through our individual actions, each of us can affect the lives of others. Our decisions and behavior can harm or benefit a variety of **stakeholders**—individuals or groups of individuals who could be affected either directly or indirectly by a decision and thus have an interest, or stake, in the decision. Examples of stakeholders in decisions made by investment industry professionals include our colleagues, our clients, our employers, the communities in which we live and work, the investment profession, and other financial market participants. In some cases, our actions may benefit all of these stakeholder groups; in other cases, our actions may benefit only some stakeholder groups; and in still other cases, our actions may benefit some stakeholder groups and

<sup>1</sup> CFA Institute and Edelman, "Investor Trust Study" (2013): <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n14.1>.

harm others. For example, recall the research analyst in the introduction who wrote misleading research reports with the aim of increasing the financial benefit to himself and his employer. In the very short term, his conduct seemed to directly benefit some stakeholders (certain clients, himself, and his employer) and to harm other stakeholders (clients who invested based on his reports). Over a longer time period, his conduct resulted in harm to himself and many other stakeholders—his employer, his employer’s clients, his colleagues, investors, and through loss of trust when the story was published, the larger financial market.

Ethics encompasses a set of moral principles and rules of conduct that provide guidance for our behavior. The word “ethics” comes from the Greek word “ethos,” meaning character, used to describe the guiding beliefs or ideals characterizing a society or societal group. Beliefs are assumptions or thoughts we hold to be true. A principle is defined as a belief or fundamental truth that serves as the foundation for a system of belief or behavior or a chain of reasoning. Our beliefs form our values—those things we deem to have worth or merit.

**Moral principles** or **ethical principles** are beliefs regarding what is good, acceptable, or obligatory behavior and what is bad, unacceptable, or forbidden behavior. Ethical principles may refer to beliefs regarding behavior that an individual expects of himself or herself, as well as shared beliefs regarding standards of behavior expected or required by a community or societal group.

Another definition of **ethics** is the study of moral principles, which can be described as the study of good and bad behavior or the study of making good choices as opposed to bad choices. The study of ethics examines the role of consequences and personal character in defining what is considered good, or ethical, conduct.

Ethical conduct is behavior that follows moral principles and balances self-interest with both the direct and the indirect consequences of the behavior on others. Ethical actions are those actions that are perceived as beneficial and conforming to the ethical expectations of society. An action may be considered beneficial if it improves the outcomes or consequences for stakeholders affected by the action. Telling the truth about the risks or costs associated with a recommended investment, for example, is an ethical action—that is, one that conforms to the ethical expectations of society in general and clients in particular. Telling the truth is also beneficial; telling the truth builds trust with customers and clients and enables them to make more informed decisions, which should lead to better outcomes for them and higher levels of client/customer satisfaction for you and your employer.

Widely acknowledged ethical principles include honesty, fairness or justice, diligence, and respect for the rights of others. Most societal groups share these fundamental ethical principles and build on them, establishing a shared set of rules regarding how members should behave in certain situations. The principles or rules may take different forms depending on the community establishing them.

Governments and related entities, for example, may establish laws and/or regulations to reflect widely shared beliefs about obligatory and forbidden conduct. Laws and regulations are rules of conduct specified by a governing body, such as a legislature or a regulator, identifying how individuals and entities under its jurisdiction should behave in certain situations. Most countries have laws and regulations governing the investment industry and the conduct of its participants. Differences in laws may reflect differences in beliefs and values.

In some countries, for example, the law requires that an investment adviser act in the best interests of his or her clients. Other countries require that investment professionals recommend investments that are suitable for their clients. Investment advisers and portfolio managers who are required by law to act in their clients’ best interests must always put their clients’ interests ahead of their own or their employers’ interests. An investment adviser who is required by law to act in a client’s best interest must understand the client’s financial objectives and risk tolerance, research

and investigate multiple investment opportunities, and recommend the investment or investment portfolio that is *most* suitable for the client in terms of meeting his or her long-term financial objectives. In addition, the investment adviser would be expected to monitor the client's financial situation and investments to ensure that the investments recommended remain the *best* overall option for meeting the client's long-term financial objectives. In countries with only a suitability requirement, it is legal for investment professionals to recommend a suitable investment to a client even if other, similar suitable investments with lower fees are available. These differences in laws reflect differences in beliefs and values.

Specific communities or societal groups in which we live and work sometimes codify their beliefs about obligatory and forbidden conduct in a written set of principles, often called a **code of ethics**. Universities, employers, and professional associations often adopt a code of ethics to communicate the organization's values and overall expectations regarding member behavior. The code of ethics serves as a general guide for how community members should act. Some communities will also expand on their codes of ethics and adopt explicit rules or standards that identify specific behaviors required of community members. These **standards of conduct** serve as benchmarks for the minimally acceptable behavior of community members and can help clarify the code of ethics. Members can choose behaviors that demonstrate even higher standards. By joining the community, members are agreeing to adhere to the community's code of ethics and standards of conduct. To promote their code of ethics and reduce the incidence of violations, communities frequently display their codes in prominent locations and in written materials. In addition, most communities require that members commit to their codes in writing on an annual or more frequent basis.

Violations of a community's established code of ethics and/or standards of conduct can harm the community in a variety of ways. Violations have the potential to damage the community's reputation among external stakeholders and the general public. Violations can also damage the community's reputation internally and lead to reduced trust among community members and can cause the organization to fracture or splinter from within. To protect the reputation of its membership and limit potential harm to innocent members, the community may take corrective actions to investigate possible violations, repair any damages, and attempt to discipline the violator or, in severe cases, revoke the violator's membership in the community.

CFA Institute is an example of a community with an established code of ethics and standards of conduct. Its members and candidates commit to adhere to shared beliefs about acceptable conduct for individuals participating in the investment industry. These beliefs are presented in the Code of Ethics and Standards of Professional Conduct (Code and Standards), which are included in the CFA Institute *Standards of Practice Handbook*. The Code of Ethics communicates the organization's principles, values, and expectations. For example, the Code states that members and candidates "place the integrity of the investment profession and the interests of clients above their own personal interests." The Standards of Professional Conduct outline minimally acceptable behaviors expected of all CFA Institute members and candidates. For example, one standard requires that "Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests." Another standard requires that "Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively."

CFA Institute members and candidates re-affirm their commitment to adhere to the Code and Standards each year. In addition, to protect the reputation of the community, members and candidates agree to submit a Professional Conduct Statement each year

disclosing conduct that may have violated the Code and Standards. To protect members and candidates, CFA Institute has an established disciplinary process. Members and candidates who violate the Code and Standards are subject to disciplinary action.

**EXAMPLE 1****Ethics**

- 1 Which of the following statements is *most* accurate? Ethics can be described as:
  - A a commitment to upholding the law.
  - B an individual's personal opinion about right and wrong.
  - C a set of moral principles that provide guidance for our behavior.
- 2 Which of the following statements is *most* accurate? Standards of conduct:
  - A are a necessary component of any code of ethics.
  - B serve as a general guide regarding proper conduct by members of a group.
  - C serve as benchmarks for the minimally acceptable behavior required of members of a group.

**Solution to 1:**

C is correct. Ethics can be described as a set of moral principles that provide guidance for our behavior; these may be moral principles shared by a community or societal group.

**Solution to 2:**

C is correct. Standards of conduct serve as benchmarks for the minimally acceptable behavior required of members of a group. Some organizations will adopt only a code of ethics, which communicates the organization's values and overall expectations regarding member behavior. Others may adopt both a code of ethics and standards of conduct. Standards of conduct identify specific behavior required of community members and serve as benchmarks for the minimally acceptable behavior of community members.

**ETHICS AND PROFESSIONALISM****3**

As you progress in your career, you may find that attitudes among your peers vary: Some of your peers may be happy to have a job, others may consider themselves fortunate to find a vocation, and some may consider themselves part of a profession. What are the differences? A job is very simply the work someone does to earn a living. A vocation is a job or occupation to which someone is particularly well suited and is very dedicated. Often, people will refer to a vocation as a calling: They work in service of a cause they consider worthy. A profession is the ultimate evolution of an occupation, resulting from the efforts of members practicing the occupation at a high level and creating a set of ethics and standards of conduct for the entire group. A profession has several characteristics that distinguish it from ordinary occupations. A profession is

- 1 based on specialized knowledge and skills.

- 2 based on service to others.
- 3 practiced by members who share and agree to adhere to a common code of ethics.

Professionals use their specialized knowledge and skills to serve their clients—with whom they have a special relationship and to whom they have a special duty. Clients differ from customers. A customer purchases goods or services in a single transaction or series of transactions and pays for each transaction or series of transactions. A client, in contrast, enters into an ongoing relationship with a professional, hiring the professional to use his or her special knowledge for the benefit of the client, usually for a fee. The relationship between client and professional is based on trust rather than transactions. In exchange for the agreed-on fee, the professional accepts the duty to place the client's interests first at all times.

In any given profession, the code of ethics communicates the shared principles and expected behaviors of its members. In addition to providing members with guidance for decision making, a code of ethics may generate confidence among not only members of the profession but also individuals who are not members of the profession, such as clients, prospective clients, and/or the general public. The code of ethics informs and provides some assurance to the public that the profession's members will use their specialized skills and knowledge in service of others.

Some codes will be enhanced and clarified by the adoption of standards of conduct or specific benchmarks of behavior required of members. These standards may be principle based or rule based. The CFA Institute Code and Standards are an example of principle-based standards; they are based on the shared principles of honesty, integrity, transparency, diligence, and placing client interests first. Rule-based standards are often narrowly defined, applying to specific groups of individuals in specific circumstances. Principle-based standards, such as those of CFA Institute, apply to all candidates and members at all times regardless of title, position, occupation, geographic location, or specific situation.

As a CFA Program candidate, you are expected to act in accordance with the ethical and professional competency responsibilities of the investment profession as expressed in the Code and Standards. The Code and Standards are designed to foster and reinforce a culture of responsibility and professionalism. The Code and Standards apply to all your professional activities, including but not limited to trading securities for yourself and/or others, providing investment advice, conducting research, and performing other investment services.

## EXAMPLE 2

### Ethics and Professionalism

- 1 Which of the following statements *best* describes how professionals use their specialized knowledge and skills? Professionals use their specialized knowledge and skills:
  - A in service to others.
  - B to advance their career.
  - C for the exclusive benefit of their employers.
- 2 Which of the following statements is *most* accurate? A profession's code of ethics:
  - A includes standards of conduct or specific benchmarks for behavior.

- B** ensures that all members of a profession will act ethically at all times.
- C** publicly communicates the shared principles and expected behaviors of a profession's members.

**Solution to 1:**

A is correct. Professionals use specialized knowledge and skills in service to others. Their career and employer may benefit, but those results are not the primary focus of a professional's use of his or her specialized knowledge and skills.

**Solution to 2:**

C is correct. A profession's code of ethics publicly communicates the shared principles and expected behaviors of a profession's members. The existence of a code of ethics does not ensure that all members will behave in a manner consistent with the code and act ethically at all times. A profession will often establish a disciplinary process to address alleged violations of the code of ethics. A profession may adopt standards of conduct to enhance and clarify the code of ethics.

## CHALLENGES TO ETHICAL CONDUCT

# 4

Professionals generally aim to be responsible and to adhere to high moral standards, so what is the benefit of studying ethics? Throughout our careers, we may find ourselves in difficult or at least unfamiliar situations in which an appropriate course of action is not immediately clear and/or there may be more than one seemingly acceptable choice; studying ethics helps us prepare for such situations. This section addresses challenges to engaging in ethical conduct. Failure to acknowledge, understand, or consider these challenges can lead to poor decision making, resulting in unintentional consequences, such as unethical conduct and potential violations of the Code and Standards.

Several challenges can make adherence to ethical conduct difficult. First, people tend to believe that they are ethical people and that their ethical standards are higher than average. Of course, everyone cannot be above average. However, surveys show this belief in above averageness remains. As reported in *A Crisis of Culture* (2013), for example, 71% of surveyed financial services executives rated their firm's reputation for ethical conduct better than the rest of the industry.<sup>2</sup> Among those surveyed, 59% rated the industry's reputation for ethical conduct as positive. In contrast, a survey of global consumer sentiment conducted the same year revealed that only 46% of consumers surveyed trusted financial service providers to do the right thing.<sup>3</sup> In fact, financial services was the least trusted of all industries included in the survey.

These survey results illustrate overconfidence, a common behavioral bias that can lead to faulty decision making. Studies have shown that our beliefs and emotions frequently interfere with our cognitive reasoning and result in behavioral bias, a tendency to behave in a way that is not strictly rational.<sup>4</sup> As a result of the overconfidence bias, we are more likely to overestimate the morality of our own behavior, particularly in situations that we have not faced before. The overconfidence bias can result in a

<sup>2</sup> Economist Intelligence Unit, "A Crisis of Culture: Valuing Ethics and Knowledge in Financial Services," Economist Intelligence Unit Report sponsored by CFA Institute (2013).

<sup>3</sup> CFA Institute and Edelman, "Investor Trust Study" (2013): <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n14.1>.

<sup>4</sup> Max H. Bazerman and Don A. Moore, *Judgment in Managerial Decision Making*, 8th ed. (Hoboken, NJ: John Wiley & Sons, 2013).

failure to consider, explicitly or implicitly, important inputs and variables needed to form the best decision from an ethical perspective. In general, the overconfidence bias leads us to place too much importance on internal traits and intrinsic motivations, such as “I’m honest and would not lie,” even though studies have shown that internal traits are generally not the main determinant of whether or not someone will behave ethically in a given situation.<sup>5</sup>

A second challenge is that decision makers often fail to recognize and/or significantly underestimate the effect of situational influences, such as what other people around them are doing. **Situational influences** are external factors, such as environmental or cultural elements, that shape our thinking, decision making, and behavior. Social psychologists have studied how much situational influences affect our behavior and have found that even good people with honorable motives can and often will be influenced to do unethical things when put into difficult situations.<sup>6</sup> Experiments have shown that even people who consider themselves strong, independent, free thinkers will conform to social pressures in many situations.<sup>7</sup> The bystander effect, for example, demonstrates that people are less likely to intervene in an emergency when others are present. Fortunately, experiments have also shown that situational influences can induce people to act more ethically. For example, people tend to behave more ethically when they think someone else is watching or when there is a mirror placed close to them.<sup>8</sup> The important concept to understand is that situational influences have a very powerful and often unrecognized effect on our thinking and behavior. Thus, learning to recognize situational influences is critical to making good decisions.

Common situational influences in the investment industry that can shape thinking and behavior include money and prestige. One experiment found that simply mentioning money can reduce ethical behavior. In the experiment, participants were less likely to cooperate when playing a game if the game was called the Wall Street Game, rather than the Community Game.<sup>9</sup> In the investment industry, large financial rewards—including individual salaries, bonuses, and/or investment gains—can induce honest and well-intentioned individuals to act in ways that others might not consider ethical. Large financial rewards and/or prestige can motivate individuals to act in their own short-term self-interests, ignoring possible short-term risks or consequences to themselves and others as well as long-term risks or consequences for both themselves and others. Another extremely powerful situational influence is loyalty. Loyalty to supervisors or organizations, fellow employees, and other colleagues can tempt individuals to make compromises and take actions that they would reject under different situational influences or judge harshly when taken by others.

Situational influences often blind people to other important considerations. Bonuses, promotions, prestige, and loyalty to employer and colleagues are examples of situational influences that frequently have a disproportionate weight in our decision making. Our brains more easily and quickly identify, recognize, and consider these short-term situational influences than longer-term considerations, such as a commitment to maintaining our integrity and contributing to the integrity of the financial markets. Although absolutely important, these long-term considerations often have

<sup>5</sup> Lee Ross and Richard E. Nisbett, *The Person and the Situation: Perspectives of Social Psychology* (New York: McGraw-Hill, 1991).

<sup>6</sup> Stanley Milgram, *Obedience to Authority: An Experimental View* (New York: Harper & Row, 1974).

<sup>7</sup> Philip G. Zimbardo, *The Power and Pathology of Imprisonment: Hearings Before Subcommittee No. 3 of the Committee on the Judiciary, 92nd Congress, Corrections: Part II, Prisons, Prison Reform, and Prisoners’ Rights* Congressional Record (Serial No. 15, 25 October 1971).

<sup>8</sup> John M. Darley and C. Daniel Batson, “From Jerusalem to Jericho: A Study of Situational and Dispositional Variables in Helping Behavior,” *Journal of Personality and Social Psychology*, vol. 27, no. 1 (1973): 100–108.

<sup>9</sup> Varda Liberman, Steven M. Samuels, and Lee Ross, “The Name of the Game: Predictive Power of Reputations versus Situational Labels in Determining Prisoner’s Dilemma Game Moves,” *Personality and Social Psychology Bulletin*, vol. 30, no. 9 (September 2004): 1175–1185.

less immediate consequences than situational influences, making them less obvious as factors to consider in a decision and, therefore, less likely to influence our overall decision making. Situational influences shift our brain's focus from the long term to the short or immediate term. When our decision making is too narrowly focused on short-term factors and/or self-interest, we tend to ignore and/or minimize the longer-term risks and/or costs and consequences to ourselves and others, and the likelihood of suffering ethical lapses and making poor decisions increases.

The story of Enron Corporation, a US energy company, illustrates the power of situational influences. In the late 1990s, with approximately 20,000 employees, the company's culture focused on increasing current revenues and the share price without regard for the long-term sustainability or consequences of such a culture. Management received significant stock options, which provided strong motivation to make decisions and take actions that would increase the share price. The focus on share price was inescapable; employees were greeted by the stock ticker in lobbies and elevators and on their computer screens. The focus on share price overshadowed considerations about stakeholders and the long-term sustainability of the business and its profits. Under these situational influences, some senior managers made poor decisions and eventually succumbed to unethical conduct. They devised and adopted complex accounting strategies that inflated revenues, obscured the company's financial performance, and hid billions of dollars in debt. In October 2001, the financial press revealed what Enron's accounting practices had previously concealed. Shares of Enron, which had reached a high of US\$90.75 in mid-2000, fell to less than US\$1 by the end of November 2001. The company, which had claimed revenues of nearly US\$111 billion in 2000, secured a place in the record books as one of the largest bankruptcies in US history. Dozens of former executives and employees were investigated, and many were charged with fraud and/or conspiracy. Sixteen individuals pled guilty, including Chief Financial Officer (CFO) Andrew S. Fastow, who pled guilty to conspiracy, forfeited nearly US\$30 million in cash and property, and was sentenced to six years in prison. After a lengthy investigation and trial, former Chief Executive Officer Jeffrey K. Skilling was convicted in May 2006 of fraud, conspiracy, insider trading, and making false statements. He was sentenced to more than 24 years in prison, a sentence that was eventually reduced to 14 years.<sup>10</sup>

Loyalty to employer and/or colleagues is an extremely powerful situational influence. Our colleagues can influence our thinking and behavior in both positive and negative ways. For example, colleagues may have encouraged you to signal your commitment to your career and high ethical standards by enrolling in the CFA Program. If you work for or with people who are not bound by the Code and Standards, they might encourage you to take actions that are consistent with local law, unaware that the recommended conduct falls short of the Code and Standards.

Well-intentioned firms may adopt or develop strong compliance programs to encourage adherence to rules, regulations, and policies. A strong compliance policy is a good start to developing an ethical culture, but a focus on adherence to rules may not be sufficient. A compliance approach may not encourage decision makers to consider the larger picture and can oversimplify decision making. Taken to the extreme, a strong compliance culture can become another situational influence that blinds employees to other important considerations. In a firm focused primarily on compliance, employees may adopt a "check the box" mentality rather than an ethical decision-making approach. Employees may ask the question "What *can* I do?" rather than "What *should* I do?" At Enron, for example, in compliance with procedures, CFO Fastow dutifully disclosed that he was the owner of several partnerships planning to

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<sup>10</sup> Chairman Kenneth M. Lay was also convicted of fraud, conspiracy, and making false statements. Lay died on 5 July 2006 of heart failure while awaiting sentencing. Because he died before he could appeal the verdict, the convictions were subsequently vacated.

transact business with Enron. With powerful situational influences at work, Fastow and board members focused on “What *can* I do?” rather than “What *should* I do?” Compliance required that Fastow make the ownership disclosures and request approval for the proposed business transactions from Enron’s board of directors, which he did. Board members seemed to focus on the compliance requirements to provide board approval of the proposed transactions rather than considering their obligations to shareholders. In so doing, they neglected to view the issue from a broader perspective and consider “What *should* we do?” Consequently, they failed to recognize that the proposed transactions placed Fastow’s interests in direct conflict with those of his employer and its shareholders. By focusing on the compliance requirements to provide board approval, board members failed to prevent Fastow from engaging in activity that enriched himself at the expense of his employer and its shareholders. The Enron case illustrates both the power of situational influences and the limitations of a compliance approach, which can contribute to overconfidence and is insufficient for ensuring ethical decision making,

### EXAMPLE 3

#### Challenges to Ethical Conduct

- 1 Which of the following will *most likely* determine whether an individual will behave unethically?
  - A The person’s character
  - B The person’s internal traits and intrinsic motivation
  - C External factors, such as environmental or cultural elements
- 2 Which of the following statements is *most* accurate?
  - A Large financial rewards, such as bonuses, are the most powerful situational influences.
  - B When decision making focuses on short-term factors, the likelihood of ethical conduct increases.
  - C Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others.

#### Solution to 1:

C is correct. Social psychologists have shown that even good people may behave unethically in difficult situations. Situational influences, which are external factors (e.g., environmental or cultural elements), can shape our thinking, decision making, and behavior and are more likely to lead to unethical behavior than internal traits or character.

#### Solution to 2:

C is correct. Situational influences can motivate individuals to act in their short-term self-interests without recognizing the long-term risks or consequences for themselves and others. Large financial rewards are powerful situational influences, but in some situations, other situational influences, such as loyalty to colleagues, may be even more powerful.

## THE IMPORTANCE OF ETHICAL CONDUCT IN THE INVESTMENT INDUSTRY

# 5

Why are high ethical standards so important for the investment industry and investment professionals? As the global financial crisis of 2008 demonstrated, isolated and seemingly unimportant individual decisions, such as approving loans to individuals unable to provide proof of stable income, in aggregate can precipitate a market crisis that can lead to economic difficulties and job losses for millions of individuals. In an interconnected global economy and marketplace, each market participant must strive to understand how his or her decisions and actions, and the products and services he or she provides, may affect others not just in the short term but also the long term.

The investment industry serves society by matching those who supply capital, or money, with those who seek capital to finance, or fund, their activities. For simplicity, let us refer to those who supply capital as investors and those who seek capital as borrowers. Borrowers may seek capital to achieve long-term goals, such as building or upgrading factories, schools, bridges, highways, airports, railroads, or other facilities. They may also seek short-term capital to fund short-term goals and/or support their daily operations. Borrowers seeking capital to meet short- and long-term objectives include sovereign entities, businesses, schools, hospitals, companies, and other organizations that serve others. Some borrowers will turn to banks or other lending institutions to finance their activities; others will turn to the financial markets to access the funds they need to achieve their goals.

In exchange for supplying capital to fund the borrowers' endeavors, investors expect that their investments will generate returns that compensate them for the use of their funds and the risks involved. Before providing capital, diligent and disciplined investors will evaluate the risks and rewards of providing the capital. Some risks, such as a downturn in the economy or a new competitor, could adversely affect the returns expected from the investment. To help evaluate the potential risks and rewards of the investment, investors conduct research, reading and evaluating the borrower's financial statements, management's business plan, research reports, industry reports, and competitive analyses. Responsible investors will not invest their capital unless they trust that their capital will be used in the way that has been described and is likely to generate the returns they desire. Investors and society benefit when capital flows to borrowers that can create the most value from the capital through their products and services.

Capital flows more efficiently between investors and borrowers when financial market participants are confident that all parties will behave ethically. Ethical behavior builds and fosters trust, which has benefits for individuals, firms, the financial markets, and society. When people believe that a person or institution is reliable and acts in accordance with their expectations, they are more willing to take risks involving those people and institutions. For example, when people trust their financial advisers, institutions, and the financial markets, they are more likely to invest their money and accept the risk of short-term price fluctuations because they can reasonably believe that their investments will provide them with long-term benefits. Entrepreneurs are more likely to accept the risk of expanding their businesses, and hiring additional employees, if they believe they will be able to attract investors with the funds needed to expand at a reasonable cost. The higher the level of trust in the financial system, the more people are willing to participate in the financial markets. Broad participation in the financial markets enables the flow of capital to fund the growth in goods, services, and infrastructure that benefits society with new and often better hospitals, bridges, products, services, and jobs. Broad participation in the financial markets also means

that the need and demand for investment professionals increase, resulting in more job opportunities for those seeking to use their specialized skills and knowledge of the financial markets in service to others.

Ethics always matter, but ethics are of particular importance in the investment industry because the investment industry and financial markets are built on trust. Trust is important to all business, yet it is especially important in the investment industry for several reasons, including the nature of the client relationship, differences in knowledge and access to information, and the nature of investment products and services.

In the client relationship, investors entrust their assets to financial firms for care and safekeeping. By doing so, clients charge the firm and its employees with a special responsibility; they are putting their faith and trust in the firm and its employees to protect their assets. If the firm and its employees fail to protect clients' assets, it could have severe consequences for those clients. Without trust in that protection, the firm and its employees would not have any business.

Those who work in the investment industry, as well as those who work in other professions, have specialized knowledge and sometimes better access to information. Having specialized knowledge and better access to information is an advantage in any relationship, giving one party more power than the other. Investors trust that the professionals they hire will not use their knowledge to take advantage of them. They rely on the investment professional to use his or her specialized knowledge to serve or benefit their clients' interests.

Another reason why trust is so important in the investment industry has to do with the nature of its products and services. In other industries—such as the transportation industry, the technology industry, the retail industry, or the food industry—companies produce products and/or provide services that are tangible and/or clearly visible. We can hold an electronic tablet in our hands and inspect it. We can use software programs, shop at retailers, dine at restaurant chains, and watch films. We can judge the quality of the product or service based on a variety of factors: How well does it perform its intended function? How efficient is it? How durable is it? How appealing is it? Is the price reasonable or appropriate for the product or service?

In the investment industry, many investments are intangible and appear only as numbers on a page or a screen. Investors cannot hold, inspect, or test their intended purchases as they can a smartphone or a television set, each of which often come with warranties should they fail to function as advertised. Without tangible products to inspect, and with no warranties for protection should the product or service fail to perform as expected, investors must rely on the information provided about the investment—both before and after purchase. When they call their financial adviser and ask to see their investments, they receive either an electronic or printed statement with a list of holdings. They trust that the information is accurate and complete—a fair representation—just as they trust that the investment professionals with whom they are dealing will protect their interests. The globalization of finance also means that investment professionals are likely to have business opportunities in new or unfamiliar places. Without trust, financial transactions, including global transactions, are less likely to occur.

Because of these factors, trust is the very foundation of the financial markets. This trust is built, fostered, and maintained by the ethical actions of all the individuals who work and/or participate in the markets, including those who work for companies, banks, investment firms, sovereign entities, rating agencies, accounting firms, financial advisers and planners, and institutional and retail investors. When market participants act ethically, investors and others can trust that the numbers on the screen or the page are accurate representations and be confident that investing and participating in the financial markets is worthwhile.

Ethical behavior by all market participants can lead to broader participation in the markets, protection of clients' interests, and more opportunities for investment professionals and their firms. Ethical behavior by firms can lead to higher levels of success and profitability for the firms as well as their employees. Clients are attracted to firms with trustworthy reputations, leading to more business, higher revenues, and more profits. Ethical firms may also enjoy lower relative costs than unethical firms because regulators are less likely to have cause to initiate costly investigations or impose significant fines on firms in which high ethical standards are the norm.

Conversely, unethical behavior erodes and can even destroy trust. When clients and investors suspect that they are not receiving accurate information or that the market is not a level playing field, they lose trust. Investors with low trust are less willing to accept risks. They may demand a higher return for the use of their capital, choose to invest elsewhere, or choose not to invest at all. Any of these actions would increase costs for borrowers seeking capital to finance their activities. Without access to capital, borrowers may not be able to meet their goals of building new factories, bridges, or hospitals. Decreases in investments can harm society by reducing jobs, growth, and innovation. Unethical behavior ultimately harms not only clients, but also the firm, its employees, and others.

Diminished trust in financial markets can reduce growth in the investment industry and tarnish the reputation of firms and individuals in the industry, even if they did not participate in the unethical behavior. Unethical behavior interferes with the ability of markets to channel capital to the borrowers that can create the most value from the capital, contributing to economic growth. Both markets and society suffer when unethical behavior destroys trust in financial markets. For you personally, unethical behavior can cost you your job, reputation, and professional stature and can lead to monetary penalties and possibly time in jail.

#### EXAMPLE 4

### The Importance of Ethical Conduct in the Investment Industry

Which of the following statements is *most* accurate? Investment professionals have a special responsibility to act ethically because:

- A the industry is heavily regulated.
- B they are entrusted to protect clients' assets.
- C the profession requires compliance with its code of ethics.

#### Solution:

B is correct. Investment professionals have a special responsibility because clients entrust them to protect the clients' assets.

## ETHICAL VS. LEGAL STANDARDS

# 6

Many times, stakeholders have common ethical expectations. Other times, different stakeholders will have different perceptions and perspectives and use different criteria to decide whether something is beneficial and/or ethical.

Laws and regulations often codify ethical actions that lead to better outcomes for society or specific groups of stakeholders. For example, some laws and regulations require businesses and their representatives to tell the truth. They require specific

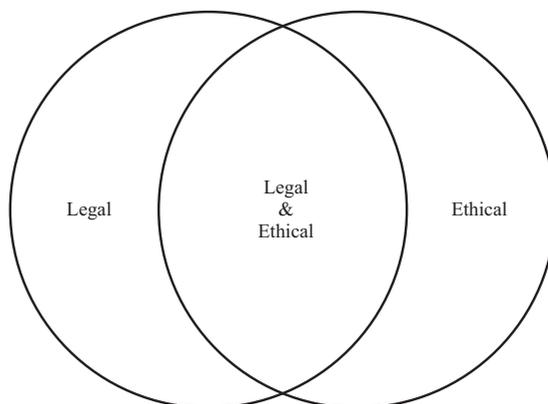
written disclosures in marketing and other materials. Complying with such rules is considered an ethical action; it creates a more satisfactory outcome that conforms to stakeholders' ethical expectations. As an example, consider disclosure requirements mandated by securities regulators regarding the risks of investing. Complying with such rules creates better outcomes for you, your clients, and your employer. First, compliance with the rule reduces the risk that clients will invest in securities without understanding the risks involved, which, in turn, reduces the risk that clients will file complaints and/or take legal action if their investments decline in value. Complying with the rules also reduces the risk that regulators will initiate an investigation, file charges, or/and discipline or sanction you and/or your employer. Any of these actions could jeopardize the reputation and future prospects of you and your employer. Conduct that reduces these risks (e.g., following disclosure rules) would be considered ethical; it leads to better outcomes for you, your clients, and your employer and conforms to the ethical expectations of various stakeholders.

Although laws frequently codify ethical actions, legal and ethical conduct are not always the same. Think about the diagram in Exhibit 1. Many types of conduct are both legal and ethical, but some conduct may be one and not the other. Some legal behaviors or activities may be considered unethical, and some behaviors or activities considered ethical may be deemed illegal in certain jurisdictions. Acts of civil disobedience, such as peaceful protests, may be in response to laws that individuals consider unethical. The act of civil disobedience may itself be considered ethical, and yet it violates existing local laws.

The investment industry has examples of conduct that may be legal but considered by some to be unethical. Some countries, for example, do not have laws prohibiting trading while in possession of material nonpublic information, but many investment professionals and CFA Institute consider such trading unethical.

Another area in which ethics and laws may conflict is the area of "whistleblowing." Whistleblowing refers to the disclosure by an individual of dishonest, corrupt, or illegal activity by an organization or government. Depending on the circumstances, a whistleblower may violate organizational policies and even local laws with the disclosure; thus, a whistleblower's actions may be deemed illegal and yet considered by some to be ethical.

**Exhibit 1** Types of Conduct



Some people advocate that increased regulation and monitoring of the behavior of participants in the investment industry will increase trust in the financial markets. Although this approach may work in some circumstances, the law is not always the

best mechanism to reduce unethical behavior for several reasons. First, laws typically follow market practices; regulators may proactively design laws and regulations to address existing or anticipated practices that may adversely affect the fairness and efficiency of markets or reactively design laws and regulations in response to a crisis or an event that resulted in significant monetary losses and loss of confidence/trust in the financial system. Regulators' responses typically take significant time, during which the problematic practice may continue or even grow. Once enacted, a new law may be vague, conflicting, and/or too narrow in scope. A new law may reduce or even eliminate the existing activity while simultaneously creating an opportunity for a different, but similarly problematic, activity. Additionally, laws vary across countries or jurisdictions, allowing questionable practices to move to places that lack laws relevant to the questionable practice. Laws are also subject to interpretation and compliance by market participants, who may choose to interpret the law in the most advantageous way possible or delay compliance until a later date. For these reasons, laws and regulations are insufficient to ensure the ethical behavior of investment professionals and market participants.

Ethical conduct goes beyond what is legally required and encompasses what different societal groups or communities, including professional associations, consider to be ethically correct behavior. To act ethically, individuals need to be able to think through the facts of the situation and make good choices even in the absence of clear laws or rules. In many cases, there is no simple algorithm or formula that will always lead to an ethical course of action. Ethics requires judgment—the ability to make considered decisions and reach sensible conclusions. Good ethical judgment requires actively considering the interests of stakeholders and trying to benefit multiple stakeholders—clients, family, colleagues, employers, market participants, and so forth—and minimize risks, including reputational risk.

#### EXAMPLE 5

### Ethical vs. Legal Standards

- 1 Which of the following statements is *most* accurate?
  - A All legal behavior is ethical behavior.
  - B Some ethical behavior may be illegal.
  - C Legal standards represent the highest standard.
- 2 Which of the following statements is *most* accurate?
  - A Increased regulations are the most useful means to reduce unethical behavior by market participants.
  - B Regulators quickly design and implement laws and regulations to address practices that adversely affect the fairness and efficiency of markets.
  - C New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

#### Solution to 1:

B is correct. Some ethical behavior may be illegal. Civil disobedience is an example of what may be illegal behavior that some consider to be ethical. Legal and ethical behavior often coincide but not always. Standards of conduct based on ethical principles may represent a higher standard of behavior than the behavior required by law.

**Solution to 2:**

C is correct. New laws designed to reduce or eliminate conduct that adversely affects the markets can create opportunities for different, but similarly problematic, conduct.

**7****ETHICAL DECISION-MAKING FRAMEWORKS**

Laws, regulations, professional standards, and codes of ethics can guide ethical behavior, but individual judgment is a critical ingredient in making principled choices and engaging in appropriate conduct. One strategy to increase trust in the investment industry is to increase the ability and motivation of market participants to act ethically and help them minimize the likelihood of unethical actions. By integrating ethics into the decision-making activities of employees, firms can enhance the ability and the motivation of employees to act ethically, thereby reducing the likelihood of unethical actions. The ability to relate an ethical decision-making framework to a firm's or profession's code of ethics allows investment professionals to bring the principles of the code of ethics to life. An investment professional's natural desire to "do the right thing" can be reinforced by building a culture of integrity in the workplace. Development, maintenance, and demonstration of a strong culture of integrity within the firm by senior management may be the single most important factor in promoting ethical behavior among the firm's employees.

Adopting a code that clearly lays out the ethical principles that guide the thought processes and conduct the firm expects from its employees is a critical first step. But a code of ethics, although necessary, is insufficient. Simply nurturing an inclination to do right is no match for the multitude of daily decisions that investment professionals make. We need to exercise ethical decision-making skills to develop the muscle memory necessary for fundamentally ethical people to make good decisions despite the reality of conflicts and our natural instinct for self-preservation. Just as coaching and practice transform our natural ability to run across a field into the technique and endurance required to run a race, teaching, reinforcing, and practicing ethical decision-making skills prepare us to confront the hard issues effectively. It is good for business, individuals, firms, the industry, and the markets, as well as society as a whole, to engage in the investment management profession in a highly ethical manner. A strong ethical culture that helps honest, ethical people engage in ethical behavior will foster the trust of investors, lead to robust global financial markets, and ultimately benefit society. That is why ethics matter.

When faced with decisions that can affect multiple stakeholders, investment professionals must have a well-developed set of principles; otherwise, their thought processes can lead to, at best, indecision and, at worst, fraudulent conduct and destruction of the public trust. Establishing an ethical framework to guide your internal thought process regarding how to act is a crucial step to engaging in ethical conduct. Investment professionals are generally comfortable analyzing and making decisions from an economic (profit/loss) perspective. Given the importance of ethical behavior in carrying out professional responsibilities, it is also important to analyze decisions and their potential consequences from an ethical perspective. Using a framework for ethical decision making will help investment professionals to effectively examine their choices in the context of conflicting interests common to their professional obligations (e.g., researching and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze and choose options in a way that allows them to meet high standards of ethical behavior. An ethical decision-making framework

provides investment professionals with a tool to help them adhere to a code of ethics. By applying the framework and analyzing the particular circumstances of each available alternative, investment professionals are able to determine the best course of action to fulfill their responsibilities in an ethical manner.

An ethical decision-making framework will help a decision maker see the situation from multiple perspectives and pay attention to aspects of the situation that may be less evident with a short-term, self-focused perspective. The goal of getting a broader picture of a situation is to be able to create a plan of action that is less likely to harm stakeholders and more likely to benefit them. If a decision maker does not know or understand the effects of his or her actions on stakeholders, the likelihood of making a decision and taking action that harms stakeholders is more likely to occur, even if unintentionally. Finally, an ethical decision-making framework helps decision makers justify their actions to a broader audience of stakeholders.

Ethical decision-making frameworks are designed to facilitate the decision-making process for all decisions. They help people look at and evaluate a decision from multiple perspectives, enabling them to identify important issues they might not otherwise consider. Using an ethical decision-making framework consistently will help you develop sound judgment and decision-making skills and avoid making decisions that have unanticipated ethical consequences. Ethical decision-making frameworks come in many forms with varying degrees of detail. A general ethical decision-making framework is shown in Exhibit 2.

#### **Exhibit 2 Ethical Decision-Making Framework**

- Identify: Relevant facts, stakeholders and duties owed, ethical principles, conflicts of interest
- Consider: Situational influences, additional guidance, alternative actions
- Decide and act
- Reflect: Was the outcome as anticipated? Why or why not?

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The ethical decision-making process includes multiple phases, each of which has multiple components. The process is often iterative, and you, the decision maker, may move between phases in an order different from what is presented. For simplicity, we will discuss the phases sequentially. In the initial phase, you will want to identify the important facts that you have available to you, as well as information that you may not have but would like to have to give yourself a more complete understanding of the situation. You will also want to identify the stakeholders—clients, family, colleagues, your employer, market participants, and so forth—and the duties you have to each of them. You will then want to identify relevant ethical principles and/or legal requirements that might apply to the situation. You should also identify any potential conflicts of interest inherent in the situation or conflicts in the duties you hold to others. For example, your duty to your client may conflict with your duty to your employer.

In the second phase of ethical decision making, you will take time to consider the situational influences as well as personal behavioral biases that could affect your thinking and thus decision making. These situational influences and biases could include a desire to please your boss, to be seen as successful by your peers and family, to gain acceptance, to earn a large bonus, and so on. During this phase, you may seek additional guidance from trusted sources—perhaps a family member, colleague, or mentor who can help you think through the situation and help you identify and evaluate alternative actions. You may turn to your compliance department for assistance or you may even consult outside legal counsel. Seeking additional guidance is a critical

step in viewing the situation from different perspectives. You should seek guidance from someone who is not affected by the same situational influences and behavioral biases as you are and can, therefore, provide a fresh perspective. You should also seek guidance from your firm's policies and procedures and the CFA Institute Code and Standards. A helpful technique might be to imagine how an ethical peer or role model might act in the situation.

The next phase of the framework is to make a decision and act. After you have acted on your decision, you should take the time to reflect on and assess your decision and its outcome. Was the outcome what you anticipated? Why or why not? Had you properly identified all the important facts, stakeholders, duties to stakeholders, conflicts of interest, and relevant ethical principles? Had you considered the situational influences? Did you identify personal behavioral biases that might affect your thinking? Had you sought sufficient guidance? Had you considered and properly evaluated a variety of alternative actions? You may want to reflect on the decision multiple times as the immediate and longer-term consequences of your decision and actions become apparent.

The process is often iterative. After identifying the relevant facts and considering situational influences, you may, for example, decide that you cannot make a decision without more information. You may seek additional guidance on how to obtain the information you need. You may also begin considering alternative actions regarding how to proceed based on expectations of what the additional information will reveal, or you may wait until you have more information, reflect on what you have done and learned so far, and start the process over again. Sometimes cases can be complicated and multiple iterations may reveal that no totally acceptable solution can be created. Applying an ethical decision-making framework can help you evaluate the situation so you can make the best possible decision. The next section shows applications of the framework shown in Exhibit 2.

## 7.1 Applying the Framework

To illustrate how the framework could be applied in your career, consider the scenario in Example 6.

### EXAMPLE 6

#### Applying an Ethical Decision-Making Framework I

You have been hired as a junior analyst with a major investment bank. When you join the bank, you receive a copy of the firm's policies as well as training on the policies. Your supervisor is the senior technology analyst for the investment bank. As part of your duties, you gather information, draft documents, conduct analysis, and perform other support functions for the senior analyst.

Your employer is one of several investment banks working on the initial public offering (IPO) of a well-known technology company. The IPO is expected to generate significant revenues for the investment banks participating in the offering. The IPO has been highly anticipated and is in the news every day.

You are thrilled when your supervisor asks you to work on several research projects related to analyzing and valuing the upcoming IPO for investors. You eagerly compile information and draft a one-page outline. You stop to consider what other information you could add to improve the report before proceeding. You realize that you have two excellent contacts in the technology industry who could review your work and provide some additional and potentially valuable perspectives. You draft an email to your contacts reading:

I am working on an analysis and valuation of Big Tech Company for investors. My employer is one of the banks participating in the IPO, and I want to make sure I have considered everything. I was hoping you could give me feedback on the prospects and risks facing Big Tech. Please treat all the attached material as confidential.

Before hitting the send button, you stop and think about the ethical decision-making framework you have studied. You decide to apply the framework and jot down some notes as you work through the process: On the first page, you work through the identification phase and make a list of the relevant facts, stakeholders to whom you owe a duty, potential conflicts of interest, and ethical principles. This list is shown in Exhibit 3.

### Exhibit 3 Identification Phase

- 1 Relevant facts:
  - *Working on the deal/IPO of the decade*
  - *Employer is one of several investment banks working on IPO*
  - *The IPO is highly anticipated*
  - *A successful IPO could lead to additional investment banking deals and revenues for the firm*
  - *Supervisor is relying on me*
  - *Employer has documented policies and procedures*
  - *Industry is regulated, with many rules and regulations in place*
- 2 Stakeholders and duties owed. I have a duty to the following:
  - *Supervisor*
  - *Employer*
  - *Employer's corporate client, the technology company*
  - *Employer's asset management and other investing clients*
  - *Employer's partners in the IPO*
  - *Investors and market participants interested in the IPO*
  - *All capital market participants*
- 3 Conflicts or potential conflicts of interest include the following:
  - *Gathering additional research versus maintaining confidentiality*
  - *Duty to supervisor versus desire to impress*
  - *Duty to corporate client versus duty to other clients of the firm*
  - *The firm's corporate client benefits from a high IPO price whereas the firm's asset management clients would benefit from a low IPO price*
  - *Desire to work on more deals/IPOs versus objective analysis of the investment potential of this deal*
  - *My bonus, compensation, and career prospects are tied to my supervisor's and the IPO's success; duty to employer*
- 4 Ethical principles that are relevant to this situation include the following:
  - *Duty of loyalty to employer*

*(continued)*

**Exhibit 3 (Continued)**

- *Client interests come first*
- *Maintain confidences and confidentiality of information*

On the next page, you write notes relating to the second phase of the framework, considering the various situational factors and the guidance available to you before considering alternative actions. These notes are shown in Exhibit 4.

**Exhibit 4 Consideration Phase**

- 1 Situational influences:
  - *The firm's written policies*
  - *The bank will earn big fees from the IPO*
  - *I want to impress my boss—and potential future bosses*
  - *My bonus, compensation, and career prospects will be influenced by my contribution to this deal and other deals*
  - *I am one of very few people working on this deal; it is a real honor, and others would be impressed that I am working on this deal*
  - *My employer is filled with successful and wealthy people who are go-getters; I want to be successful and wealthy like them*
- 2 Additional guidance. I could seek guidance from the following:
  - *The firm's code of ethics*
  - *The firm's written policies*
  - *A peer in my firm*
  - *My supervisor, the senior analyst*
  - *The compliance department*
  - *A mentor either at the firm or perhaps from university*
  - *The CFA Institute Code and Standards*
- 3 Alternative actions. I could consider the following:
  - *Asking contacts what they have heard*
  - *Submitting the report as a draft and suggesting that contacts in the industry might be able to provide more perspective*
  - *Sending a survey to various technology industry veterans soliciting their viewpoints on developments*

After completing these steps, you decide to check the firm's policies. Under a section entitled "Research Analyst Role in Securities Offerings," the manual states, "You may not distribute any written (which include email, fax, electronic, and other means) material related to companies and/or their offerings . . . during the course of any offering and the related quiet period."

You read further and note a section entitled "Wall Crossing Policy and Procedures" that states that "employees with confidential information may not communicate the information to anyone who does not have a valid need to know" without first obtaining clearance from the legal and compliance department.

You decide that your contacts do not have a “valid need to know” and that it is unlikely the firm’s legal and compliance professionals would approve sharing the information. You then decide to mention your contacts to the senior research analyst. He suggests that they may have some useful perspective and that you might talk to them to hear their perspective and cautions you not to disclose any information about any of the firm’s clients, pending deals, or research. You return to your desk, delete the email, and following the senior research analyst’s advice, call your contacts on the telephone to discuss the technology sector, its prospects, and its challenges. During the calls, you take care not to reveal any details about Big Tech Company or its offering.

Whatever action you take, you should take time afterward to reflect on the decision and the outcome. Was the outcome as anticipated? Why or why not?

The initial facts presented in the example are based on the real-life experience of a young junior analyst working on a highly anticipated IPO. The junior analyst may or may not have used an ethical decision-making framework to evaluate his situation. Without seeking additional guidance, the junior analyst sent an email similar to the one in the example with an attachment that included confidential, proprietary information, including the senior analyst’s analysis and forecasts. Months later, long after the IPO offering, the junior analyst’s email was discovered by his employer. When questioned, he admitted that he had received training regarding the firm’s policies and that he did not discuss or seek approval from anyone before sending the email. Two days later, the firm terminated the junior analyst’s employment and reported to regulatory authorities that he had been terminated for distributing written materials, by email, during a securities offering in violation of firm policies that prohibit the dissemination of any written materials during the course of a securities offering and related periods. The junior analyst’s supervisor also lost his job for failing to properly supervise the analyst. Multiple regulators investigated the matter, and the firm was fined millions of dollars for failing to supervise its employees properly. The information regarding the junior analyst’s termination was posted and remains available on the regulator’s website for all to see. Future employers conducting routine background checks will know that the analyst was terminated for violating firm policies relating to a securities offering.

The example presented is similar to situations faced by many analysts. Using an ethical decision-making framework will help you evaluate situations from multiple perspectives, avoid poor decision making, and avoid the consequences that can result from taking an ill-conceived course of action. Using an ethical decision-making framework is no guarantee of a positive outcome but may help you avoid making unethical decisions.

#### **EXAMPLE 7**

### **Applying an Ethical Decision-Making Framework II**

A financial adviser has been saving a portion of his salary to purchase a new vehicle. He is on track to have enough saved within the next three months. His employer has offered a special bonus for this quarter, which will go to the team that attracts the most new investors into the firm’s investment funds. In addition to the potential bonus, the firm pays a 5% commission to employees who sell shares in the firm’s investment funds. Several of the funds are highly rated, including one designed to provide steady income to investors.

The financial adviser has added only a few new investors to the firm's funds, but his teammates have been very successful in their efforts. The end of the quarter is one week away, and his team is competing closely with another team for the bonus. One of his teammates informs the financial adviser that he really needs the bonus so his elderly mother can receive medical treatment.

Later that day, the financial adviser meets with an elderly client on a limited income who is seeking more income from his investment portfolio. The client is 89 years old and in poor health. According to the client's will, the client's investment portfolio will go to his favorite charity upon his death.

- 1 Which of the following situational influences is likely to have the *most* effect on the financial adviser's efforts to get new clients to invest in the funds? His relationship with his:
  - A client.
  - B employer.
  - C teammates.
- 2 Which of the following statements is *most* accurate? An ethical decision-making framework:
  - A is only beneficial when a firm lacks a code of ethics.
  - B is used to improve compliance with laws and regulations.
  - C is a tool for analyzing the potential alternative actions and consequences of a decision.
- 3 Which of the following is *most* accurate? Ethical decision-making frameworks:
  - A raise awareness of different perspectives.
  - B focus attention on short-term consequences.
  - C allocate more weight to those who will directly benefit from the decision.
- 4 Which of the following is *most* accurate? Ethical decision-making frameworks:
  - A are not needed if behavior is legal.
  - B identify who gains the most from a decision.
  - C can help reduce unanticipated ethical lapses and unexpected consequences.
- 5 Using an ethical decision-making framework, which of the following duties would *most likely* take precedence in the scenario described? The financial adviser's duty to his:
  - A client.
  - B employer.
  - C colleagues.
- 6 Using an ethical decision-making framework, the financial adviser would *most likely*:
  - A recommend that the elderly client invest at least some of his assets in the highly rated fund.
  - B research other investments that can provide steady income before making a recommendation to his elderly client.
  - C disclose the commission he would earn before recommending that the elderly client invest at least some of his assets in the highly rated fund.

**Solution to 1:**

C is correct. The financial adviser's relationship with his teammates is likely to have the most effect on the financial adviser's efforts.

**Solution to 2:**

C is correct. An ethical decision-making framework is a tool for analyzing the potential alternative actions and consequences of a decision.

**Solution to 3:**

A is correct. Ethical decision-making frameworks raise awareness of different perspectives.

**Solution to 4:**

C is correct. Ethical decision-making frameworks can help avoid unanticipated ethical consequences.

**Solution to 5:**

A is correct. Using an ethical decision-making framework, the financial adviser's relationship with his client would most likely take precedence in this scenario. The adviser should put his client's interests first. The exception to client interests taking precedence occurs when market integrity effects take precedence.

**Solution to 6:**

B is correct. Using an ethical decision-making framework, the financial adviser would identify the relevant facts, stakeholders, duties owed, and potential conflicts. In this scenario, the financial adviser owes a duty to his client as well as his employer. His client's interests take precedence over all other interests. The bonus and his colleague's desire to help his mother are situational influences. To navigate this situation, the financial adviser should seek additional information; he should research the risk and return parameters and fee structures of other investments that can provide steady income before making a recommendation to his client.

## CONCLUSION

# 8

This reading introduced ideas and concepts that will help you understand the importance of ethical behavior in the investment industry as well as the challenges to adhering to high ethical standards. A code of ethics will communicate an organization's values and the expected behavior of its members as well as provide guidance for decision making. A code of ethics may be further enhanced and clarified by the adoption of standards of conduct. An ethical decision-making framework combined with a code of ethics may help investment professionals analyze their decisions in a way that identifies potential conflicts and negative consequences.

Knowing the rules to apply in a particular situation, although important, may not be sufficient to ensure ethical conduct if used alone. Responsible professionals in the investment industry must be able both to recognize areas that are prone to ethical pitfalls and to identify and process those circumstances and influences that can impair judgment and lead to ethical lapses.

## SUMMARY

- Ethics refers to the study of making good choices. Ethics encompasses a set of moral principles and rules of conduct that provide guidance for our behavior.
- Situational influences are external factors that may shape our behavior.
- Challenges to ethical behavior include being overconfident in our own morality, underestimating the effect of situational influences, and focusing on the immediate rather than long-term outcomes or consequences of a decision.
- In any given profession, the code of ethics publicly communicates the established principles and expected behavior of its members.
- Members of a profession use specialized knowledge and skills to serve others; they share and agree to adhere to a common code of ethics to serve others and advance the profession.
- A code of ethics helps foster public confidence that members of the profession will use their specialized skills and knowledge to serve their clients and others.
- High ethical standards always matter and are of particular importance in the investment industry, which is based almost entirely on trust. Clients trust investment professionals to use their specialized skills and knowledge to serve clients and protect client assets. All stakeholders gain long-term benefits when investment professionals adhere to high ethical standards.
- Rules and laws often codify ethical actions that lead to better outcomes for society or specific groups of stakeholders.
- Organizations and individuals generally adhere to legal standards, but legal standards are often created to address past ethical failings and do not provide guidance for an evolving and increasingly complex world.
- Legal standards are often rule based. Ethical conduct goes beyond legal standards, balancing self-interest with the direct and indirect consequences of behavior on others.
- A framework for ethical decision making can help people look at and evaluate a decision from different perspectives, enabling them to identify important issues, make wise decisions, and limit unintended consequences.

## PRACTICE PROBLEMS

- 1 Benchmarks for minimally acceptable behaviors of community members are:
  - A a code of ethics.
  - B laws and regulations.
  - C standards of conduct.
- 2 Specialized knowledge and skills, a commitment to serve others, and a shared code of ethics *best* characterize a(n):
  - A vocation.
  - B profession.
  - C occupation.
- 3 Which of the following *best* identifies an internal trait that may lead to poor ethical decision making?
  - A Overconfidence
  - B Loyalty to employer
  - C Promise of money or prestige
- 4 Situational influences in decision making will *most likely* be minimized if:
  - A strong compliance programs are in place.
  - B longer-term consequences are considered.
  - C individuals believe they are truthful and honest.
- 5 Decision makers who use a compliance approach are *most likely* to:
  - A avoid situational influences.
  - B oversimplify decision making.
  - C consider more factors than when using an ethical decision-making approach.
- 6 When unethical behavior erodes trust in an investment firm, that firm is *more likely* to experience:
  - A lower revenues only.
  - B higher expenses only.
  - C lower revenues and higher expenses.
- 7 Which is an example of an activity that may be legal but that CFA Institute considers unethical?
  - A Making legally required disclosures in marketing materials
  - B Trading while in possession of material nonpublic information
  - C Disclosure by an employee of his or her own company's dishonest activity
- 8 An ethical decision-making framework will *most likely*:
  - A include a pre-determined, uniform sequence.
  - B focus exclusively on confirmable facts and relationships.
  - C help avoid a decision that has unanticipated ethical consequences.

## SOLUTIONS

- 1 C is correct. Standards of conduct are applied to specific communities or societal groups and identify specific behaviors required of community members. These standards of conduct serve as benchmarks for the minimally acceptable behavior of community members. Codes of ethics serve as a general guide for how community members should act; they communicate the organization's values and overall expectations regarding member behavior, but they do not identify specific behaviors required of community members. Laws and regulations are rules of conduct defined by governments and related entities about obligatory and forbidden conduct broadly applicable for individuals and entities under their jurisdiction.
- 2 B is correct. A profession has several characteristics that distinguish it from an occupation or vocation, such as specialized knowledge and skills, service to others, and a code of ethics shared by its members. A profession is the ultimate evolution of an occupation, resulting from excellence in practice and expected adherence to a code of ethics and standards of practice.
- 3 A is correct. An overconfidence bias can lead individuals to put too much importance on internal traits and intrinsic motivations, such as their own perceptions of personal honesty, that can lead to faulty decision making. Loyalty to an employer and promise of money or prestige are situational influences that can lead to faulty decision making.
- 4 B is correct. Consciously considering long-term consequences will help offset situational influences. We more easily recognize and consider short-term situational influences than longer-term considerations because longer-term considerations have fewer immediate consequences than situational influences do. When decision making is too narrowly focused on short-term factors, we tend to ignore longer-term risks and consequences, and the likelihood of poor ethical decision making increases. A strong compliance policy is a good first step toward developing an ethical culture; a focus on rules adherence may not be sufficient. Emphasis on compliance may not encourage decision makers to consider the larger picture and can oversimplify decision making. Taken to the extreme, a strong compliance culture can become another situational influence that blinds employees to other important considerations. An overconfidence bias can place too much importance on internal traits and intrinsic motivations, such as "I'm honest and would not lie," even though studies have shown that internal traits are generally not the main determinant of whether or not someone will behave ethically in a given situation.
- 5 B is correct. A compliance approach can oversimplify decision making and may not encourage decision makers to consider the larger picture. A strong compliance culture may be a good start in developing an ethical culture but can become another situational influence that may result in employees failing to consider other important factors.
- 6 C is correct. Unethical behavior ultimately harms investment firms. Clients are not attracted if they suspect unethical behavior, leading to less business and lower revenues. Investment firms may also experience higher relative costs because regulators are more likely to have cause to initiate costly investigations.

- 7 B is correct. The investment industry has examples of conduct that may be legal but that CFA Institute considers unethical. Trading while in possession of material nonpublic information is not prohibited by law worldwide and can, therefore, be legal, but CFA Institute considers such trading unethical.
- 8 C is correct. Using an ethical decision-making framework consistently will help you develop sound judgment and decision-making skills and avoid making decisions that have unanticipated ethical consequences. The decision-making process is often iterative, and the decision maker may move between phases of the framework. A decision maker should consider more than confirmable facts and relationships; for example, the decision maker should consider situational influences and personal biases.



## READING

# 2

## Code of Ethics and Standards of Professional Conduct

### LEARNING OUTCOMES

<i>Mastery</i>	<i>The candidate should be able to:</i>
<input type="checkbox"/>	a. describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards;
<input type="checkbox"/>	b. state the six components of the Code of Ethics and the seven Standards of Professional Conduct;
<input type="checkbox"/>	c. explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard.

### PREFACE

The *Standards of Practice Handbook (Handbook)* provides guidance to the people who grapple with real ethical dilemmas in the investment profession on a daily basis; the *Handbook* addresses the professional intersection where theory meets practice and where the concept of ethical behavior crosses from the abstract to the concrete. The *Handbook* is intended for a diverse and global audience: CFA Institute members navigating ambiguous ethical situations; supervisors and direct/indirect reports determining the nature of their responsibilities to each other, to existing and potential clients, and to the broader financial markets; and candidates preparing for the Chartered Financial Analyst (CFA) examinations.

Recent events in the global financial markets have tested the ethical mettle of financial market participants, including CFA Institute members. The standards taught in the CFA Program and by which CFA Institute members and candidates must abide represent timeless ethical principles and professional conduct for all market conditions. Through adherence to these standards, which continue to serve as the model for ethical behavior in the investment profession globally, each market participant does his or her part to improve the integrity and efficient operations of the financial markets.

The *Handbook* provides guidance in understanding the interconnectedness of the aspirational and practical principles and provisions of the Code of Ethics and Standards of Professional Conduct (Code and Standards). The Code contains high-level aspirational ethical principles that drive members and candidates to create a

positive and reputable investment profession. The Standards contain practical ethical principles of conduct that members and candidates must follow to achieve the broader industry expectations. However, applying the principles individually may not capture the complexity of ethical requirements related to the investment industry. The Code and Standards should be viewed and interpreted as an interwoven tapestry of ethical requirements. Through members' and candidates' adherence to these principles as a whole, the integrity of and trust in the capital markets are improved.

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

Generally, changes to the Code and Standards over the years have been minor. CFA Institute has revised the language of the Code and Standards and occasionally added a new standard to address a prominent issue of the day. For instance, in 1992, CFA Institute added the standard addressing performance presentation to the existing list of standards.

Major changes came in 2005 with the ninth edition of the *Handbook*. CFA Institute adopted new standards, revised some existing standards, and reorganized the standards. The revisions were intended to clarify the requirements of the Code and Standards and effectively convey to its global membership what constitutes “best practice” in a number of areas relating to the investment profession.

The Code and Standards must be regularly reviewed and updated if they are to remain effective and continue to represent the highest ethical standards in the global investment industry. CFA Institute strongly believes that revisions of the Code and Standards are not undertaken for cosmetic purposes but to add value by addressing legitimate concerns and improving comprehension.

Changes to the Code and Standards have far-reaching implications for the CFA Institute membership, the CFA Program, and the investment industry as a whole. CFA Institute members and candidates are *required* to adhere to the Code and Standards. In addition, the Code and Standards are increasingly being adopted, in whole or in part, by firms and regulatory authorities. Their relevance goes well beyond CFA Institute members and candidates.

## Standards of Practice Handbook

The periodic revisions of the Code and Standards have come in conjunction with updates of the *Standards of Practice Handbook*. The *Handbook* is the fundamental element of the ethics education effort of CFA Institute and the primary resource for guidance in interpreting and implementing the Code and Standards. The *Handbook* seeks to educate members and candidates on how to apply the Code and Standards to their professional lives and thereby benefit their clients, employers, and the investing public in general. The *Handbook* explains the purpose of the Code and Standards and how they apply in a variety of situations. The sections discuss and amplify each standard and suggest procedures to prevent violations.

Examples in the “Application of the Standard” sections are meant to illustrate how the standard applies to hypothetical but factual situations. The names contained in the examples are fictional and are not meant to refer to any actual person or entity. Unless otherwise stated (e.g., one or more people specifically identified), individuals in each example are CFA Institute members and holders of the CFA designation. Because factual circumstances vary so widely and often involve gray areas, the explanatory material and examples are not intended to be all inclusive. Many examples set forth in the application sections involve standards that have legal counterparts; *members*

*are strongly urged to discuss with their supervisors and legal and compliance departments the content of the Code and Standards and the members' general obligations under the Code and Standards.*

CFA Institute recognizes that the presence of any set of ethical standards may create a false sense of security unless the documents are fully understood, enforced, and made a meaningful part of everyday professional activities. The *Handbook* is intended to provide a useful frame of reference that suggests ethical professional behavior in the investment decision-making process. This book cannot cover every contingency or circumstance, however, and it does not attempt to do so. The development and interpretation of the Code and Standards are evolving processes; the Code and Standards will be subject to continuing refinement.

## Summary of Changes in the Eleventh Edition

The comprehensive review of the Code and Standards in 2005 resulted in principle requirements that remain applicable today. The review carried out for the eleventh edition focused on market practices that have evolved since the tenth edition. Along with updates to the guidance and examples within the *Handbook*, the eleventh edition includes an update to the Code of Ethics that embraces the members' role of maintaining the social contract between the industry and investors. Additionally, there are three changes to the Standards of Professional Conduct, which recognize the importance of proper supervision, clear communications with clients, and the expanding educational programs of CFA Institute.

### *Inclusion of Updated CFA Institute Mission*

The CFA Institute Board of Governors approved an updated mission for the organization that is included in the Preamble to the Code and Standards. The new mission conveys the organization's conviction in the investment industry's role in the betterment of society at large.

#### **Mission:**

To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

### *Updated Code of Ethics Principle*

One of the bullets in the Code of Ethics was updated to reflect the role that the capital markets have in the greater society. As members work to promote and maintain the integrity of the markets, their actions should also help maintain the social contract with investors.

#### **Old:**

Promote the integrity of and uphold the rules governing capital markets.

#### **New:**

Promote the integrity and viability of the global capital markets for the ultimate benefit of society.

***New Standard Regarding Responsibilities of Supervisors [IV(C)]***

The standard for members and candidates with supervision or authority over others within their firms was updated to bring about improvements in preventing illegal and unethical actions from occurring. The prior version of Standard IV(C) focused on the detection and prevention of violations. The updated version stresses broader compliance expectations, which include the detection and prevention aspects of the original version.

***Old:***

Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

***New:***

Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

***Additional Requirement under the Standard for Communication with Clients and Prospective Clients [V(B)]***

Given the constant development of new and exotic financial instruments and strategies, the standard regarding communicating with clients now includes an implicit requirement to discuss the risks and limitations of recommendations being made to clients. The new principle and related guidance take into account the fact that levels of disclosure will differ between products and services. Members and candidates, along with their firms, must determine the specific disclosures their clients should receive while ensuring appropriate transparency of the individual firms' investment processes.

***Addition:***

Disclose to clients and prospective clients significant limitations and risks associated with the investment process.

***Modification to Standard VII(A)***

Since this standard was developed, CFA Institute has launched additional educational programs. The updated standard not only maintains the integrity of the CFA Program but also expands the same ethical considerations when members or candidates participate in such programs as the CIPM Program and the CFA Institute Investment Foundations certificate program. Whether participating as a member assisting with the curriculum or an examination or as a sitting candidate within a program, we expect them to engage in these programs as they would participate in the CFA Program.

***Old:***

Conduct as Members and Candidates in the CFA Program

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

**New:****Conduct as Participants in CFA Institute Programs**

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

**General Guidance and Example Revision**

The guidance and examples were updated to reflect practices and scenarios applicable to today's investment industry. Two concepts that appear frequently in the updates in this edition relate to the increased use of social media for business communications and the use of and reliance on the output of quantitative models. The use of social media platforms has increased significantly since the publication of the tenth edition. And although financial modeling is not new to the industry, this update reflects upon actions that are viewed as possible contributing factors to the financial crises of the past decade.

**CFA Institute Professional Conduct Program**

All CFA Institute members and candidates enrolled in the CFA Program are required to comply with the Code and Standards. The CFA Institute Board of Governors maintains oversight and responsibility for the Professional Conduct Program (PCP), which, in conjunction with the Disciplinary Review Committee (DRC), is responsible for enforcement of the Code and Standards. The DRC is a volunteer committee of CFA charterholders who serve on panels to review conduct and partner with Professional Conduct staff to establish and review professional conduct policies. The CFA Institute Bylaws and Rules of Procedure for Professional Conduct (Rules of Procedure) form the basic structure for enforcing the Code and Standards. The Professional Conduct division is also responsible for enforcing testing policies of other CFA Institute education programs as well as the professional conduct of Certificate in Investment Performance Measurement (CIPM) certificants.

Professional Conduct inquiries come from a number of sources. First, members and candidates must self-disclose on the annual Professional Conduct Statement all matters that question their professional conduct, such as involvement in civil litigation or a criminal investigation or being the subject of a written complaint. Second, written complaints received by Professional Conduct staff can bring about an investigation. Third, CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or another public source. Fourth, candidate conduct is monitored by proctors who complete reports on candidates suspected to have violated testing rules on exam day. Lastly, CFA Institute may also conduct analyses of scores and exam materials after the exam, as well as monitor online and social media to detect disclosure of confidential exam information.

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

If the member or candidate does not accept the charges and proposed sanction, the matter is referred to a panel composed of DRC members. Panels review materials and presentations from Professional Conduct staff and from the member or candidate. The panel's task is to determine whether a violation of the Code and Standards or testing policies occurred and, if so, what sanction should be imposed.

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

## Adoption of the Code and Standards

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

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

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

CFA Institute welcomes public acknowledgement, when appropriate, that firms are complying with the CFA Institute Code of Ethics and Standards of Professional Conduct and encourages firms to notify us of the adoption plans. For firms that would like to distribute the Code and Standards to clients and potential clients, attractive one-page copies of the Code and Standards, including translations, are available on the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)).

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

## Acknowledgments

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

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

field, including brokers, investment advisers, banks, and insurance companies. In most instances, the SPC members have important supervisory responsibilities within their firms.

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

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

The SPC has spent countless hours reviewing and discussing revisions to the Code and Standards and updates to the guidance that make up the eleventh edition of the *Handbook*. Following is a list of the current and former members of the SPC who generously donated their time and energy to this effort.

James E. Hollis III, CFA, Chair

Rik Albrecht, CFA

Terence E. Burns, CFA

Laura Dagan, CFA

Samuel B. Jones, Jr., CFA

Ulrike Kaiser-Boeing, CFA

Jinliang (Jack) Li, CFA

Christopher C. Loop, CFA,

James M. Meeth, CFA

Guy G. Rutherford, Jr., CFA

Edouard Senechal, CFA

Wenliang (Richard) Wang, CFA

Peng Lian Wee, CFA

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## ETHICS AND THE INVESTMENT INDUSTRY

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

### Why Ethics Matters

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

Not only does unethical behavior by individuals have serious personal consequences—ranging from job loss and reputational damage to fines and even jail—but unethical conduct from market participants, investment professionals, and those who service investors can damage investor trust and thereby impair the sustainability of

the global capital markets as a whole. Unfortunately, there seems to be an unending parade of stories bringing to light accounting frauds and manipulations, Ponzi schemes, insider-trading scandals, and other misdeeds. Not surprisingly, this has led to erosion in public confidence in investment professionals. Empirical evidence from numerous surveys documents the low standing in the eyes of the investing public of banks and financial services firms—the very institutions that are entrusted with the economic well-being and retirement security of society.

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

### ***Ethics, Society, and the Capital Markets***

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

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

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

### ***Capital Market Sustainability and the Actions of One***

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

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

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

### ***The Relationship between Ethics and Regulations***

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

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

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

### ***Applying an Ethical Framework***

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

Most investment professionals are used to making decisions from a business (profit/loss) outlook. But given the importance of ethical behavior in carrying out professional responsibilities, it is critical to also analyze decisions and potential conduct from an ethical perspective. Utilizing a framework for ethical decision making will help investment professionals effectively examine their conduct in the context of conflicting interests common to their professional obligations (e.g., researching

and gathering information, developing investment recommendations, and managing money for others). Such a framework will allow investment professionals to analyze their conduct in a way that meets high standards of ethical behavior.

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

### ***Commitment to Ethics by Firms***

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

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

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

### ***Ethical Commitment of CFA Institute***

An important goal of CFA Institute is to ensure that the organization and its members and candidates develop, promote, and follow the highest ethical standards in the investment industry. The CFA Institute Code of Ethics (Code) and Standards of Professional Conduct (Standards) are the foundation supporting the organization's quest to uphold the industry's highest standards of individual and corporate practice and to help serve the greater good. The Code is a set of principles that define the overarching conduct CFA Institute expects from its members and CFA Program candidates. The Code works in tandem with the Standards, which outline professional conduct that constitutes fair and ethical business practices.

For more than 50 years, CFA Institute members and candidates have been required to abide by the organization's Code and Standards. Periodically, CFA Institute has revised and updated its Code and Standards to ensure that they remain relevant to the changing nature of the investment profession and representative of the highest standard of professional conduct. Within this *Handbook*, CFA Institute addresses ethical principles for the profession, including individual professionalism; responsibilities to capital markets, clients, and employers; ethics involved in investment analysis, recommendations, and actions; and possible conflicts of interest. Although the investment world has become a far more complex place since the first publication of the *Standard of Practice Handbook*, distinguishing right from wrong remains the paramount principle of the Code and Standards.

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

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

By reviewing these resources and discussing with their peers, market participants can further enhance their abilities to apply an effective ethical decision-making framework. In time, this should help restore some of the trust recently lost by investors.

Markets function to an important extent on trust. Recent events have shown the fragility of this foundation and the devastating consequences that can ensue when it is fundamentally questioned. Investment professionals should remain mindful of the long-term health of financial markets and incorporate this concern for the market's sustainability in their investment decision making. CFA Institute and the Standards of Practice Council hope this edition of the *Handbook* will assist and guide investment professionals in meeting the ethical demands of the highly interconnected global capital markets for the ultimate benefit of society.

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## CFA INSTITUTE CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT

### Preamble

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

## The Code of Ethics

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation (“Members and Candidates”) must:

- Act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

## Standards of Professional Conduct

### I. PROFESSIONALISM

#### A Knowledge of the Law

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

#### B Independence and Objectivity

Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another’s independence and objectivity.

#### C Misrepresentation

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

#### D Misconduct

Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

### II. INTEGRITY OF CAPITAL MARKETS

#### A Material Nonpublic Information

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

**B Market Manipulation**

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

**III. DUTIES TO CLIENTS**

**A Loyalty, Prudence, and Care**

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

**B Fair Dealing**

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

**C Suitability**

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

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

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

**D Performance Presentation**

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

**E Preservation of Confidentiality**

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

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

**IV. DUTIES TO EMPLOYERS**

**A Loyalty**

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

**B Additional Compensation Arrangements**

Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

**C Responsibilities of Supervisors**

Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

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

**A Diligence and Reasonable Basis**

Members and Candidates must:

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

**B Communication with Clients and Prospective Clients**

Members and Candidates must:

- 1 Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
- 2 Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
- 3 Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
- 4 Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

**C Record Retention**

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

**VI. CONFLICTS OF INTEREST**

**A Disclosure of Conflicts**

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

**B Priority of Transactions**

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

**C Referral Fees**

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

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

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

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

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

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



## READING

# 3

## Guidance for Standards I–VII

### LEARNING OUTCOMES

<i>Mastery</i>	<i>The candidate should be able to:</i>
<input type="checkbox"/>	a. demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity;
<input type="checkbox"/>	b. distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards;
<input type="checkbox"/>	c. recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

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## STANDARD I: PROFESSIONALISM

### Standard I(A) Knowledge of the Law



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

### Guidance

#### Highlights:

- *Relationship between the Code and Standards and Applicable Law*
- *Participation in or Association with Violations by Others*
- *Investment Products and Applicable Laws*

Members and candidates must understand the applicable laws and regulations of the countries and jurisdictions where they engage in professional activities. These activities may include, but are not limited to, trading of securities or other financial instruments, providing investment advice, conducting research, or performing other investment services. On the basis of their reasonable and good faith understanding, members and candidates must comply with the laws and regulations that directly govern their professional activities and resulting outcomes and that protect the interests of the clients.

When questions arise, members and candidates should know their firm's policies and procedures for accessing compliance guidance. This standard does not require members and candidates to become experts, however, in compliance. Additionally, members and candidates are not required to have detailed knowledge of or be experts on all the laws that could potentially govern their activities.

During times of changing regulations, members and candidates must remain vigilant in maintaining their knowledge of the requirements for their professional activities. New financial products and processes, along with uncovered ethical missteps, create an environment for recurring and potentially wide-ranging regulatory changes. Members and candidates are also continually provided improved and enhanced methods of communicating with both clients and potential clients, such as mobile applications and web-based social networking platforms. As new local, regional, and global requirements are updated to address these and other changes, members, candidates, and their firms must adjust their procedures and practices to remain in compliance.

#### ***Relationship between the Code and Standards and Applicable Law***

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

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

Members and candidates must adhere to the following principles:

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

The applicable laws governing the responsibilities of a member or candidate should be viewed as the minimal threshold of acceptable actions. When members and candidates take actions that exceed the minimal requirements, they further support the conduct required of Standard I(A).

CFA Institute members are obligated to abide by the CFA Institute Articles of Incorporation, Bylaws, Code of Ethics, Standards of Professional Conduct, Rules of Procedure, Membership Agreement, and other applicable rules promulgated by CFA Institute, all as amended periodically. CFA candidates who are not members must also abide by these documents (except for the Membership Agreement) as well as rules and regulations related to the administration of the CFA examination, the Candidate Responsibility Statement, and the Candidate Pledge.

#### ***Participation in or Association with Violations by Others***

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

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

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

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

#### ***Investment Products and Applicable Laws***

Members and candidates involved in creating or maintaining investment services or investment products or packages of securities and/or derivatives should be mindful of where these products or packages will be sold as well as their places of origination. The applicable laws and regulations of the countries or regions of origination and expected sale should be understood by those responsible for the supervision of

the services or creation and maintenance of the products or packages. Members or candidates should make reasonable efforts to review whether associated firms that are distributing products or services developed by their employing firm also abide by the laws and regulations of the countries and regions of distribution. Members and candidates should undertake the necessary due diligence when transacting cross-border business to understand the multiple applicable laws and regulations in order to protect the reputation of their firm and themselves.

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

### Exhibit 1 Global Application of the Code and Standards

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

- NS: country with no securities laws or regulations
- LS: country with *less* strict securities laws and regulations than the Code and Standards
- MS: country with *more* strict securities laws and regulations than the Code and Standards

Applicable Law	Duties	Explanation
Member resides in NS country, does business in LS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, the member must adhere to the Code and Standards.
Member resides in NS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.
Member resides in LS country, does business in NS country; LS law applies.	Member must adhere to the Code and Standards.	Because applicable law is less strict than the Code and Standards, member must adhere to the Code and Standards.
Member resides in LS country, does business in MS country; MS law applies.	Member must adhere to the law of MS country.	Because applicable law is stricter than the Code and Standards, member must adhere to the more strict applicable law.

**Exhibit 1 (Continued)**

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

## Recommended Procedures for Compliance

### *Members and Candidates*

Suggested methods by which members and candidates can acquire and maintain understanding of applicable laws, rules, and regulations include the following:

- *Stay informed:* Members and candidates should establish or encourage their employers to establish a procedure by which employees are regularly informed about changes in applicable laws, rules, regulations, and case law. In many instances, the employer’s compliance department or legal counsel can provide such information in the form of memorandums distributed to employees in the organization. Also, participation in an internal or external continuing education program is a practical method of staying current.
- *Review procedures:* Members and candidates should review, or encourage their employers to review, the firm’s written compliance procedures on a regular basis to ensure that the procedures reflect current law and provide adequate guidance to employees about what is permissible conduct under the law and/or the Code and Standards. Recommended compliance procedures for specific items of the Code and Standards are discussed in this *Handbook* in the “Guidance” sections associated with each standard.
- *Maintain current files:* Members and candidates should maintain or encourage their employers to maintain readily accessible current reference copies of applicable statutes, rules, regulations, and important cases.

### *Distribution Area Laws*

Members and candidates should make reasonable efforts to understand the applicable laws—both country and regional—for the countries and regions where their investment products are developed and are most likely to be distributed to clients.

### *Legal Counsel*

When in doubt about the appropriate action to undertake, it is recommended that a member or candidate seek the advice of compliance personnel or legal counsel concerning legal requirements. If a potential violation is being committed by a fellow employee, it may also be prudent for the member or candidate to seek the advice of the firm’s compliance department or legal counsel.

### *Dissociation*

When dissociating from an activity that violates the Code and Standards, members and candidates should document the violation and urge their firms to attempt to persuade the perpetrator(s) to cease such conduct. To dissociate from the conduct, a member or candidate may have to resign his or her employment.

### *Firms*

The formality and complexity of compliance procedures for firms depend on the nature and size of the organization and the nature of its investment operations. Members and candidates should encourage their firms to consider the following policies and procedures to support the principles of Standard I(A):

- *Develop and/or adopt a code of ethics:* The ethical culture of an organization starts at the top. Members and candidates should encourage their supervisors or managers to adopt a code of ethics. Adhering to a code of ethics facilitates solutions when people face ethical dilemmas and can prevent the need for employees to resort to a “whistleblowing” solution publicly alleging

concealed misconduct. CFA Institute has published the *Asset Manager Code of Professional Conduct*, which firms may adopt or use as the basis for their codes (visit [www.cfainstitute.org](http://www.cfainstitute.org)).

- *Provide information on applicable laws:* Pertinent information that highlights applicable laws and regulations might be distributed to employees or made available in a central location. Information sources might include primary information developed by the relevant government, governmental agencies, regulatory organizations, licensing agencies, and professional associations (e.g., from their websites); law firm memorandums or newsletters; and association memorandums or publications (e.g., *CFA Institute Magazine*).
- *Establish procedures for reporting violations:* Firms might provide written protocols for reporting suspected violations of laws, regulations, or company policies.

## Application of the Standard

### *Example 1 (Notification of Known Violations):*

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

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

### *Example 2 (Dissociating from a Violation):*

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

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

### *Example 3 (Dissociating from a Violation):*

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

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

**Example 4 (Following the Highest Requirements):**

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

*Comment:* Collins must abide by the requirements of the Code and Standards, which might be more strict than the rules of the developing country. He should be aware of the risks that a small market and the absence of a fairly regulated flow of information to the market represent to his ability to obtain information and make timely judgments. He should include this factor in formulating his advice to clients. In handling material nonpublic information that accidentally comes into his possession, he must follow Standard II(A)—Material Nonpublic Information.

**Example 5 (Following the Highest Requirements):**

Laura Jameson works for a multinational investment adviser based in the United States. Jameson lives and works as a registered investment adviser in the tiny, but wealthy, island nation of Karramba. Karramba's securities laws state that no investment adviser registered and working in that country can participate in initial public offerings (IPOs) for the adviser's personal account. Jameson, believing that, as a US citizen working for a US-based company, she should comply only with US law, has ignored this Karrambian law. In addition, Jameson believes that as a charterholder, as long as she adheres to the Code and Standards requirement that she disclose her participation in any IPO to her employer and clients when such ownership creates a conflict of interest, she is meeting the highest ethical requirements.

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

**Example 6 (Laws and Regulations Based on Religious Tenets):**

Amanda Janney is employed as a fixed-income portfolio manager for a large international firm. She is on a team within her firm that is responsible for creating and managing a fixed-income hedge fund to be sold throughout the firm's distribution centers to high-net-worth clients. Her firm receives expressions of interest from potential clients from the Middle East who are seeking investments that comply with Islamic

law. The marketing and promotional materials for the fixed-income hedge fund do not specify whether or not the fund is a suitable investment for an investor seeking compliance with Islamic law. Because the fund is being distributed globally, Janney is concerned about the reputation of the fund and the firm and believes disclosure of whether or not the fund complies with Islamic law could help minimize potential mistakes with placing this investment.

*Comment:* As the financial market continues to become globalized, members and candidates will need to be aware of the differences between cultural and religious laws and requirements as well as the different governmental laws and regulations. Janney and the firm could be proactive in their efforts to acknowledge areas where the new fund may not be suitable for clients.

**Example 7 (Reporting Potential Unethical Actions):**

Krista Blume is a junior portfolio manager for high-net-worth portfolios at a large global investment manager. She observes a number of new portfolios and relationships coming from a country in Europe where the firm did not have previous business and is told that a broker in that country is responsible for this new business. At a meeting on allocation of research resources to third-party research firms, Blume notes that this broker has been added to the list and is allocated payments for research. However, she knows the portfolios do not invest in securities in the broker's country, and she has not seen any research come from this broker. Blume asks her supervisor about the name being on the list and is told that someone in marketing is receiving the research and that the name being on the list is OK. She believes that what may be going on is that the broker is being paid for new business through the inappropriate research payments, and she wishes to dissociate from the misconduct.

*Comment:* Blume should follow the firm's policies and procedures for reporting potential unethical activity, which may include discussions with her supervisor or someone in a designated compliance department. She should communicate her concerns appropriately while advocating for disclosure between the new broker relationship and the research payments.

**Example 8 (Failure to Maintain Knowledge of the Law):**

Colleen White is excited to use new technology to communicate with clients and potential clients. She recently began posting investment information, including performance reports and investment opinions and recommendations, to her Facebook page. In addition, she sends out brief announcements, opinions, and thoughts via her Twitter account (for example, "Prospects for future growth of XYZ company look good! #makingmoney4U"). Prior to White's use of these social media platforms, the local regulator had issued new requirements and guidance governing online electronic communication. White's communications appear to conflict with the recent regulatory announcements.

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

## Standard I(B) Independence and Objectivity



Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

### Guidance

#### Highlights:

- *Buy-Side Clients*
- *Fund Manager and Custodial Relationships*
- *Investment Banking Relationships*
- *Performance Measurement and Attribution*
- *Public Companies*
- *Credit Rating Agency Opinions*
- *Influence during the Manager Selection/Procurement Process*
- *Issuer-Paid Research*
- *Travel Funding*

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

External sources may try to influence the investment process by offering analysts and portfolio managers a variety of benefits. Corporations may seek expanded research coverage, issuers and underwriters may wish to promote new securities offerings, brokers may want to increase commission business, and independent rating agencies may be influenced by the company requesting the rating. Benefits may include gifts, invitations to lavish functions, tickets, favors, or job referrals. One type of benefit is the allocation of shares in oversubscribed IPOs to investment managers for their personal accounts. This practice affords managers the opportunity to make quick profits that may not be available to their clients. Such a practice is prohibited under Standard I(B). Modest gifts and entertainment are acceptable, but special care must be taken by members and candidates to resist subtle and not-so-subtle pressures to act in conflict with the interests of their clients. Best practice dictates that members and candidates reject any offer of gift or entertainment that could be expected to threaten their independence and objectivity.

Receiving a gift, benefit, or consideration from a *client* can be distinguished from gifts given by entities seeking to influence a member or candidate to the detriment of other clients. In a client relationship, the client has already entered some type of compensation arrangement with the member, candidate, or his or her firm. A gift from a client could be considered supplementary compensation. The potential for obtaining influence to the detriment of other clients, although present, is not as great

as in situations where no compensation arrangement exists. When possible, prior to accepting “bonuses” or gifts from clients, members and candidates should disclose to their employers such benefits offered by clients. If notification is not possible prior to acceptance, members and candidates must disclose to their employer benefits previously accepted from clients. Disclosure allows the employer of a member or candidate to make an independent determination about the extent to which the gift may affect the member’s or candidate’s independence and objectivity.

Members and candidates may also come under pressure from their own firms to, for example, issue favorable research reports or recommendations for certain companies with potential or continuing business relationships with the firm. The situation may be aggravated if an executive of the company sits on the bank or investment firm’s board and attempts to interfere in investment decision making. Members and candidates acting in a sales or marketing capacity must be especially mindful of their objectivity in promoting appropriate investments for their clients.

Left unmanaged, pressures that threaten independence place research analysts in a difficult position and may jeopardize their ability to act independently and objectively. One of the ways that research analysts have coped with these pressures in the past is to use subtle and ambiguous language in their recommendations or to temper the tone of their research reports. Such subtleties are lost on some investors, however, who reasonably expect research reports and recommendations to be straightforward and transparent and to communicate clearly an analyst’s views based on unbiased analysis and independent judgment.

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

Members and candidates also should be aware that some of their professional or social activities within CFA Institute or its member societies may subtly threaten their independence or objectivity. When seeking corporate financial support for conventions, seminars, or even weekly society luncheons, the members or candidates responsible for the activities should evaluate both the actual effect of such solicitations on their independence and whether their objectivity might be perceived to be compromised in the eyes of their clients.

### ***Buy-Side Clients***

One source of pressure on sell-side analysts is buy-side clients. Institutional clients are traditionally the primary users of sell-side research, either directly or with soft dollar brokerage. Portfolio managers may have significant positions in the security of a company under review. A rating downgrade may adversely affect the portfolio’s performance, particularly in the short term, because the sensitivity of stock prices to ratings changes has increased in recent years. A downgrade may also affect the manager’s compensation, which is usually tied to portfolio performance. Moreover, portfolio performance is subject to media and public scrutiny, which may affect the manager’s professional reputation. Consequently, some portfolio managers implicitly or explicitly support sell-side ratings inflation.

Portfolio managers have a responsibility to respect and foster the intellectual honesty of sell-side research. Therefore, it is improper for portfolio managers to threaten or engage in retaliatory practices, such as reporting sell-side analysts to the covered company in order to instigate negative corporate reactions. Although most portfolio managers do not engage in such practices, the perception by the research analyst that a reprisal is possible may cause concern and make it difficult for the analyst to maintain independence and objectivity.

### ***Fund Manager and Custodial Relationships***

Research analysts are not the only people who must be concerned with maintaining their independence. Members and candidates who are responsible for hiring and retaining outside managers and third-party custodians should not accept gifts, entertainment, or travel funding that may be perceived as impairing their decisions. The use of secondary fund managers has evolved into a common practice to manage specific asset allocations. The use of third-party custodians is common practice for independent investment advisory firms and helps them with trading capabilities and reporting requirements. Primary and secondary fund managers, as well as third-party custodians, often arrange educational and marketing events to inform others about their business strategies, investment process, or custodial services. Members and candidates must review the merits of each offer individually in determining whether they may attend yet maintain their independence.

### ***Investment Banking Relationships***

Some sell-side firms may exert pressure on their analysts to issue favorable research reports on current or prospective investment banking clients. For many of these firms, income from investment banking has become increasingly important to overall firm profitability because brokerage income has declined as a result of price competition. Consequently, firms offering investment banking services work hard to develop and maintain relationships with investment banking clients and prospects. These companies are often covered by the firm's research analysts because companies often select their investment banks on the basis of the reputation of their research analysts, the quality of their work, and their standing in the industry.

In some countries, research analysts frequently work closely with their investment banking colleagues to help evaluate prospective investment banking clients. In other countries, because of past abuses in managing the obvious conflicts of interest, regulators have established clear rules prohibiting the interaction of these groups. Although collaboration between research analysts and investment banking colleagues may benefit the firm and enhance market efficiency (e.g., by allowing firms to assess risks more accurately and make better pricing assumptions), it requires firms to carefully balance the conflicts of interest inherent in the collaboration. Having analysts work with investment bankers is appropriate only when the conflicts are adequately and effectively managed and disclosed. Firm managers have a responsibility to provide an environment in which analysts are neither coerced nor enticed into issuing research that does not reflect their true opinions. Firms should require public disclosure of actual conflicts of interest to investors.

Members, candidates, and their firms must adopt and follow perceived best practices in maintaining independence and objectivity in the corporate culture and protecting analysts from undue pressure by their investment banking colleagues. The "firewalls" traditionally built between these two functions must be managed to minimize conflicts of interest; indeed, enhanced firewall policies may go as far as prohibiting all communications between these groups. A key element of an enhanced firewall is separate reporting structures for personnel on the research side and personnel on the investment banking side. For example, investment banking personnel should not have any authority to approve, disapprove, or make changes to research reports or recommendations. Another element should be a compensation arrangement that minimizes the pressures on research analysts and rewards objectivity and accuracy. Compensation arrangements should not link analyst remuneration directly to investment banking assignments in which the analyst may participate as a team member. Firms should also regularly review their policies and procedures to determine whether

analysts are adequately safeguarded and to improve the transparency of disclosures relating to conflicts of interest. The highest level of transparency is achieved when disclosures are prominent and specific rather than marginalized and generic.

#### ***Performance Measurement and Attribution***

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

#### ***Public Companies***

Analysts may be pressured to issue favorable reports and recommendations by the companies they follow. Not every stock is a "buy," and not every research report is favorable—for many reasons, including the cyclical nature of many business activities and market fluctuations. For instance, a "good company" does not always translate into a "good stock" rating if the current stock price is fully valued. In making an investment recommendation, the analyst is responsible for anticipating, interpreting, and assessing a company's prospects and stock price performance in a factual manner. Many company managers, however, believe that their company's stock is undervalued, and these managers may find it difficult to accept critical research reports or ratings downgrades. Company managers' compensation may also be dependent on stock performance.

Due diligence in financial research and analysis involves gathering information from a wide variety of sources, including public disclosure documents (such as proxy statements, annual reports, and other regulatory filings) and also company management and investor-relations personnel, suppliers, customers, competitors, and other relevant sources. Research analysts may justifiably fear that companies will limit their ability to conduct thorough research by denying analysts who have "negative" views direct access to company managers and/or barring them from conference calls and other communication venues. Retaliatory practices include companies bringing legal action against analysts personally and/or their firms to seek monetary damages for the economic effects of negative reports and recommendations. Although few companies engage in such behavior, the perception that a reprisal is possible is a reasonable concern for analysts. This concern may make it difficult for them to conduct the comprehensive research needed to make objective recommendations. For further information and guidance, members and candidates should refer to the CFA Institute publication *Best Practice Guidelines Governing Analyst/Corporate Issuer Relations* ([www.cfainstitute.org](http://www.cfainstitute.org)).

#### ***Credit Rating Agency Opinions***

Credit rating agencies provide a service by grading the fixed-income products offered by companies. Analysts face challenges related to incentives and compensation schemes that may be tied to the final rating and successful placement of the product. Members and candidates employed at rating agencies should ensure that procedures and processes at the agencies prevent undue influences from a sponsoring company during the analysis. Members and candidates should abide by their agencies' and the industry's standards of conduct regarding the analytical process and the distribution of their reports.

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

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

#### ***Influence during the Manager Selection/Procurement Process***

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

When serving in a hiring capacity, members and candidates should not solicit gifts, contributions, or other compensation that may affect their independence and objectivity. Solicitations do not have to benefit members and candidates personally to conflict with Standard I(B). Requesting contributions to a favorite charity or political organization may also be perceived as an attempt to influence the decision-making process. Additionally, members and candidates serving in a hiring capacity should refuse gifts, donations, and other offered compensation that may be perceived to influence their decision-making process.

When working to earn a new investment allocation, members and candidates should not offer gifts, contributions, or other compensation to influence the decision of the hiring representative. The offering of these items with the intent to impair the independence and objectivity of another person would not comply with Standard I(B). Such prohibited actions may include offering donations to a charitable organization or political candidate referred by the hiring representative.

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

#### ***Issuer-Paid Research***

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

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

Members and candidates must adhere to strict standards of conduct that govern how the research is to be conducted and what disclosures must be made in the report. Analysts must engage in thorough, independent, and unbiased analysis and must fully disclose potential conflicts of interest, including the nature of their compensation. Otherwise, analysts risk misleading investors.

Investors need clear, credible, and thorough information about companies, and they need research based on independent thought. At a minimum, issuer-paid research should include a thorough analysis of the company's financial statements based on publicly disclosed information, benchmarking within a peer group, and industry analysis. Analysts must exercise diligence, independence, and thoroughness in conducting their research in an objective manner. Analysts must distinguish between fact and opinion in their reports. Conclusions must have a reasonable and adequate basis and must be supported by appropriate research.

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

### ***Travel Funding***

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

## **Recommended Procedures for Compliance**

Members and candidates should adhere to the following practices and should encourage their firms to establish procedures to avoid violations of Standard I(B):

- *Protect the integrity of opinions:* Members, candidates, and their firms should establish policies stating that every research report concerning the securities of a corporate client should reflect the unbiased opinion of the analyst. Firms should also design compensation systems that protect the integrity of the investment decision process by maintaining the independence and objectivity of analysts.

- *Create a restricted list:* If the firm is unwilling to permit dissemination of adverse opinions about a corporate client, members and candidates should encourage the firm to remove the controversial company from the research universe and put it on a restricted list so that the firm disseminates only factual information about the company.
- *Restrict special cost arrangements:* When attending meetings at an issuer's headquarters, members and candidates should pay for commercial transportation and hotel charges. No corporate issuer should reimburse members or candidates for air transportation. Members and candidates should encourage issuers to limit the use of corporate aircraft to situations in which commercial transportation is not available or in which efficient movement could not otherwise be arranged. Members and candidates should take particular care that when frequent meetings are held between an individual issuer and an individual member or candidate, the issuer should not always host the member or candidate.
- *Limit gifts:* Members and candidates must limit the acceptance of gratuities and/or gifts to token items. Standard I(B) does not preclude customary, ordinary business-related entertainment as long as its purpose is not to influence or reward members or candidates. Firms should consider a strict value limit for acceptable gifts that is based on the local or regional customs and should address whether the limit is per gift or an aggregate annual value.
- *Restrict investments:* Members and candidates should encourage their investment firms to develop formal policies related to employee purchases of equity or equity-related IPOs. Firms should require prior approval for employee participation in IPOs, with prompt disclosure of investment actions taken following the offering. Strict limits should be imposed on investment personnel acquiring securities in private placements.
- *Review procedures:* Members and candidates should encourage their firms to implement effective supervisory and review procedures to ensure that analysts and portfolio managers comply with policies relating to their personal investment activities.
- *Independence policy:* Members, candidates, and their firms should establish a formal written policy on the independence and objectivity of research and implement reporting structures and review procedures to ensure that research analysts do not report to and are not supervised or controlled by any department of the firm that could compromise the independence of the analyst. More detailed recommendations related to a firm's policies regarding research objectivity are set forth in the CFA Institute statement *Research Objectivity Standards* ([www.cfainstitute.org](http://www.cfainstitute.org)).
- *Appointed officer:* Firms should appoint a senior officer with oversight responsibilities for compliance with the firm's code of ethics and all regulations concerning its business. Firms should provide every employee with the procedures and policies for reporting potentially unethical behavior, violations of regulations, or other activities that may harm the firm's reputation.

## Application of the Standard

### *Example 1 (Travel Expenses):*

Steven Taylor, a mining analyst with Bronson Brokers, is invited by Precision Metals to join a group of his peers in a tour of mining facilities in several western US states. The company arranges for chartered group flights from site to site and for accommodations in Spartan Motels, the only chain with accommodations near the mines,

for three nights. Taylor allows Precision Metals to pick up his tab, as do the other analysts, with one exception—John Adams, an employee of a large trust company who insists on following his company’s policy and paying for his hotel room himself.

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

**Example 2 (Research Independence):**

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

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

**Example 3 (Research Independence and Intrafirm Pressure):**

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

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

**Example 4 (Research Independence and Issuer Relationship Pressure):**

As in Example 3, Walter Fritz has concluded that Metals & Mining stock is overvalued at its current level, but he is concerned that a negative research report might jeopardize a close rapport that he has nurtured over the years with Metals & Mining’s CEO, chief finance officer, and investment relations officer. Fritz is concerned that a negative report might result also in management retaliation—for instance, cutting him off from participating in conference calls when a quarterly earnings release is made,

denying him the ability to ask questions on such calls, and/or denying him access to top management for arranging group meetings between Hilton Brokerage clients and top Metals & Mining managers.

*Comment:* As in Example 3, Fritz’s analysis must be objective and based solely on consideration of company fundamentals. Any pressure from Metals & Mining is inappropriate. Fritz should reinforce the integrity of his conclusions by stressing that his investment recommendation is based on relative valuation, which may include qualitative issues with respect to Metals & Mining’s management.

***Example 5 (Research Independence and Sales Pressure):***

As support for the sales effort of her corporate bond department, Lindsey Warner offers credit guidance to purchasers of fixed-income securities. Her compensation is closely linked to the performance of the corporate bond department. Near the quarter’s end, Warner’s firm has a large inventory position in the bonds of Milton, Ltd., and has been unable to sell the bonds because of Milton’s recent announcement of an operating problem. Salespeople have asked her to contact large clients to push the bonds.

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

***Example 6 (Research Independence and Prior Coverage):***

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

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

***Example 7 (Gifts and Entertainment from Related Party):***

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

*Comment:* Grant has violated Standard I(B) because accepting these substantial gifts may impede his independence and objectivity. Every member and candidate 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. By accepting the trip, Grant has opened himself up to the accusation that he may give the broker favored treatment in return.

**Example 8 (Gifts and Entertainment from Client):**

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

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

Best practices for monitoring include comparing the transaction costs of the Knowlden account with the costs of other accounts managed by Green and other similar accounts within Tisbury. The supervisor could also compare the performance returns with the returns of other clients with the same mandate. This comparison will assist in determining whether a pattern of favoritism by Green is disadvantaging other Tisbury clients or the possibility that this favoritism could affect her future behavior.

**Example 9 (Travel Expenses from External Manager):**

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

*Comment:* Although Wayne can probably put to good use the knowledge he gained from the trip in selecting portfolio managers and in other areas of managing the pension plan, his recommendation of Penguin Advisors may be tainted by the possible conflict incurred when he participated in a trip partly paid for by Penguin Advisors and when he was in the daily company of the president of Penguin Advisors. To avoid violating Standard I(B),

Wayne's basic expenses for travel and accommodations should have been paid by his employer or the pension plan; contact with the president of Penguin Advisors should have been limited to informational or educational events only; and the trip, the organizer, and the sponsor should have been made a matter of public record. Even if his actions were not in violation of Standard I(B), Wayne should have been sensitive to the public perception of the trip when reported in the newspaper and the extent to which the subjective elements of his decision might have been affected by the familiarity that the daily contact of such a trip would encourage. This advantage would probably not be shared by firms competing with Penguin Advisors.

**Example 10 (Research Independence and Compensation Arrangements):**

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

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

**Example 11 (Recommendation Objectivity and Service Fees):**

Two years ago, Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class of funds. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review Western's funds to determine whether they were suitable for clients of Central Midas Bank. The manager completed the normal due diligence review and determined that the new funds were fairly valued in the market with fee structures on a par with competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments.

Now, two years later, the funds managed by Western begin to underperform their peers. Wade is counting on the fees to reach his profitability targets and continues to push these funds as acceptable investments for Central's clients.

*Comment:* Wade is violating Standard I(B) because the fee arrangement has affected the objectivity of his recommendations. Wade is relying on the fee as a component of the department's profitability and is unwilling to offer other products that may affect the fees received.

See also Standard VI(A)–Disclosure of Conflicts.

**Example 12 (Recommendation Objectivity):**

Bob Thompson has been doing research for the portfolio manager of the fixed-income department. His assignment is to do sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives “prepays” (prepayments of mortgages) and losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. Thompson insists that the analysis should include a scenario run with –10% for Year 1, –5% for Year 2, and then (to project a worst-case scenario) 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative.

Thompson conducts his research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, an unlikely but possible environment. Based on the results of the enhanced scenarios, Thompson does not recommend the purchase of the securitization. Against the general market trends, the manager follows Thompson’s recommendation and does not invest. The following year, the housing market collapses. In avoiding the subprime investments, the manager’s portfolio outperforms its peer group that year.

*Comment:* Thompson’s actions in running the worst-case scenario against the protests of the portfolio manager are in alignment with the principles of Standard I(B). Thompson did not allow his research to be pressured by the general trends of the market or the manager’s desire to limit the research to historical norms.

See also Standard V(A)–Diligence and Reasonable Basis.

**Example 13 (Influencing Manager Selection Decisions):**

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

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

**Example 14 (Influencing Manager Selection Decisions):**

Adrian Mandel, CFA, had heard about the manager search competition for the UDPBU Pension Fund through a broker/dealer contact. The contact told him that a well-known retired professional golfer, Bobby “The Bear” Finlay, who had become a licensed broker/dealer serving as a pension consultant, was orchestrating the UDPBU manager search. Finlay had gained celebrity status with several labor union pension

fund boards by entertaining their respective board members and regaling them with colorful stories of fellow pro golfers' antics in clubhouses around the world. Mandel decided to improve ZZYY's chances of being invited to participate in the search competition by befriending Finlay to curry his favor. Knowing Finlay's love of entertainment, Mandel wined and dined Finlay at high-profile bistros where Finlay could glow in the fan recognition lavished on him by all the other patrons. Mandel's endeavors paid off handsomely when Finlay recommended to the UDPBU board that ZZYY be entered as one of three finalist asset management firms in its search.

*Comment:* Similar to Example 13, Mandel lavished gifts, benefits, and other considerations in the form of expensive entertainment that could reasonably be expected to influence the consultant to recommend the hiring of his firm. Therefore, Mandel was in violation of Standard I(B).

**Example 15 (Fund Manager Relationships):**

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

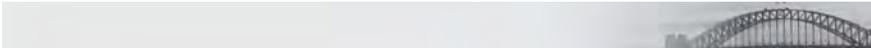
*Comment:* Scott would be in violation of Standard I(B) if she did not disclose the change in her final report. The analysis of managers' performance should not be influenced by personal relationships or the size of the allocation to the outside managers. By not including the change, Scott would not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

**Example 16 (Intrafirm Pressure):**

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

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

## Standard I(C) Misrepresentation



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

### Guidance

#### Highlights:

- *Impact on Investment Practice*
- *Performance Reporting*
- *Social Media*
- *Omissions*
- *Plagiarism*
- *Work Completed for Employer*

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

A misrepresentation is any untrue statement or omission of a fact or any statement that is otherwise false or misleading. A member or candidate must not knowingly omit or misrepresent information or give a false impression of a firm, organization, or security in the member's or candidate's oral representations, advertising (whether in the press or through brochures), electronic communications, or written materials (whether publicly disseminated or not). In this context, "knowingly" means that the member or candidate either knows or should have known that the misrepresentation was being made or that omitted information could alter the investment decision-making process.

Written materials include, but are not limited to, research reports, underwriting documents, company financial reports, market letters, newspaper columns, and books. Electronic communications include, but are not limited to, internet communications, webpages, mobile applications, and e-mails. Members and candidates who use webpages should regularly monitor materials posted on these sites to ensure that they contain current information. Members and candidates should also ensure that all reasonable precautions have been taken to protect the site's integrity and security and that the site does not misrepresent any information and does provide full disclosure.

Standard I(C) prohibits members and candidates from guaranteeing clients any specific return on volatile investments. Most investments contain some element of risk that makes their return inherently unpredictable. For such investments, guaranteeing either a particular rate of return or a guaranteed preservation of investment capital (e.g., "I can guarantee that you will earn 8% on equities this year" or "I can guarantee that you will not lose money on this investment") is misleading to investors. Standard I(C) does not prohibit members and candidates from providing clients with information on investment products that have guarantees built into the structure of the products themselves or for which an institution has agreed to cover any losses.

### ***Impact on Investment Practice***

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

Members and candidates should exercise care and diligence when incorporating third-party information. Misrepresentations resulting from the use of the credit ratings, research, testimonials, or marketing materials of outside parties become the responsibility of the investment professional when it affects that professional's business practices.

Investing through outside managers continues to expand as an acceptable method of investing in areas outside a firm's core competencies. Members and candidates must disclose their intended use of external managers and must not represent those managers' investment practices as their own. Although the level of involvement of outside managers may change over time, appropriate disclosures by members and candidates are important in avoiding misrepresentations, especially if the primary activity is to invest directly with a single external manager. Standard V(B)—Communication with Clients and Prospective Clients discusses in further detail communicating the firm's investment practices.

### ***Performance Reporting***

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

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

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

Members and candidates should take reasonable steps to provide accurate and reliable security pricing information to clients on a consistent basis. Changing pricing providers should not be based solely on the justification that the new provider reports a higher current value of a security. Consistency in the reported information

will improve the perception of the valuation process for illiquid securities. Clients will likely have additional confidence that they were able to make an informed decision about continuing to hold these securities in their portfolios.

### ***Social Media***

The advancement of online discussion forums and communication platforms, commonly referred to as “social media,” is placing additional responsibilities on members and candidates. When communicating through social media channels, members and candidates should provide only the same information they are allowed to distribute to clients and potential clients through other traditional forms of communication. The online or interactive aspects of social media do not remove the need to be open and honest about the information being distributed.

Along with understanding and following existing and newly developing rules and regulations regarding the allowed use of social media, members and candidates should also ensure that all communications in this format adhere to the requirements of the Code and Standards. The perceived anonymity granted through these platforms may entice individuals to misrepresent their qualifications or abilities or those of their employer. Actions undertaken through social media that knowingly misrepresent investment recommendations or professional activities are considered a violation of Standard I(C).

### ***Omissions***

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

Omissions in the performance measurement and attribution process can also misrepresent a manager’s performance and skill. Members and candidates should encourage their firms to develop strict policies for composite development to prevent cherry picking—situations in which selected accounts are presented as representative of the firm’s abilities. The omission of any accounts appropriate for the defined composite may misrepresent to clients the success of the manager’s implementation of its strategy.

### ***Plagiarism***

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

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

Misrepresentation through plagiarism in investment management can take various forms. The simplest and most flagrant example is to take a research report or study done by another firm or person, change the names, and release the material as one’s

own original analysis. This action is a clear violation of Standard I(C). Other practices include (1) using excerpts from articles or reports prepared by others either verbatim or with only slight changes in wording without acknowledgment, (2) citing specific quotations as attributable to “leading analysts” and “investment experts” without naming the specific references, (3) presenting statistical estimates of forecasts prepared by others and identifying the sources but without including the qualifying statements or caveats that may have been used, (4) using charts and graphs without stating their sources, and (5) copying proprietary computerized spreadsheets or algorithms without seeking the cooperation or authorization of their creators.

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

Standard I(C) also applies to plagiarism in oral communications, such as through group meetings; visits with associates, clients, and customers; use of audio/video media (which is rapidly increasing); and telecommunications, including electronic data transfer and the outright copying of electronic media.

One of the most egregious practices in violation of this standard is the preparation of research reports based on multiple sources of information without acknowledging the sources. Examples of information from such sources include ideas, statistical compilations, and forecasts combined to give the appearance of original work. Although there is no monopoly on ideas, members and candidates must give credit where it is clearly due. Analysts should not use undocumented forecasts, earnings projections, asset values, and so on. Sources must be revealed to bring the responsibility directly back to the author of the report or the firm involved.

### ***Work Completed for Employer***

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

## **Recommended Procedures for Compliance**

### ***Factual Presentations***

Members and candidates can prevent unintentional misrepresentations of their qualifications or the services they or their firms provide if each member and candidate understands the limit of the firm’s or individual’s capabilities and the need to be accurate and complete in presentations. Firms can provide guidance for employees who make

written or oral presentations to clients or potential clients by providing a written list of the firm's available services and a description of the firm's qualifications. This list should suggest ways of describing the firm's services, qualifications, and compensation that are both accurate and suitable for client or customer presentations. Firms can also help prevent misrepresentation by specifically designating which employees are authorized to speak on behalf of the firm. Regardless of whether the firm provides guidance, members and candidates should make certain that they understand the services the firm can perform and its qualifications.

### ***Qualification Summary***

In addition, to ensure accurate presentations to clients, each member and candidate should prepare a summary of his or her own qualifications and experience and a list of the services the member or candidate is capable of performing. Firms can assist member and candidate compliance by periodically reviewing employee correspondence and documents that contain representations of individual or firm qualifications.

### ***Verify Outside Information***

When providing information to clients from a third party, members and candidates share a responsibility for the accuracy of the marketing and distribution materials that pertain to the third party's capabilities, services, and products. Misrepresentation by third parties can damage the member's or candidate's reputation, the reputation of the firm, and the integrity of the capital markets. Members and candidates should encourage their employers to develop procedures for verifying information of third-party firms.

### ***Maintain Webpages***

Members and candidates who publish a webpage should regularly monitor materials posted on the site to ensure that the site contains current information. Members and candidates should also ensure that all reasonable precautions have been taken to protect the site's integrity, confidentiality, and security and that the site does not misrepresent any information and provides full disclosure.

### ***Plagiarism Policy***

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

- ***Maintain copies:*** Keep copies of all research reports, articles containing research ideas, material with new statistical methodologies, and other materials that were relied on in preparing the research report.
- ***Attribute quotations:*** Attribute to their sources any direct quotations, including projections, tables, statistics, model/product ideas, and new methodologies prepared by persons other than recognized financial and statistical reporting services or similar sources.
- ***Attribute summaries:*** Attribute to their sources any paraphrases or summaries of material prepared by others. For example, to support his analysis of Brown Company's competitive position, the author of a research report on Brown might summarize another analyst's report on Brown's chief competitor, but the author of the Brown report must acknowledge in his own report the reliance on the other analyst's report.

## Application of the Standard

### **Example 1 (Disclosure of Issuer-Paid Research):**

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

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

### **Example 2 (Correction of Unintentional Errors):**

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

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

### **Example 3 (Noncorrection of Known Errors):**

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

*Comment:* Even though Muhammad may not have been directly responsible for the misrepresentation of his credentials in the firm's promotional material, he used this material numerous times over an extended period and should have known of the misrepresentation. Thus, Muhammad has violated Standard I(C).

**Example 4 (Plagiarism):**

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

*Comment:* Grant plagiarized Barton's report by reproducing large parts of it in her own report without acknowledgment.

**Example 5 (Misrepresentation of Information):**

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

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

**Example 6 (Potential Information Misrepresentation):**

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

*Comment:* Although there is risk that the institution offering the certificates of deposits and money market accounts could go bankrupt, in the United States, these accounts are insured by the US government through the Federal Deposit Insurance Corporation. Therefore, using the term "guaranteed" in this context is not inappropriate as long as the amount is within the government-insured limit. Abdrabbo should explain these facts to the clients.

**Example 7 (Plagiarism):**

Steve Swanson is a senior analyst in the investment research department of Ballard and Company. Apex Corporation has asked Ballard to assist in acquiring the majority ownership of stock in the Campbell Company, a financial consulting firm, and to prepare a report recommending that stockholders of Campbell agree to the acquisition. Another investment firm, Davis and Company, had already prepared a report for Apex analyzing both Apex and Campbell and recommending an exchange ratio. Apex has

given the Davis report to Ballard officers, who have passed it on to Swanson. Swanson reviews the Davis report and other available material on Apex and Campbell. From his analysis, he concludes that the common stocks of Campbell and Apex represent good value at their current prices; he believes, however, that the Davis report does not consider all the factors a Campbell stockholder would need to know to make a decision. Swanson reports his conclusions to the partner in charge, who tells him to “use the Davis report, change a few words, sign your name, and get it out.”

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

**Example 8 (Plagiarism):**

Claude Browning, a quantitative analyst for Double Alpha, Inc., returns from a seminar in great excitement. At that seminar, Jack Jorrely, a well-known quantitative analyst at a national brokerage firm, discussed one of his new models in great detail, and Browning is intrigued by the new concepts. He proceeds to test the model, making some minor mechanical changes but retaining the concepts, until he produces some very positive results. Browning quickly announces to his supervisors at Double Alpha that he has discovered a new model and that clients and prospective clients should be informed of this positive finding as ongoing proof of Double Alpha’s continuing innovation and ability to add value.

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

**Example 9 (Plagiarism):**

Fernando Zubia would like to include in his firm’s marketing materials some “plain-language” descriptions of various concepts, such as the price-to-earnings (P/E) multiple and why standard deviation is used as a measure of risk. The descriptions come from other sources, but Zubia wishes to use them without reference to the original authors. Would this use of material be a violation of Standard I(C)?

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

**Example 10 (Plagiarism):**

Through a mainstream media outlet, Erika Schneider learns about a study that she would like to cite in her research. Should she cite both the mainstream intermediary source as well as the author of the study itself when using that information?

*Comment:* In all instances, a member or candidate must cite the actual source of the information. Best practice for Schneider would be to obtain the information directly from the author and review it before citing it in

a report. In that case, Schneider would not need to report how she found out about the information. For example, suppose Schneider read in the *Financial Times* about a study issued by CFA Institute; best practice for Schneider would be to obtain a copy of the study from CFA Institute, review it, and then cite it in her report. If she does not use any interpretation of the report from the *Financial Times* and the newspaper does not add value to the report itself, the newspaper is merely a conduit of the original information and does not need to be cited. If she does not obtain the report and review the information, Schneider runs the risk of relying on second-hand information that may misstate facts. If, for example, the *Financial Times* erroneously reported some information from the original CFA Institute study and Schneider copied that erroneous information without acknowledging CFA Institute, she could be the object of complaints. Best practice would be either to obtain the complete study from its original author and cite only that author or to use the information provided by the intermediary and cite both sources.

**Example 11 (Misrepresentation of Information):**

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

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

**Example 12 (Misrepresentation of Information):**

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

*Comment:* As a member of the investment team, Stafford is qualified to recognize the degree of accuracy of the materials that characterize the portfolio, and he is correct to be worried about Appleton's responsibility for a misrepresentation of the risks. Thus, he should continue to pursue the issue of Open Air's inaccurate promotion of the portfolio according to the firm's policies and procedures.

The Code and Standards stress protecting the reputation of the firm and the sustainability and integrity of the capital markets. Misrepresenting the quality and risks associated with the investment pool may lead to negative consequences for others well beyond the direct investors.

**Example 13 (Avoiding a Misrepresentation):**

Trina Smith is a fixed-income portfolio manager at a pension fund. She has observed that the market for highly structured mortgages is the focus of salespeople she meets and that these products represent a significant number of trading opportunities. In discussions about this topic with her team, Smith learns that calculating yields on changing cash flows within the deal structure requires very specialized vendor software. After more research, they find out that each deal is unique and that deals can have more than a dozen layers and changing cash flow priorities. Smith comes to the conclusion that, because of the complexity of these securities, the team cannot effectively distinguish between potentially good and bad investment options. To avoid misrepresenting their understanding, the team decides that the highly structured mortgage segment of the securitized market should not become part of the core of the fund's portfolio; they will allow some of the less complex securities to be part of the core.

*Comment:* Smith is in compliance with Standard I(C) by not investing in securities that she and her team cannot effectively understand. Because she is not able to describe the risk and return profile of the securities to the pension fund beneficiaries and trustees, she appropriately limits the fund's exposure to this sector.

**Example 14 (Misrepresenting Composite Construction):**

Robert Palmer is head of performance for a fund manager. When asked to provide performance numbers to fund rating agencies, he avoids mentioning that the fund manager is quite liberal in composite construction. The reason accounts are included/excluded is not fully explained. The performance values reported to the rating agencies for the composites, although accurate for the accounts shown each period, may not present a true representation of the fund manager's ability.

*Comment:* "Cherry picking" accounts to include in either published reports or information provided to rating agencies conflicts with Standard I(C). Moving accounts into or out of a composite to influence the overall performance results materially misrepresents the reported values over time. Palmer should work with his firm to strengthen its reporting practices concerning composite construction to avoid misrepresenting the firm's track record or the quality of the information being provided.

**Example 15 (Presenting Out-of-Date Information):**

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

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

*Comment:* Finch is violating Standard I(C) by providing information that misrepresents aspects of the funds. By not providing the sales team and, ultimately, the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets. Finch

can instruct the sales team to clarify the deficiencies in the fact sheets with clients and ensure they have the most recent fund prospectus document before accepting orders for investing in any fund.

**Example 16 (Overemphasis of Firm Results):**

Bob Anderson is chief compliance officer for Optima Asset Management Company, a firm currently offering eight funds to clients. Seven of the eight had 10-year returns below the median for their respective sectors. Anderson approves a recent advertisement, which includes this statement: “Optima Asset Management is achieving excellent returns for its investors. The Optima Emerging Markets Equity fund, for example, has 10-year returns that exceed the sector median by more than 10%.”

*Comment:* From the information provided it is difficult to determine whether a violation has occurred as long as the sector outperformance is correct. Anderson may be attempting to mislead potential clients by citing the performance of the sole fund that achieved such results. Past performance is often used to demonstrate a firm’s skill and abilities in comparison to funds in the same sectors.

However, if all the funds outperformed their respective benchmarks, then Anderson’s assertion that the company “is achieving excellent returns” may be factual. Funds may exhibit positive returns for investors, exceed benchmarks, and yet have returns below the median in their sectors.

Members and candidates need to ensure that their marketing efforts do not include statements that misrepresent their skills and abilities to remain compliant with Standard I(C). Unless the returns of a single fund reflect the performance of a firm as a whole, the use of a singular fund for performance comparisons should be avoided.

## Standard I(D) Misconduct



Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

### Guidance

Whereas Standard I(A) addresses the obligation of members and candidates to comply with applicable law that governs their professional activities, Standard I(D) addresses *all* conduct that reflects poorly on the professional integrity, good reputation, or competence of members and candidates. Any act that involves lying, cheating, stealing, or other dishonest conduct is a violation of this standard if the offense reflects adversely on a member’s or candidate’s professional activities. Although CFA Institute discourages any sort of unethical behavior by members and candidates, the Code and Standards are primarily aimed at conduct and actions related to a member’s or candidate’s professional life.

Conduct that damages trustworthiness or competence may include behavior that, although not illegal, nevertheless negatively affects a member’s or candidate’s ability to perform his or her responsibilities. For example, abusing alcohol during business hours might constitute a violation of this standard because it could have a detrimental effect

on the member's or candidate's ability to fulfill his or her professional responsibilities. Personal bankruptcy may not reflect on the integrity or trustworthiness of the person declaring bankruptcy, but if the circumstances of the bankruptcy involve fraudulent or deceitful business conduct, the bankruptcy may be a violation of this standard.

In some cases, the absence of appropriate conduct or the lack of sufficient effort may be a violation of Standard I(D). The integrity of the investment profession is built on trust. A member or candidate—whether an investment banker, rating or research analyst, or portfolio manager—is expected to conduct the necessary due diligence to properly understand the nature and risks of an investment before making an investment recommendation. By not taking these steps and, instead, relying on someone else in the process to perform them, members or candidates may violate the trust their clients have placed in them. This loss of trust may have a significant impact on the reputation of the member or candidate and the operations of the financial market as a whole.

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

## Recommended Procedures for Compliance

In addition to ensuring that their own behavior is consistent with Standard I(D), to prevent general misconduct, members and candidates should encourage their firms to adopt the following policies and procedures to support the principles of Standard I(D):

- *Code of ethics:* Develop and/or adopt a code of ethics to which every employee must subscribe, and make clear that any personal behavior that reflects poorly on the individual involved, the institution as a whole, or the investment industry will not be tolerated.
- *List of violations:* Disseminate to all employees a list of potential violations and associated disciplinary sanctions, up to and including dismissal from the firm.
- *Employee references:* Check references of potential employees to ensure that they are of good character and not ineligible to work in the investment industry because of past infractions of the law.

## Application of the Standard

### *Example 1 (Professionalism and Competence):*

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

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

**Example 2 (Fraud and Deceit):**

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

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

**Example 3 (Fraud and Deceit):**

Jody Brink, an analyst covering the automotive industry, volunteers much of her spare time to local charities. The board of one of the charitable institutions decides to buy five new vans to deliver hot lunches to low-income elderly people. Brink offers to donate her time to handle purchasing agreements. To pay a long-standing debt to a friend who operates an automobile dealership—and to compensate herself for her trouble—she agrees to a price 20% higher than normal and splits the surcharge with her friend. The director of the charity ultimately discovers the scheme and tells Brink that her services, donated or otherwise, are no longer required.

*Comment:* Brink engaged in conduct involving dishonesty, fraud, and misrepresentation and has violated Standard I(D).

**Example 4 (Personal Actions and Integrity):**

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

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

**Example 5 (Professional Misconduct):**

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

*Comment:* Rasmussen has clearly come across an error in policies, procedures, and compliance practices within the firm's operations. According to the firm's procedures for reporting potentially unethical activity, she

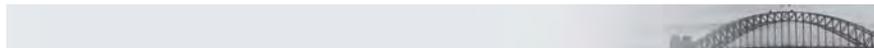
should pursue the issue by gathering some proof of her reason for doubt. Should all internal communications within the firm not satisfy her concerns, Rasmussen should consider reporting the potential unethical activity to the appropriate regulator.

See also Standard IV(A) for guidance on whistleblowing and Standard IV(C) for the duties of a supervisor.

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## STANDARD II: INTEGRITY OF CAPITAL MARKETS

### Standard II(A) Material Nonpublic Information



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

### Guidance

#### Highlights:

- *What Is “Material” Information?*
- *What Constitutes “Nonpublic” Information?*
- *Mosaic Theory*
- *Social Media*
- *Using Industry Experts*
- *Investment Research Reports*

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

The prohibition on using this information goes beyond the direct buying and selling of individual securities or bonds. Members and candidates must not use material nonpublic information to influence their investment actions related to derivatives (e.g., swaps or option contracts), mutual funds, or other alternative investments. *Any* trading based on material nonpublic information constitutes a violation of Standard II(A). The expansion of financial products and the increasing interconnectivity of financial markets globally have resulted in new potential opportunities for trading on material nonpublic information.

***What Is “Material” Information?***

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

The specificity of the information, the extent of its difference from public information, its nature, and its reliability are key factors in determining whether a particular piece of information fits the definition of material. For example, material information may include, but is not limited to, information on the following:

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

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

Also, the more ambiguous the effect of the information on price, the less material that information is considered. If it is unclear whether and to what extent the information will affect the price of a security, the information may not be considered material. The passage of time may also render information that was once important immaterial.

### ***What Constitutes “Nonpublic” Information?***

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

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

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

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

### ***Mosaic Theory***

A financial analyst gathers and interprets large quantities of information from many sources. The analyst may use significant conclusions derived from the analysis of public and nonmaterial nonpublic information as the basis for investment recommendations and decisions even if those conclusions would have been material inside information had they been communicated directly to the analyst by a company. Under the “mosaic theory,” financial analysts are free to act on this collection, or mosaic, of information without risking violation.

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

Much of the information used by analysts comes directly from companies. Analysts often receive such information through contacts with corporate insiders, especially investor-relations staff and financial officers. Information may be disseminated in the

form of press releases, through oral presentations by company executives in analysts' meetings or conference calls, or during analysts' visits to company premises. In seeking to develop the most accurate and complete picture of a company, analysts should also reach beyond contacts with companies themselves and collect information from other sources, such as customers, contractors, suppliers, and the companies' competitors.

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

Investment professionals should note, however, that although analysts are free to use mosaic information in their research reports, they should save and document all their research [see Standard V(C)—Record Retention]. Evidence of the analyst's knowledge of public and nonmaterial nonpublic information about a corporation strengthens the assertion that the analyst reached his or her conclusions solely through appropriate methods rather than through the use of material nonpublic information.

### **Social Media**

The continuing advancement in technology allows members, candidates, and the industry at large to exchange information at rates not previously available. It is important for investment professionals to understand the implications of using information from the internet and social media platforms because all such information may not actually be considered public.

Some social media platforms require membership in specific groups in order to access the published content. Members and candidates participating in groups with membership limitations should verify that material information obtained from these sources can also be accessed from a source that would be considered available to the public (e.g., company filings, webpages, and press releases).

Members and candidates may use social media platforms to communicate with clients or investors without conflicting with this standard. As long as the information reaches all clients or is open to the investing public, the use of these platforms would be comparable with other traditional forms of communications, such as e-mails and press releases. Members and candidates, as required by Standard I(A), should also complete all appropriate regulatory filings related to information distributed through social media platforms.

### **Using Industry Experts**

The increased demand for insights for understanding the complexities of some industries has led to an expansion of engagement with outside experts. As the level of engagement increased, new businesses formed to connect analysts and investors with individuals who have specialized knowledge of their industry (e.g., technology or pharmaceuticals). These networks offer investors the opportunity to reach beyond their usual business circles to speak with experts regarding economic conditions, industry trends, and technical issues relating to specific products and services.

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

and laws or duties to others. As the recent string of insider-trading cases displayed, some experts are willing to provide confidential and protected information for the right incentive.

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

### ***Investment Research Reports***

When a particularly well-known or respected analyst issues a report or makes changes to his or her recommendation, that information alone may have an effect on the market and thus may be considered material. Theoretically, under Standard II(A), such a report would have to be made public at the time it was distributed to clients. The analyst is not a company insider, however, and does not have access to inside information. Presumably, the analyst created the report from information available to the public (mosaic theory) and by using his or her expertise to interpret the information. The analyst's hard work, paid for by the client, generated the conclusions.

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

## **Recommended Procedures for Compliance**

### ***Achieve Public Dissemination***

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

### ***Adopt Compliance Procedures***

Members and candidates should encourage their firms to adopt compliance procedures to prevent the misuse of material nonpublic information. Particularly important is improving compliance in such areas as the review of employee and proprietary trading, the review of investment recommendations, documentation of firm procedures, and the supervision of interdepartmental communications in multiservice firms. Compliance procedures should suit the particular characteristics of a firm, including its size and the nature of its business.

Members and candidates are encouraged to inform their supervisor and compliance personnel of suspected inappropriate use of material nonpublic information as the basis for security trading activities or recommendations being made within their firm.

### ***Adopt Disclosure Procedures***

Members and candidates should encourage their firms to develop and follow disclosure policies designed to ensure that information is disseminated to the marketplace in an equitable manner. For example, analysts from small firms should receive the

same information and attention from a company as analysts from large firms receive. Similarly, companies should not provide certain information to buy-side analysts but not to sell-side analysts, or vice versa. Furthermore, a company should not discriminate among analysts in the provision of information or “blackball” particular analysts who have given negative reports on the company in the past.

Within investment and research firms, members and candidates should encourage the development of and compliance with procedures for distributing new and updated investment opinions to clients. Recommendations of this nature may represent material market-moving information that needs to be communicated to all clients fairly.

### ***Issue Press Releases***

Companies should consider issuing press releases prior to analyst meetings and conference calls and scripting those meetings and calls to decrease the chance that further information will be disclosed. If material nonpublic information is disclosed for the first time in an analyst meeting or call, the company should promptly issue a press release or otherwise make the information publicly available.

### ***Firewall Elements***

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

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

### ***Appropriate Interdepartmental Communications***

Although documentation requirements must, for practical reasons, take into account the differences between the activities of small firms and those of large, multiservice firms, firms of all sizes and types benefit by improving the documentation of their internal enforcement of firewall procedures. Therefore, even at small firms, procedures concerning interdepartmental communication, the review of trading activity, and the investigation of possible violations should be compiled and formalized.

### ***Physical Separation of Departments***

As a practical matter, to the greatest extent possible, firms should consider the physical separation of departments and files to prevent the communication of sensitive information that should not be shared. For example, the investment banking and corporate finance areas of a brokerage firm should be separated from the sales and research departments, and a bank’s commercial lending department should be segregated from its trust and research departments.

### ***Prevention of Personnel Overlap***

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

### ***A Reporting System***

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

A single supervisor or compliance officer should have the specific authority and responsibility of deciding whether information is material and whether it is sufficiently public to be used as the basis for investment decisions. Ideally, the supervisor or compliance officer responsible for communicating information to a firm's research or brokerage area would not be a member of that area.

### ***Personal Trading Limitations***

Firms should consider restrictions or prohibitions on personal trading by employees and should carefully monitor both proprietary trading and personal trading by employees. Firms should require employees to make periodic reports (to the extent that such reporting is not already required by securities laws) of their own transactions and transactions made for the benefit of family members. Securities should be placed on a restricted list when a firm has or may have material nonpublic information. The broad distribution of a restricted list often triggers the sort of trading the list was developed to avoid. Therefore, a watch list shown to only the few people responsible for compliance should be used to monitor transactions in specified securities. The use of a watch list in combination with a restricted list is an increasingly common means of ensuring effective control of personal trading.

### ***Record Maintenance***

Multiservice firms should maintain written records of the communications between various departments. Firms should place a high priority on training and should consider instituting comprehensive training programs, particularly for employees in sensitive areas.

### ***Proprietary Trading Procedures***

Procedures concerning the restriction or review of a firm's proprietary trading while the firm possesses material nonpublic information will necessarily depend on the types of proprietary trading in which the firm may engage. A prohibition on all types of proprietary activity when a firm comes into possession of material nonpublic information is *not* appropriate. For example, when a firm acts as a market maker, a prohibition on proprietary trading may be counterproductive to the goals of maintaining the confidentiality of information and market liquidity. This concern is particularly important in the relationships between small, regional broker/dealers and small issuers. In many situations, a firm will take a small issuer public with the understanding that the firm will continue to be a market maker in the stock. In such instances, a withdrawal by the firm from market-making activities would be a clear tip to outsiders. Firms that continue market-making activity while in the possession of material nonpublic information should, however, instruct their market makers to remain passive with respect to the market—that is, to take only the contra side of unsolicited customer trades.

In risk-arbitrage trading, the case for a trading prohibition is more compelling than it is in the case of market making. The impetus for arbitrage trading is neither passive nor reactive, and the potential for illegal profits is greater than in market making. The most prudent course for firms is to suspend arbitrage activity when a security is placed on the watch list. Those firms that continue arbitrage activity face a high hurdle in proving the adequacy of their internal procedures for preventing trading on material nonpublic information and must demonstrate a stringent review and documentation of firm trades.

### ***Communication to All Employees***

Members and candidates should encourage their employers to circulate written compliance policies and guidelines to all employees. Policies and guidelines should be used in conjunction with training programs aimed at enabling employees to recognize material nonpublic information. Such information is not always clearly identifiable.

Employees must be given sufficient training to either make an informed decision or to realize they need to consult a supervisor or compliance officer before engaging in questionable transactions. Appropriate policies reinforce that using material nonpublic information is illegal in many countries. Such trading activities based on material nonpublic information undermine the integrity of the individual, the firm, and the capital markets.

## **Application of the Standard**

### ***Example 1 (Acting on Nonpublic Information):***

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

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

**Example 2 (Controlling Nonpublic Information):**

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

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

**Example 3 (Selective Disclosure of Material Information):**

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

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

**Example 4 (Determining Materiality):**

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

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

**Example 5 (Applying the Mosaic Theory):**

Jagdish Teja is a buy-side analyst covering the furniture industry. Looking for an attractive company to recommend as a buy, he analyzes several furniture makers by studying their financial reports and visiting their operations. He also talks to some designers and retailers to find out which furniture styles are trendy and popular. Although none of the companies that he analyzes are a clear buy, he discovers that one of them, Swan Furniture Company (SFC), may be in financial trouble. SFC's extravagant new designs have been introduced at substantial cost. Even though these designs initially attracted attention, the public is now buying more conservative furniture from other makers. Based on this information and on a profit-and-loss analysis, Teja believes that SFC's next quarter earnings will drop substantially. He issues a sell recommendation for SFC. Immediately after receiving that recommendation, investment managers start reducing the SFC stock in their portfolios.

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

**Example 6 (Applying the Mosaic Theory):**

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

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

**Example 7 (Analyst Recommendations as Material Nonpublic Information):**

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

*Comment:* When Zito receives advance notice of Clement's change of opinion, she knows it will have a material impact on the stock price, even if she is not totally aware of Clement's underlying reasoning. She is not a client

of Clement but obtains early access to the material nonpublic information prior to publication. Her trades are thus based on material nonpublic information and violate Standard II(A).

Zito further violates the Standard by relaying the information to her father. It would not matter if he or any other family member traded; the act of providing the information violates Standard II(A). The fact that the information is provided to a family member does not absolve someone of the prohibition of using or communicating material nonpublic information.

***Example 8 (Acting on Nonpublic Information):***

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

*Comment:* Even though Kellogg believes that Mayfield would not break the law by disclosing inside information and money was lost on the purchase, Kellogg should not have purchased additional shares of National. It is the member's or candidate's responsibility to make sure, before executing investment actions, that comments about earnings are not material nonpublic information. Kellogg has violated Standard II(A).

***Example 9 (Mosaic Theory):***

John Doll is a research analyst for a hedge fund that also sells its research to a select group of paying client investment firms. Doll's focus is medical technology companies and products, and he has been in the business long enough and has been successful enough to build up a very credible network of friends and experts in the business. Doll has been working on a major research report recommending Boyce Health, a medical device manufacturer. He recently ran into an old acquaintance at a wedding who is a senior executive at Boyce, and Doll asked about the business. Doll was drawn to a statement that the executive, who has responsibilities in the new products area, made about a product: "I would not get too excited about the medium-term prospects; we have a lot of work to do first." Doll incorporated this and other information about the new Boyce product in his long-term recommendation of Boyce.

*Comment:* Doll's conversation with the senior executive is part of the mosaic of information used in recommending Boyce. When holding discussions with a firm executive, Doll would need to guard against soliciting or obtaining material nonpublic information. Before issuing the report, the executive's statement about the continuing development of the product would need to be weighed against the other known public facts to determine whether it would be considered material.

**Example 10 (Materiality Determination):**

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

*Comment:* There are often rumors and whisper numbers before a release of any kind. The text message from the other trader would most likely be considered market noise. Unless Nadler knew that the trader had an ongoing business relationship with the public firm, he had no reason to suspect he was receiving material nonpublic information that would prevent him from completing the trading request of the portfolio manager.

**Example 11 (Using an Expert Network):**

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

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

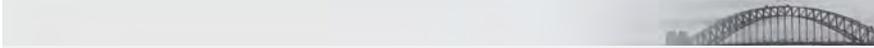
**Example 12 (Using an Expert Network):**

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

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

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

## Standard II(B) Market Manipulation



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

### Guidance

#### Highlights:

- *Information-Based Manipulation*
- *Transaction-Based Manipulation*

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

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

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

#### *Information-Based Manipulation*

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

### **Transaction-Based Manipulation**

Transaction-based manipulation involves instances where a member or candidate knew or should have known that his or her actions could affect the pricing of a security. This type of manipulation includes, but is not limited to, the following:

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

Standard II(B) is not intended to preclude transactions undertaken on legitimate trading strategies based on perceived market inefficiencies. The intent of the action is critical to determining whether it is a violation of this standard.

## **Application of the Standard**

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

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

*Comment:* The principal owner of FIS violated Standard II(B) by using inaccurate reporting and misleading information under the guise of independent analysis to artificially increase the stock price of the companies. Furthermore, the principal owner violated Standard V(A)—Diligence and Reasonable Basis by not having a reasonable and adequate basis for recommending the two companies and violated Standard VI(A)—Disclosure of Conflicts by not disclosing to investors the compensation agreements (which constituted a conflict of interest).

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

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

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

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

*Comment:* John violated Standard II(B) by fraudulently creating the appearance that there was a greater investor interest in the stock through the online rumors. Additionally, through his trading strategy, he created the

appearance that there was greater liquidity in the stock than actually existed. He was able to manipulate the price through both misinformation and trading practices.

**Example 3 (Creating Artificial Price Volatility):**

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

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

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

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

*Comment:* Murphy violated Standard II(B) by aiming to create artificial price volatility designed to have a material impact on the price of an issuer’s stock. Moreover, by lacking an adequate basis for the recommendation, Murphy also violated Standard V(A)—Diligence and Reasonable Basis.

**Example 4 (Personal Trading and Volume):**

Rajesh Sekar manages two funds—an equity fund and a balanced fund—whose equity components are supposed to be managed in accordance with the same model. According to that model, the funds’ holdings in stock of Digital Design Inc. (DD) are excessive. Reduction of the DD holdings would not be easy, however, because the stock has low liquidity in the stock market. Sekar decides to start trading larger portions of DD stock back and forth between his two funds to slowly increase the price; he believes market participants will see growing volume and increasing price and become interested in the stock. If other investors are willing to buy the DD stock because of such interest, then Sekar will be able to get rid of at least some of his overweight position without inducing price decreases. In this way, the whole transaction will be for the benefit of fund participants, even if additional brokers’ commissions are incurred.

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

**Example 5 (“Pump-Priming” Strategy):**

ACME Futures Exchange is launching a new bond futures contract. To convince investors, traders, arbitrageurs, hedgers, and so on, to use its contract, the exchange attempts to demonstrate that it has the best liquidity. To do so, it enters into agreements with members in which they commit to a substantial minimum trading volume on the new contract over a specific period in exchange for substantial reductions of their regular commissions.

*Comment:* The formal liquidity of a market is determined by the obligations set on market makers, but the actual liquidity of a market is better estimated by the actual trading volume and bid–ask spreads. Attempts to mislead participants about the actual liquidity of the market constitute a violation of Standard II(B). In this example, investors have been intentionally misled to believe they chose the most liquid instrument for some specific purpose, but they could eventually see the actual liquidity of the contract significantly reduced after the term of the agreement expires. If the ACME Futures Exchange fully discloses its agreement with members to boost transactions over some initial launch period, it will not violate Standard II(B). ACME’s intent is not to harm investors but, on the contrary, to give them a better service. For that purpose, it may engage in a liquidity-pumping strategy, but the strategy must be disclosed.

**Example 6 (Creating Artificial Price Volatility):**

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

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

*Comment:* By exaggerating her earnings projections in order to try to fuel a quick gain in Hygene’s stock price, Gordon is in violation of Standard II(B). Furthermore, by virtue of previewing her intentions of revising upward her earnings projections to only a select group of clients, she is in violation of Standard III(B)—Fair Dealing. However, it would have been acceptable for Gordon to write a report that

- framed her earnings projection in a range of possible outcomes,

- outlined clearly the assumptions used in her Hygene models that took into consideration the findings from her trip through Latin America, and
- was distributed to all Picador & Co. clients in an equitable manner.

***Example 7 (Pump and Dump Strategy):***

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

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

***Example 8 (Manipulating Model Inputs):***

Bill Mandeville supervises a structured financing team for Superior Investment Bank. His responsibilities include packaging new structured investment products and managing Superior's relationship with relevant rating agencies. To achieve the best rating possible, Mandeville uses mostly positive scenarios as model inputs—scenarios that reflect minimal downside risk in the assets underlying the structured products. The resulting output statistics in the rating request and underwriting prospectus support the idea that the new structured products have minimal potential downside risk. Additionally, Mandeville's compensation from Superior is partially based on both the level of the rating assigned and the successful sale of new structured investment products but does not have a link to the long-term performance of the instruments.

Mandeville is extremely successful and leads Superior as the top originator of structured investment products for the next two years. In the third year, the economy experiences difficulties and the values of the assets underlying structured products significantly decline. The subsequent defaults lead to major turmoil in the capital markets, the demise of Superior Investment Bank, and the loss of Mandeville's employment.

*Comment:* Mandeville manipulates the inputs of a model to minimize associated risk to achieve higher ratings. His understanding of structured products allows him to skillfully decide which inputs to include in support of the desired rating and price. This information manipulation for short-term gain, which is in violation of Standard II(B), ultimately causes significant damage to many parties and the capital markets as a whole. Mandeville should have realized that promoting a rating and price with inaccurate information could cause not only a loss of price confidence in the particular structured product but also a loss of investor trust in the system. Such loss of confidence affects the ability of the capital markets to operate efficiently.

***Example 9 (Information Manipulation):***

Allen King is a performance analyst for Torrey Investment Funds. King believes that the portfolio manager for the firm's small- and microcap equity fund dislikes him because the manager never offers him tickets to the local baseball team's games but does offer tickets to other employees. To incite a potential regulatory review of the manager, King creates user profiles on several online forums under the portfolio manager's name and starts rumors about potential mergers for several of the smaller

companies in the portfolio. As the prices of these companies' stocks increase, the portfolio manager sells the position, which leads to an investigation by the regulator as King desired.

*Comment:* King has violated Standard II(B) even though he did not personally profit from the market's reaction to the rumor. In posting the false information, King misleads others into believing the companies were likely to be acquired. Although his intent was to create trouble for the portfolio manager, his actions clearly manipulated the factual information that was available to the market.

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## STANDARD III: DUTIES TO CLIENTS

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



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

### Guidance

#### Highlights:

- *Understanding the Application of Loyalty, Prudence, and Care*
- *Identifying the Actual Investment Client*
- *Developing the Client's Portfolio*
- *Soft Commission Policies*
- *Proxy Voting Policies*

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

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

Standard III(A) sets minimum expectations for members and candidates when fulfilling their responsibilities to their clients. Regulatory and legal requirements for such duties can vary across the investment industry depending on a variety of factors,

including job function of the investment professional, the existence of an adviser/client relationship, and the nature of the recommendations being offered. From the perspective of the end user of financial services, these different standards can be arcane and confusing, leaving investors unsure of what level of service to expect from investment professionals they employ. The single standard of conduct described in Standard III(A) benefits investors by establishing a benchmark for the duties of loyalty, prudence, and care and clarifies that all CFA Institute members and candidates, regardless of job title, local laws, or cultural differences, are required to comply with these fundamental responsibilities. Investors hiring members or candidates who must adhere to the duty of loyalty, prudence, and care set forth in this standard can be confident that these responsibilities are a requirement regardless of any legally imposed fiduciary duties.

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

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

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

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

A member or candidate who does not provide advisory services to a client but who acts only as a trade execution professional must prudently work in the client's interest when completing requested trades. Acting in the client's best interest requires these professionals to use their skills and diligence to execute trades in the most favorable terms that can be achieved. Members and candidates operating in such positions must use care to operate within the parameters set by the client's trading instructions.

Members and candidates may also operate in a blended environment where they execute client trades and offer advice on a limited set of investment options. The extent of the advisory arrangement and limitations should be outlined in the agreement with the client at the outset of the relationship. For instance, members and candidates should

inform clients that the advice provided will be limited to the propriety products of the firm and not include other products available on the market. Clients who want access to a wider range of investment products would have the information necessary to decide not to engage with members or candidates working under these restrictions.

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

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

### ***Identifying the Actual Investment Client***

The first step for members and candidates in fulfilling their duty of loyalty to clients is to determine the identity of the "client" to whom the duty of loyalty is owed. In the context of an investment manager managing the personal assets of an individual, the client is easily identified. When the manager is responsible for the portfolios of pension plans or trusts, however, the client is not the person or entity who hires the manager but, rather, the beneficiaries of the plan or trust. The duty of loyalty is owed to the ultimate beneficiaries.

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

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

Members and candidates with positions whose responsibilities do not include direct investment management also have "clients" that must be considered. Just as there are various types of advisory relationships, members and candidates must look at their roles and responsibilities when making a determination of who their clients are. Sometimes the client is easily identifiable; such is the case in the relationship between a company executive and the firm's public shareholders. At other times, the client may be the investing public as a whole, in which case the goals of independence and objectivity of research surpass the goal of loyalty to a single organization.

### ***Developing the Client's Portfolio***

The duty of loyalty, prudence, and care owed to the individual client is especially important because the professional investment manager typically possesses greater knowledge in the investment arena than the client does. This disparity places the individual client in a vulnerable position; the client must trust the manager. The manager in these situations should ensure that the client's objectives and expectations for the

performance of the account are realistic and suitable to the client's circumstances and that the risks involved are appropriate. In most circumstances, recommended investment strategies should relate to the long-term objectives and circumstances of the client.

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

Members and candidates must follow any guidelines set by their clients for the management of their assets. Some clients, such as charitable organizations and pension plans, have strict investment policies that limit investment options to certain types or classes of investment or prohibit investment in certain securities. Other organizations have aggressive policies that do not prohibit investments by type but, instead, set criteria on the basis of the portfolio's total risk and return.

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

#### ***Soft Commission Policies***

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

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

#### ***Proxy Voting Policies***

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

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

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

## Recommended Procedures for Compliance

### *Regular Account Information*

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

### *Client Approval*

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

### *Firm Policies*

Members and candidates should address and encourage their firms to address the following topics when drafting the statements or manuals containing their policies and procedures regarding responsibilities to clients:

- *Follow all applicable rules and laws:* Members and candidates must follow all legal requirements and applicable provisions of the Code and Standards.
- *Establish the investment objectives of the client:* Make a reasonable inquiry into a client’s investment experience, risk and return objectives, and financial constraints prior to making investment recommendations or taking investment actions.
- *Consider all the information when taking actions:* When taking investment actions, members and candidates must consider the appropriateness and suitability of the investment relative to (1) the client’s needs and circumstances, (2) the investment’s basic characteristics, and (3) the basic characteristics of the total portfolio.
- *Diversify:* Members and candidates should diversify investments to reduce the risk of loss, unless diversification is not consistent with plan guidelines or is contrary to the account objectives.
- *Carry out regular reviews:* Members and candidates should establish regular review schedules to ensure that the investments held in the account adhere to the terms of the governing documents.
- *Deal fairly with all clients with respect to investment actions:* Members and candidates must not favor some clients over others and should establish policies for allocating trades and disseminating investment recommendations.
- *Disclose conflicts of interest:* Members and candidates must disclose all actual and potential conflicts of interest so that clients can evaluate those conflicts.
- *Disclose compensation arrangements:* Members and candidates should make their clients aware of all forms of manager compensation.

- *Vote proxies:* In most cases, members and candidates should determine who is authorized to vote shares and vote proxies in the best interests of the clients and ultimate beneficiaries.
- *Maintain confidentiality:* Members and candidates must preserve the confidentiality of client information.
- *Seek best execution:* Unless directed by the client as ultimate beneficiary, members and candidates must seek best execution for their clients. (Best execution is defined in the preceding text.)
- *Place client interests first:* Members and candidates must serve the best interests of clients.

## Application of the Standard

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

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

*Comment:* Standard III(A) requires that a member or candidate, in evaluating a takeover bid, act prudently and solely in the interests of plan participants and beneficiaries. To meet this requirement, a member or candidate must carefully evaluate the long-term prospects of the company against the short-term prospects presented by the takeover offer and by the ability to invest elsewhere. In this instance, Wiley, acting on behalf of his employer, which was the trustee for a pension plan, clearly violated Standard III(A). He used the pension plan to perpetuate existing management, perhaps to the detriment of plan participants and the company’s shareholders, and to benefit himself. Wiley’s responsibilities to the plan participants and beneficiaries should have taken precedence over any ties of his bank to corporate managers and over his self-interest. Wiley had a duty to examine the takeover offer on its own merits and to make an independent decision. The guiding principle is the appropriateness of the investment decision to the pension plan, not whether the decision benefited Wiley or the company that hired him.

### *Example 2 (Client Commission Practices):*

JNI, a successful investment counseling firm, serves as investment manager for the pension plans of several large regionally based companies. Its trading activities generate a significant amount of commission-related business. JNI uses the brokerage and research services of many firms, but most of its trading activity is handled through a large brokerage company, Thompson, Inc., because the executives of the two firms have a close friendship. Thompson’s commission structure is high in comparison with charges for similar brokerage services from other firms. JNI considers Thompson’s

research services and execution capabilities average. In exchange for JNI directing its brokerage to Thompson, Thompson absorbs a number of JNI overhead expenses, including those for rent.

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

**Example 3 (Brokerage Arrangements):**

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

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

**Example 4 (Brokerage Arrangements):**

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

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

**Example 5 (Client Commission Practices):**

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

commission business to SouthAM so she can take the trip. SouthAM has conveniently timed the briefing trip to coincide with the beginning of Carnival season, so Parker also decides to spend five days of vacation in Rio de Janeiro at the end of the trip. Parker uses commission dollars to pay for the five days of hotel expenses.

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

**Example 6 (Excessive Trading):**

Vida Knauss manages the portfolios of a number of high-net-worth individuals. A major part of her investment management fee is based on trading commissions. Knauss engages in extensive trading for each of her clients to ensure that she attains the minimum commission level set by her firm. Although the securities purchased and sold for the clients are appropriate and fall within the acceptable asset classes for the clients, the amount of trading for each account exceeds what is necessary to accomplish the client's investment objectives.

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

**Example 7 (Managing Family Accounts):**

Adam Dill recently joined New Investments Asset Managers. To assist Dill in building a book of clients, both his father and brother opened new fee-paying accounts. Dill followed all the firm's procedures in noting his relationships with these clients and in developing their investment policy statements.

After several years, the number of Dill's clients has grown, but he still manages the original accounts of his family members. An IPO is coming to market that is a suitable investment for many of his clients, including his brother. Dill does not receive the amount of stock he requested, so to avoid any appearance of a conflict of interest, he does not allocate any shares to his brother's account.

*Comment:* Dill has violated Standard III(A) because he is not acting for the benefit of his brother's account as well as his other accounts. The brother's account is a regular fee-paying account comparable to the accounts of his other clients. By not allocating the shares proportionately across *all* accounts for which he thought the IPO was suitable, Dill is disadvantaging specific clients.

Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm.

**Example 8 (Identifying the Client):**

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

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

**Example 9 (Identifying the Client):**

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

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

**Example 10 (Client Loyalty):**

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

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

**Example 11 (Execution-Only Responsibilities):**

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

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

## Standard III(B) Fair Dealing



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

### Guidance

#### Highlights:

- *Investment Recommendations*
- *Investment Action*

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

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

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

Standard III(B) covers conduct in two broadly defined categories—investment recommendations and investment action.

#### *Investment Recommendations*

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

An investment recommendation is any opinion expressed by a member or candidate in regard to purchasing, selling, or holding a given security or other investment. The opinion may be disseminated to customers or clients through an initial detailed research report, through a brief update report, by addition to or deletion from a list of recommended securities, or simply by oral communication. A recommendation that is distributed to anyone outside the organization is considered a communication for general distribution under Standard III(B).

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

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

### ***Investment Action***

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

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

Members and candidates should disclose to clients and prospective clients the documented allocation procedures they or their firms have in place and how the procedures would affect the client or prospect. The disclosure should be clear and complete so that the client can make an informed investment decision. Even when

complete disclosure is made, however, members and candidates must put client interests ahead of their own. A member's or candidate's duty of fairness and loyalty to clients can never be overridden by client consent to patently unfair allocation procedures.

Treating clients fairly also means that members and candidates should not take advantage of their position in the industry to the detriment of clients. For instance, in the context of IPOs, members and candidates must make bona fide public distributions of "hot issue" securities (defined as securities of a public offering that are trading at a premium in the secondary market whenever such trading commences because of the great demand for the securities). Members and candidates are prohibited from withholding such securities for their own benefit and must not use such securities as a reward or incentive to gain benefit.

## Recommended Procedures for Compliance

### *Develop Firm Policies*

Although Standard III(B) refers to a member's or candidate's responsibility to deal fairly and objectively with clients, members and candidates should also encourage their firms to establish compliance procedures requiring all employees who disseminate investment recommendations or take investment actions to treat customers and clients fairly. At the very least, a member or candidate should recommend appropriate procedures to management if none are in place. And the member or candidate should make management aware of possible violations of fair-dealing practices within the firm when they come to the attention of the member or candidate.

The extent of the formality and complexity of such compliance procedures depends on the nature and size of the organization and the type of securities involved. An investment adviser who is a sole proprietor and handles only discretionary accounts might not disseminate recommendations to the public, but that adviser should have formal written procedures to ensure that all clients receive fair investment action.

Good business practice dictates that initial recommendations be made available to all customers who indicate an interest. Although a member or candidate need not communicate a recommendation to all customers, the selection process by which customers receive information should be based on suitability and known interest, not on any preferred or favored status. A common practice to assure fair dealing is to communicate recommendations simultaneously within the firm and to customers.

Members and candidates should consider the following points when establishing fair-dealing compliance procedures:

- *Limit the number of people involved:* Members and candidates should make reasonable efforts to limit the number of people who are privy to the fact that a recommendation is going to be disseminated.
- *Shorten the time frame between decision and dissemination:* Members and candidates should make reasonable efforts to limit the amount of time that elapses between the decision to make an investment recommendation and the time the actual recommendation is disseminated. If a detailed institutional recommendation that might take two or three weeks to publish is in preparation, a short summary report including the conclusion might be published in advance. In an organization where both a research committee and an investment policy committee must approve a recommendation, the meetings should be held on the same day if possible. The process of reviewing reports and printing and mailing them, faxing them, or distributing them by e-mail necessarily involves the passage of time, sometimes long periods of time. In large firms with extensive review processes, the time factor is usually not within the control of the analyst who prepares the report. Thus, many firms and their analysts communicate

to customers and firm personnel the new or changed recommendations by an update or “flash” report. The communication technique might be fax, e-mail, wire, or short written report.

- *Publish guidelines for pre-dissemination behavior:* Members and candidates should encourage firms to develop guidelines that prohibit personnel who have prior knowledge of an investment recommendation from discussing or taking any action on the pending recommendation.
- *Simultaneous dissemination:* Members and candidates should establish procedures for the timing of dissemination of investment recommendations so that all clients are treated fairly—that is, are informed at approximately the same time. For example, if a firm is going to announce a new recommendation, supervisory personnel should time the announcement to avoid placing any client or group of clients at an unfair advantage relative to other clients. A communication to all branch offices should be sent at the time of the general announcement. (When appropriate, the firm should accompany the announcement of a new recommendation with a statement that trading restrictions for the firm’s employees are now in effect. The trading restrictions should stay in effect until the recommendation is widely distributed to all relevant clients.) Once this distribution has occurred, the member or candidate may follow up separately with individual clients, but members and candidates should not give favored clients advance information when such advance notification may disadvantage other clients.
- *Maintain a list of clients and their holdings:* Members and candidates should maintain a list of all clients and the securities or other investments each client holds in order to facilitate notification of customers or clients of a change in an investment recommendation. If a particular security or other investment is to be sold, such a list can be used to ensure that all holders are treated fairly in the liquidation of that particular investment.
- *Develop and document trade allocation procedures:* When formulating procedures for allocating trades, members and candidates should develop a set of guiding principles that ensure
  - fairness to advisory clients, both in priority of execution of orders and in the allocation of the price obtained in execution of block orders or trades,
  - timeliness and efficiency in the execution of orders, and
  - accuracy of the member’s or candidate’s records as to trade orders and client account positions.

With these principles in mind, members and candidates should develop or encourage their firm to develop written allocation procedures, with particular attention to procedures for block trades and new issues. Procedures to consider are as follows:

- requiring orders and modifications or cancellations of orders to be documented and time stamped;
- processing and executing orders on a first-in, first-out basis with consideration of bundling orders for efficiency as appropriate for the asset class or the security;
- developing a policy to address such issues as calculating execution prices and “partial fills” when trades are grouped, or in a block, for efficiency;
- giving all client accounts participating in a block trade the same execution price and charging the same commission;

- when the full amount of the block order is not executed, allocating partially executed orders among the participating client accounts pro rata on the basis of order size while not going below an established minimum lot size for some securities (e.g., bonds); and
- when allocating trades for new issues, obtaining advance indications of interest, allocating securities by client (rather than portfolio manager), and providing a method for calculating allocations.

#### ***Disclose Trade Allocation Procedures***

Members and candidates should disclose to clients and prospective clients how they select accounts to participate in an order and how they determine the amount of securities each account will buy or sell. Trade allocation procedures must be fair and equitable, and disclosure of inequitable allocation methods does not relieve the member or candidate of this obligation.

#### ***Establish Systematic Account Review***

Member and candidate supervisors should review each account on a regular basis to ensure that no client or customer is being given preferential treatment and that the investment actions taken for each account are suitable for each account's objectives. Because investments should be based on individual needs and circumstances, an investment manager may have good reasons for placing a given security or other investment in one account while selling it from another account and should fully document the reasons behind both sides of the transaction. Members and candidates should encourage firms to establish review procedures, however, to detect whether trading in one account is being used to benefit a favored client.

#### ***Disclose Levels of Service***

Members and candidates should disclose to all clients whether the organization offers different levels of service to clients for the same fee or different fees. Different levels of service should not be offered to clients selectively.

## **Application of the Standard**

### ***Example 1 (Selective Disclosure):***

Bradley Ames, a well-known and respected analyst, follows the computer industry. In the course of his research, he finds that a small, relatively unknown company whose shares are traded over the counter has just signed significant contracts with some of the companies he follows. After a considerable amount of investigation, Ames decides to write a research report on the small company and recommend purchase of its shares. While the report is being reviewed by the company for factual accuracy, Ames schedules a luncheon with several of his best clients to discuss the company. At the luncheon, he mentions the purchase recommendation scheduled to be sent early the following week to all the firm's clients.

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

### ***Example 2 (Fair Dealing between Funds):***

Spencer Rivers, president of XYZ Corporation, moves his company's growth-oriented pension fund to a particular bank primarily because of the excellent investment performance achieved by the bank's commingled fund for the prior five-year period.

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

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

*Comment:* The bank's policy does not treat all customers fairly, and Jackson has violated her duty to her clients by giving priority to the growth-oriented commingled fund over all other funds and to discretionary accounts over nondiscretionary accounts. Jackson must execute orders on a systematic basis that is fair to all clients. In addition, trade allocation procedures should be disclosed to all clients when they become clients. Of course, in this case, disclosure of the bank's policy would not change the fact that the policy is unfair.

**Example 3 (Fair Dealing and IPO Distribution):**

Dominic Morris works for a small regional securities firm. His work consists of corporate finance activities and investing for institutional clients. Arena, Ltd., is planning to go public. The partners have secured rights to buy an arena football league franchise and are planning to use the funds from the issue to complete the purchase. Because arena football is the current rage, Morris believes he has a hot issue on his hands. He has quietly negotiated some options for himself for helping convince Arena to do the financing through his securities firm. When he seeks expressions of interest, the institutional buyers oversubscribe the issue. Morris, assuming that the institutions have the financial clout to drive the stock up, then fills all orders (including his own) and decreases the institutional blocks.

*Comment:* Morris has violated Standard III(B) by not treating all customers fairly. He should not have taken any shares himself and should have prorated the shares offered among all clients. In addition, he should have disclosed to his firm and to his clients that he received options as part of the deal [see Standard VI(A)—Disclosure of Conflicts].

**Example 4 (Fair Dealing and Transaction Allocation):**

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

that some of the MBSs have significantly increased in price and some have dropped. Preston decides to allocate the profitable trades to Colby and spread the losing trades among several other PWI accounts.

*Comment:* Preston has violated Standard III(B) by failing to deal fairly with her clients in taking these investment actions. Preston should have allocated the trades prior to executing the orders, or she should have had a systematic approach to allocating the trades, such as pro rata, as soon as practical after they were executed. Among other things, Preston must disclose to the client that the adviser may act as broker for, receive commissions from, and have a potential conflict of interest regarding both parties in agency cross-transactions. After the disclosure, she should obtain from the client consent authorizing such transactions in advance.

**Example 5 (Selective Disclosure):**

Saunders Industrial Waste Management (SIWM) publicly indicates to analysts that it is comfortable with the somewhat disappointing earnings-per-share projection of US\$1.16 for the quarter. Bernard Roberts, an analyst at Coffey Investments, is confident that SIWM management has understated the forecasted earnings so that the real announcement will cause an “upside surprise” and boost the price of SIWM stock. The “whisper number” (rumored) estimate based on extensive research and discussed among knowledgeable analysts is higher than US\$1.16. Roberts repeats the US\$1.16 figure in his research report to all Coffey clients but informally tells his large clients that he expects the earnings per share to be higher, making SIWM a good buy.

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

**Example 6 (Additional Services for Select Clients):**

Jenpin Weng uses e-mail to issue a new recommendation to all his clients. He then calls his three largest institutional clients to discuss the recommendation in detail.

*Comment:* Weng has not violated Standard III(B) because he widely disseminated the recommendation and provided the information to all his clients prior to discussing it with a select few. Weng’s largest clients received additional personal service because they presumably pay higher fees or because they have a large amount of assets under Weng’s management. If Weng had discussed the report with a select group of clients prior to distributing it to all his clients, he would have violated Standard III(B).

**Example 7 (Minimum Lot Allocations):**

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

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

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

**Example 8 (Excessive Trading):**

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

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

**Example 9 (Limited Social Media Disclosures):**

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

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

*Comment:* Burdette has violated Standard III(B) by sending an investment recommendation to a select group of contacts prior to distributing it to all clients. Burdette must make sure she has received the appropriate training about FIM's policies and procedures, including the appropriate business use of personal social media networks before engaging in such activities.

See Standard IV(C) for guidance related to the duties of the supervisor.

**Example 10 (Fair Dealing between Clients):**

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

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

**Standard III(C) Suitability**


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

**Guidance****Highlights:**

- *Developing an Investment Policy*
- *Understanding the Client's Risk Profile*
- *Updating an Investment Policy*
- *The Need for Diversification*
- *Addressing Unsolicited Trading Requests*
- *Managing to an Index or Mandate*

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

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

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

#### ***Developing an Investment Policy***

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

#### ***Understanding the Client's Risk Profile***

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

The use of synthetic investment vehicles and derivative investment products has introduced particular issues of risk. Members and candidates should pay careful attention to the leverage inherent in many of these vehicles or products when considering them for use in a client's investment program. Such leverage and limited liquidity, depending on the degree to which they are hedged, bear directly on the issue of suitability for the client.

### ***Updating an Investment Policy***

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

For an individual client, important changes might include the number of dependents, personal tax status, health, liquidity needs, risk tolerance, amount of wealth beyond that represented in the portfolio, and extent to which compensation and other income provide for current income needs. With respect to an institutional client, such changes might relate to the magnitude of unfunded liabilities in a pension fund, the withdrawal privileges in an employee savings plan, or the distribution requirements of a charitable foundation. Without efforts to update information concerning client factors, one or more factors could change without the investment manager's knowledge.

Suitability review can be done most effectively when the client fully discloses his or her complete financial portfolio, including those portions not managed by the member or candidate. If clients withhold information about their financial portfolios, the suitability analysis conducted by members and candidates cannot be expected to be complete; it must be based on the information provided.

### ***The Need for Diversification***

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

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

### ***Addressing Unsolicited Trading Requests***

Members and candidates may receive requests from a client for trades that do not properly align with the risk and return objectives outlined in the client's investment policy statement. These transaction requests may be based on the client's individual biases or professional experience. Members and candidates will need to make reasonable efforts to balance their clients' trading requests with their responsibilities to follow the agreed-on investment policy statement.

In cases of unsolicited trade requests that a member or candidate knows are unsuitable for a client, the member or candidate should refrain from making the trade until he or she discusses the concerns with the client. The discussions and resulting actions may encompass a variety of scenarios depending on how the requested unsuitable investment relates to the client's full portfolio.

Many times, an unsolicited request may be expected to have only a minimum impact on the entire portfolio because the size of the requested trade is small or the trade would result in a limited change to the portfolio's risk profile. In discussing the trade, the member or candidate should focus on educating the investor on how the request

deviates from the current policy statement. Following the discussion, the member or candidate may follow his or her firm's policies regarding the necessary client approval for executing unsuitable trades. At a minimum, the client should acknowledge the discussion and accept the conditions that make the recommendation unsuitable.

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

Members and candidates may have some clients who decline to modify their policy statements while insisting an unsolicited trade be made. In such instances, members or candidates will need to evaluate the effectiveness of their services to the client. The options available to the members or candidates will depend on the services provided by their employer. Some firms may allow for the trade to be executed in a new unmanaged account. If alternative options are not available, members and candidates ultimately will need to determine whether they should continue the advisory arrangement with the client.

### ***Managing to an Index or Mandate***

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

## **Recommended Procedures for Compliance**

### ***Investment Policy Statement***

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

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

### ***Regular Updates***

The investor's objectives and constraints should be maintained and reviewed periodically to reflect any changes in the client's circumstances. Members and candidates should regularly compare client constraints with capital market expectations to arrive at an appropriate asset allocation. Changes in either factor may result in a fundamental change in asset allocation. Annual review is reasonable unless business or other reasons, such as a major change in market conditions, dictate more frequent review. Members and candidates should document attempts to carry out such a review if circumstances prevent it.

### ***Suitability Test Policies***

With the increase in regulatory required suitability tests, members and candidates should encourage their firms to develop related policies and procedures. The procedures will differ according to the size of the firm and the scope of the services offered to its clients.

The test procedures should require the investment professional to look beyond the potential return of the investment and include the following:

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

## **Application of the Standard**

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

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

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

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

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

*Comment:* When determining suitability of an investment, the primary focus should be the characteristics of the client's entire portfolio, not the characteristics of single securities on an issue-by-issue basis. The basic characteristics of the entire portfolio will largely determine whether investment

recommendations are taking client factors into account. Therefore, the most important aspects of a particular investment are those that will affect the characteristics of the total portfolio. In this case, McDowell properly considers the investment in the context of the entire portfolio and thoroughly explains the investment to the client.

**Example 3 (IPS Updating):**

In a regular meeting with client Seth Jones, the portfolio managers at Blue Chip Investment Advisors are careful to allow some time to review his current needs and circumstances. In doing so, they learn that some significant changes have recently taken place in his life. A wealthy uncle left Jones an inheritance that increased his net worth fourfold, to US\$1 million.

*Comment:* The inheritance has significantly increased Jones's ability (and possibly his willingness) to assume risk and has diminished the average yield required to meet his current income needs. Jones's financial circumstances have definitely changed, so Blue Chip managers must update Jones's investment policy statement to reflect how his investment objectives have changed. Accordingly, the Blue Chip portfolio managers should consider a somewhat higher equity ratio for his portfolio than was called for by the previous circumstances, and the managers' specific common stock recommendations might be heavily tilted toward low-yield, growth-oriented issues.

**Example 4 (Following an Investment Mandate):**

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

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

**Example 5 (IPS Requirements and Limitations):**

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

*Comment:* Gubler is violating Standard III(A)—Loyalty, Prudence, and Care as well as Standard III(C). His new investment locks up part of the subsidiary's assets for at least three years and up to as many as five years and possibly beyond. The IPS requires investments in highly liquid investments and describes accepted asset classes; private equity investments with

a lockup period certainly do not qualify. Even without a lockup period, an asset class with only an occasional, and thus implicitly illiquid, market may not be suitable for the portfolio. Although an IPS typically describes objectives and constraints in great detail, the manager must also make every effort to understand the client's business and circumstances. Doing so should enable the manager to recognize, understand, and discuss with the client other factors that may be or may become material in the investment management process.

**Example 6 (Submanager and IPS Reviews):**

Paul Ostrowski's investment management business has grown significantly over the past couple of years, and some clients want to diversify internationally. Ostrowski decides to find a submanager to handle the expected international investments. Because this will be his first subadviser, Ostrowski uses the CFA Institute model "request for proposal" to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm's bottom line.

*Comment:* When selecting an external manager or subadviser, Ostrowski needs to ensure that the new manager's services are appropriate for his clients. This due diligence includes comparing the risk profile of the clients with the investment strategy of the manager. In basing the decision on the fee structure alone, Ostrowski may be violating Standard III(C).

When clients ask to diversify into international products, it is an appropriate time to review and update the clients' IPSs. Ostrowski's review may determine that the risk of international investments modifies the risk profiles of the clients or does not represent an appropriate investment.

See also Standard V(A)—Diligence and Reasonable Basis for further discussion of the review process needed in selecting appropriate submanagers.

**Example 7 (Investment Suitability—Risk Profile):**

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indexes. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

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

See also Standard VI(A)—Disclosure of Conflicts.

**Example 8 (Investment Suitability):**

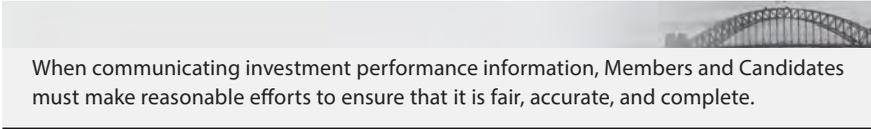
Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

*Comment:* Shrub has violated Standard III(C) because the risk profile of the new fund may not be suitable for every client. As an investment adviser, Shrub needs to establish an investment policy statement for each client and recommend only investments that match each client's risk and return profile in the IPS. Shrub is required to act as more than a simple sales agent for Elite.

Although Shrub cannot disobey the direct request of a client to purchase a specific security, he should fully discuss the risks of a planned purchase and provide reasons why it might not be suitable for a client. This requirement may lead members and candidates to decline new customers if those customers' requested investment decisions are significantly out of line with their stated requirements.

See also Standard V(A)–Diligence and Reasonable Basis.

## Standard III(D) Performance Presentation



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

### Guidance

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

Standard III(D) covers any practice that would lead to misrepresentation of a member's or candidate's performance record, whether the practice involves performance presentation or performance measurement. This standard prohibits misrepresentations of past performance or reasonably expected performance. A member or candidate must give a fair and complete presentation of performance information whenever communicating data with respect to the performance history of individual accounts, composites or groups of accounts, or composites of an analyst's or firm's performance results. Furthermore, members and candidates should not state or imply that clients will obtain or benefit from a rate of return that was generated in the past.

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

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

## Recommended Procedures for Compliance

### *Apply the GIPS Standards*

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

### *Compliance without Applying GIPS Standards*

Members and candidates can also meet their obligations under Standard III(D) by

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

## Application of the Standard

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

Kyle Taylor of Taylor Trust Company, noting the performance of Taylor's common trust fund for the past two years, states in a brochure sent to his potential clients, "You can expect steady 25% annual compound growth of the value of your investments over the year." Taylor Trust's common trust fund did increase at the rate of 25% per year for the past year, which mirrored the increase of the entire market. The fund has never averaged that growth for more than one year, however, and the average rate of growth of all of its trust accounts for five years is 5% per year.

*Comment:* Taylor's brochure is in violation of Standard III(D). Taylor should have disclosed that the 25% growth occurred only in one year. Additionally, Taylor did not include client accounts other than those in the firm's common trust fund. A general claim of firm performance should take into account the performance of all categories of accounts. Finally, by

stating that clients can expect a steady 25% annual compound growth rate, Taylor is also violating Standard I(C)—Misrepresentation, which prohibits assurances or guarantees regarding an investment.

**Example 2 (Performance Calculation and Asset Weighting):**

Anna Judd, a senior partner of Alexander Capital Management, circulates a performance report for the capital appreciation accounts for the years 1988 through 2004. The firm claims compliance with the GIPS standards. Returns are not calculated in accordance with the requirements of the GIPS standards, however, because the composites are not asset weighted.

*Comment:* Judd is in violation of Standard III(D). When claiming compliance with the GIPS standards, firms must meet *all* of the requirements, make mandatory disclosures, and meet any other requirements that apply to that firm's specific situation. Judd's violation is not from any misuse of the data but from a false claim of GIPS compliance.

**Example 3 (Performance Presentation and Prior Fund/Employer):**

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

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

**Example 4 (Performance Presentation and Simulated Results):**

Jed Davis has developed a mutual fund selection product based on historical information from the 1990–95 period. Davis tested his methodology by applying it retroactively to data from the 1996–2003 period, thus producing simulated performance results for those years. In January 2004, Davis's employer decided to offer the product and Davis began promoting it through trade journal advertisements and direct dissemination to clients. The advertisements included the performance results for the 1996–2003 period but did not indicate that the results were simulated.

*Comment:* Davis violated Standard III(D) by failing to clearly identify simulated performance results. Standard III(D) prohibits members and candidates from making any statements that misrepresent the performance achieved by them or their firms and requires members and candidates

to make every reasonable effort to ensure that performance information presented to clients is fair, accurate, and complete. Use of simulated results should be accompanied by full disclosure as to the source of the performance data, including the fact that the results from 1995 through 2003 were the result of applying the model retroactively to that time period.

***Example 5 (Performance Calculation and Selected Accounts Only):***

In a presentation prepared for prospective clients, William Kilmer shows the rates of return realized over a five-year period by a “composite” of his firm’s discretionary accounts that have a “balanced” objective. This composite, however, consisted of only a few of the accounts that met the balanced criterion set by the firm, excluded accounts under a certain asset level without disclosing the fact of their exclusion, and included accounts that did not have the balanced mandate because those accounts would boost the investment results. In addition, to achieve better results, Kilmer manipulated the narrow range of accounts included in the composite by changing the accounts that made up the composite over time.

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

***Example 6 (Performance Attribution Changes):***

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

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

*Comment:* Modifying the attribution methodology without proper notifications to clients would fail to meet the requirements of Standard III(D). Purell’s recommendation is being done solely for the interest of the firm to improve its perceived ability to meet the stated investment strategy. Such changes are unfair to clients and obscure the facts regarding the firm’s abilities.

Had Purell believed the new methodology offered improvements to the original model, then he would have needed to report the results of both calculations to the client. The report should also include the reasons why the new methodology is preferred, which would allow the client to make a meaningful comparison to prior results and provide a basis for comparing future attributions.

***Example 7 (Performance Calculation Methodology Disclosure):***

While developing a new reporting package for existing clients, Alisha Singh, a performance analyst, discovers that her company’s new system automatically calculates both time-weighted and money-weighted returns. She asks the head of client services and retention which value would be preferred given that the firm has various investment

strategies that include bonds, equities, securities without leverage, and alternatives. Singh is told not to label the return value so that the firm may show whichever value is greatest for the period.

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

**Example 8 (Performance Calculation Methodology Disclosure):**

Richmond Equity Investors manages a long–short equity fund in which clients can trade once a week (on Fridays). For transparency reasons, a daily net asset value of the fund is calculated by Richmond. The monthly fact sheets of the fund report month-to-date and year-to-date performance. Richmond publishes the performance based on the higher of the last trading day of the month (typically, not the last business day) or the last business day of the month as determined by Richmond. The fact sheet mentions only that the data are as of the end of the month, without giving the exact date. Maggie Clark, the investment performance analyst in charge of the calculations, is concerned about the frequent changes and asks her supervisor whether they are appropriate.

*Comment:* Clark's actions in questioning the changing performance metric comply with Standard III(D). She has shown concern that these changes are not presenting an accurate and complete picture of the performance generated.

## Standard III(E) Preservation of Confidentiality

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

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

## Guidance

### Highlights:

- *Status of Client*
- *Compliance with Laws*
- *Electronic Information and Security*
- *Professional Conduct Investigations by CFA Institute*

Standard III(E) requires that members and candidates preserve the confidentiality of information communicated to them by their clients, prospective clients, and former clients. This standard is applicable when (1) the member or candidate receives information because of his or her special ability to conduct a portion of the client's business or personal affairs and (2) the member or candidate receives information that arises

from or is relevant to that portion of the client's business that is the subject of the special or confidential relationship. If disclosure of the information is required by law or the information concerns illegal activities by the client, however, the member or candidate may have an obligation to report the activities to the appropriate authorities.

#### ***Status of Client***

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

#### ***Compliance with Laws***

As a general matter, members and candidates must comply with applicable law. If applicable law requires disclosure of client information in certain circumstances, members and candidates must comply with the law. Similarly, if applicable law requires members and candidates to maintain confidentiality, even if the information concerns illegal activities on the part of the client, members and candidates should not disclose such information. Additionally, applicable laws, such as inter-departmental communication restrictions within financial institutions, can impose limitations on information flow about a client within an entity that may lead to a violation of confidentiality. When in doubt, members and candidates should consult with their employer's compliance personnel or legal counsel before disclosing confidential information about clients.

#### ***Electronic Information and Security***

Because of the ever-increasing volume of electronically stored information, members and candidates need to be particularly aware of possible accidental disclosures. Many employers have strict policies about how to electronically communicate sensitive client information and store client information on personal laptops, mobile devices, or portable disk/flash drives. In recent years, regulatory authorities have imposed stricter data security laws applying to the use of mobile remote digital communication, including the use of social media, that must be considered. Standard III(E) does not require members or candidates to become experts in information security technology, but they should have a thorough understanding of the policies of their employer. The size and operations of the firm will lead to differing policies for ensuring the security of confidential information maintained within the firm. Members and candidates should encourage their firm to conduct regular periodic training on confidentiality procedures for all firm personnel, including portfolio associates, receptionists, and other non-investment staff who have routine direct contact with clients and their records.

#### ***Professional Conduct Investigations by CFA Institute***

The requirements of Standard III(E) are not intended to prevent members and candidates from cooperating with an investigation by the CFA Institute Professional Conduct Program (PCP). When permissible under applicable law, members and candidates shall consider the PCP an extension of themselves when requested to provide information about a client in support of a PCP investigation into their own conduct. Members and candidates are encouraged to cooperate with investigations into the conduct of others. Any information turned over to the PCP is kept in the strictest confidence. Members and candidates will not be considered in violation of this standard by forwarding confidential information to the PCP.

## Recommended Procedures for Compliance

The simplest, most conservative, and most effective way to comply with Standard III(E) is to avoid disclosing any information received from a client except to authorized fellow employees who are also working for the client. In some instances, however, a member or candidate may want to disclose information received from clients that is outside the scope of the confidential relationship and does not involve illegal activities. Before making such a disclosure, a member or candidate should ask the following:

- In what context was the information disclosed? If disclosed in a discussion of work being performed for the client, is the information relevant to the work?
- Is the information background material that, if disclosed, will enable the member or candidate to improve service to the client?

Members and candidates need to understand and follow their firm's electronic information communication and storage procedures. If the firm does not have procedures in place, members and candidates should encourage the development of procedures that appropriately reflect the firm's size and business operations.

### *Communicating with Clients*

Technological changes are constantly enhancing the methods that are used to communicate with clients and prospective clients. Members and candidates should make reasonable efforts to ensure that firm-supported communication methods and compliance procedures follow practices designed for preventing accidental distribution of confidential information. Given the rate at which technology changes, a regular review of privacy protection measures is encouraged.

Members and candidates should be diligent in discussing with clients the appropriate methods for providing confidential information. It is important to convey to clients that not all firm-sponsored resources may be appropriate for such communications.

## Application of the Standard

### *Example 1 (Possessing Confidential Information):*

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

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

### *Example 2 (Disclosing Confidential Information):*

Lynn Moody is an investment officer at the Lester Trust Company. She has an advisory customer who has talked to her about giving approximately US\$50,000 to charity to reduce her income taxes. Moody is also treasurer of the Home for Indigent Widows (HIW), which is planning its annual giving campaign. HIW hopes to expand its list

of prospects, particularly those capable of substantial gifts. Moody recommends that HIW's vice president for corporate gifts call on her customer and ask for a donation in the US\$50,000 range.

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

***Example 3 (Disclosing Possible Illegal Activity):***

Government officials approach Casey Samuel, the portfolio manager for Garcia Company's pension plan, to examine pension fund records. They tell her that Garcia's corporate tax returns are being audited and the pension fund is being reviewed. Two days earlier, Samuel had learned in a regular investment review with Garcia officers that potentially excessive and improper charges were being made to the pension plan by Garcia. Samuel consults her employer's general counsel and is advised that Garcia has probably violated tax and fiduciary regulations and laws.

*Comment:* Samuel should inform her supervisor of these activities, and her employer should take steps, with Garcia, to remedy the violations. If that approach is not successful, Samuel and her employer should seek advice of legal counsel to determine the appropriate steps to be taken. Samuel may well have a duty to disclose the evidence she has of the continuing legal violations and to resign as asset manager for Garcia.

***Example 4 (Disclosing Possible Illegal Activity):***

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

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

***Example 5 (Accidental Disclosure of Confidential Information):***

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

Six months later, in early January, Moody posted LTC's year-end "Market Outlook." The report outlined a new asset allocation strategy that the firm is adding to its recommendations in the new year. Moody introduced the publication with a note informing her clients that she would be discussing the changes with them individually in their upcoming meetings.

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

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

In understanding the potential sensitivity clients express surrounding the confidentiality of personal information, this event highlights a need for further training. Moody might advocate for additional warnings or controls for clients when they consider using social media platforms for two-way communications.

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## STANDARD IV: DUTIES TO EMPLOYERS

### Standard IV(A) Loyalty



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

### Guidance

#### Highlights:

- *Employer Responsibilities*
- *Independent Practice*
- *Leaving an Employer*
- *Use of Social Media*
- *Whistleblowing*
- *Nature of Employment*

Standard IV(A) requires members and candidates to protect the interests of their firm by refraining from any conduct that would injure the firm, deprive it of profit, or deprive it of the member's or candidate's skills and ability. Members and candidates

must always place the interests of clients above the interests of their employer but should also consider the effects of their conduct on the sustainability and integrity of the employer firm. In matters related to their employment, members and candidates must not engage in conduct that harms the interests of their employer. Implicit in this standard is the obligation of members and candidates to comply with the policies and procedures established by their employers that govern the employer–employee relationship—to the extent that such policies and procedures do not conflict with applicable laws, rules, or regulations or the Code and Standards.

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

### ***Employer Responsibilities***

The employer–employee relationship imposes duties and responsibilities on both parties. Employers must recognize the duties and responsibilities that they owe to their employees if they expect to have content and productive employees.

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

Employers are not obligated to adhere to the Code and Standards. In expecting to retain competent employees who are members and candidates, however, they should not develop conflicting policies and procedures. The employer is responsible for a positive working environment, which includes an ethical workplace. Senior management has the additional responsibility to devise compensation structures and incentive arrangements that do not encourage unethical behavior.

### ***Independent Practice***

Included in Standard IV(A) is the requirement that members and candidates abstain from independent competitive activity that could conflict with the interests of their employer. Although Standard IV(A) does not preclude members or candidates from entering into an independent business while still employed, members and candidates who plan to engage in independent practice for compensation must notify their employer and describe the types of services they will render to prospective independent clients, the expected duration of the services, and the compensation for the services. Members and candidates should not render services until they receive consent from their employer to all of the terms of the arrangement. “Practice” means any service that the employer currently makes available for remuneration. “Undertaking independent practice” means engaging in competitive business, as opposed to making preparations to begin such practice.

### ***Leaving an Employer***

When members and candidates are planning to leave their current employer, they must continue to act in the employer’s best interest. They must not engage in any activities that would conflict with this duty until their resignation becomes effective. It is difficult to define specific guidelines for those members and candidates who are planning to compete with their employer as part of a new venture. The circumstances

of each situation must be reviewed to distinguish permissible preparations from violations of duty. Activities that might constitute a violation, especially in combination, include the following:

- misappropriation of trade secrets,
- misuse of confidential information,
- solicitation of the employer's clients prior to cessation of employment,
- self-dealing (appropriating for one's own property a business opportunity or information belonging to one's employer), and
- misappropriation of clients or client lists.

A departing employee is generally free to make arrangements or preparations to go into a competitive business before terminating the relationship with his or her employer as long as such preparations do not breach the employee's duty of loyalty. A member or candidate who is contemplating seeking other employment must not contact existing clients or potential clients prior to leaving his or her employer for purposes of soliciting their business for the new employer. Once notice is provided to the employer of the intent to resign, the member or candidate must follow the employer's policies and procedures related to notifying clients of his or her planned departure. In addition, the member or candidate must not take records or files to a new employer without the written permission of the previous employer.

Once an employee has left the firm, the skills and experience that an employee obtained while employed are not "confidential" or "privileged" information. Similarly, simple knowledge of the names and existence of former clients is generally not confidential information unless deemed such by an agreement or by law. Standard IV(A) does not prohibit experience or knowledge gained at one employer from being used at another employer. Firm records or work performed on behalf of the firm that is stored in paper copy or electronically for the member's or candidate's convenience while employed, however, should be erased or returned to the employer unless the firm gives permission to keep those records after employment ends.

The standard does not prohibit former employees from contacting clients of their previous firm as long as the contact information does not come from the records of the former employer or violate an applicable "noncompete agreement." Members and candidates are free to use public information after departing to contact former clients without violating Standard IV(A) as long as there is no specific agreement not to do so.

Employers often require employees to sign noncompete agreements that preclude a departing employee from engaging in certain conduct. Members and candidates should take care to review the terms of any such agreement when leaving their employer to determine what, if any, conduct those agreements may prohibit.

In some markets, there are agreements between employers within an industry that outline information that departing employees are permitted to take upon resignation, such as the "Protocol for Broker Recruiting" in the United States. These agreements ease individuals' transition between firms that have agreed to follow the outlined procedures. Members and candidates who move between firms that sign such agreements may rely on the protections provided as long as they faithfully adhere to all the procedures outlined.

For example, under the agreement between many US brokers, individuals are allowed to take some general client contact information when departing. To be protected, a copy of the information the individual is taking must be provided to the local management team for review. Additionally, the specific client information may only be used by the departing employee and not others employed by the new firm.

### ***Use of Social Media***

The growth in various online networking platforms, such as LinkedIn, Twitter, and Facebook (commonly referred to as social media platforms), is providing new opportunities and challenges for businesses. Members and candidates should understand and abide by all applicable firm policies and regulations as to the acceptable use of social media platforms to interact with clients and prospective clients. This is especially important when a member or candidate is planning to leave an employer.

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

Social media connections with clients are also raising questions concerning the differences between public information and firm property. Specific accounts and user profiles of members and candidates may be created for solely professional reasons, including firm-approved accounts for client engagements. Such firm-approved business-related accounts would be considered part of the firm's assets, thus requiring members and candidates to transfer or delete the accounts as directed by their firm's policies and procedures. Best practice for members and candidates is to maintain separate accounts for their personal and professional social media activities. Members and candidates should discuss with their employers how profiles should be treated when a single account includes personal connections and also is used to conduct aspects of their professional activities.

### ***Whistleblowing***

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

### ***Nature of Employment***

A wide variety of business relationships exists within the investment industry. For instance, a member or candidate may be an employee or an independent contractor. Members and candidates must determine whether they are employees or independent contractors in order to determine the applicability of Standard IV(A). This issue will be decided largely by the degree of control exercised by the employing entity over the member or candidate. Factors determining control include whether the member's or candidate's hours, work location, and other parameters of the job are set; whether facilities are provided to the member or candidate; whether the member's or candidate's expenses are reimbursed; whether the member or candidate seeks work from other employers; and the number of clients or employers the member or candidate works for.

A member's or candidate's duties within an independent contractor relationship are governed by the oral or written agreement between the member and the client. Members and candidates should take care to define clearly the scope of their

responsibilities and the expectations of each client within the context of each relationship. Once a member or candidate establishes a relationship with a client, the member or candidate has a duty to abide by the terms of the agreement.

## Recommended Procedures for Compliance

Employers may establish codes of conduct and operating procedures for their employees to follow. Members and candidates should fully understand the policies to ensure that they are not in conflict with the Code and Standards. The following topics identify policies that members and candidates should encourage their firms to adopt if the policies are not currently in place.

### *Competition Policy*

A member or candidate must understand any restrictions placed by the employer on offering similar services outside the firm while employed by the firm. The policy may outline the procedures for requesting approval to undertake the outside service or may be a strict prohibition of such service. If a member's or candidate's employer elects to have its employees sign a noncompete agreement as part of the employment agreement, the member or candidate should ensure that the details are clear and fully explained prior to signing the agreement.

### *Termination Policy*

Members and candidates should clearly understand the termination policies of their employer. Termination policies should establish clear procedures regarding the resignation process, including addressing how the termination will be disclosed to clients and staff and whether updates posted through social media platforms will be allowed. The firm's policy may also outline the procedures for transferring ongoing research and account management responsibilities. Finally, the procedures should address agreements that allow departing employees to remove specific client-related information upon resignation.

### *Incident-Reporting Procedures*

Members and candidates should be aware of their firm's policies related to whistleblowing and encourage their firm to adopt industry best practices in this area. Many firms are required by regulatory mandates to establish confidential and anonymous reporting procedures that allow employees to report potentially unethical and illegal activities in the firm.

### *Employee Classification*

Members and candidates should understand their status within their employer firm. Firms are encouraged to adopt a standardized classification structure (e.g., part time, full time, outside contractor) for their employees and indicate how each of the firm's policies applies to each employee class.

## Application of the Standard

### *Example 1 (Soliciting Former Clients):*

Samuel Magee manages pension accounts for Trust Assets, Inc., but has become frustrated with the working environment and has been offered a position with Fiduciary Management. Before resigning from Trust Assets, Magee asks four big accounts to

leave that firm and open accounts with Fiduciary. Magee also persuades several prospective clients to sign agreements with Fiduciary Management. Magee had previously made presentations to these prospects on behalf of Trust Assets.

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

**Example 2 (Former Employer’s Documents and Files):**

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

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

**Example 3 (Addressing Rumors):**

Reuben Winston manages all-equity portfolios at Target Asset Management (TAM), a large, established investment counselor. Ten years previously, Philpott & Company, which manages a family of global bond mutual funds, acquired TAM in a diversification move. After the merger, the combined operations prospered in the fixed-income business but the equity management business at TAM languished. Lately, a few of the equity pension accounts that had been with TAM before the merger have terminated their relationships with TAM. One day, Winston finds on his voice mail the following message from a concerned client: “Hey! I just heard that Philpott is close to announcing the sale of your firm’s equity management business to Rugged Life. What is going on?” Not being aware of any such deal, Winston and his associates are stunned. Their internal inquiries are met with denials from Philpott management, but the rumors persist. Feeling left in the dark, Winston contemplates leading an employee buyout of TAM’s equity management business.

*Comment:* An employee-led buyout of TAM’s equity asset management business would be consistent with Standard IV(A) because it would rest on the permission of the employer and, ultimately, the clients. In this case,

however, in which employees suspect the senior managers or principals are not truthful or forthcoming, Winston should consult legal counsel to determine appropriate action.

***Example 4 (Ownership of Completed Prior Work):***

Laura Clay, who is unemployed, wants part-time consulting work while seeking a full-time analyst position. During an interview at Bradley Associates, a large institutional asset manager, Clay is told that the firm has no immediate research openings but would be willing to pay her a flat fee to complete a study of the wireless communications industry within a given period of time. Clay would be allowed unlimited access to Bradley's research files and would be welcome to come to the offices and use whatever support facilities are available during normal working hours. Bradley's research director does not seek any exclusivity for Clay's output, and the two agree to the arrangement on a handshake. As Clay nears completion of the study, she is offered an analyst job in the research department of Winston & Company, a brokerage firm, and she is pondering submitting the draft of her wireless study for publication by Winston.

*Comment:* Although she is under no written contractual obligation to Bradley, Clay has an obligation to let Bradley act on the output of her study before Winston & Company or Clay uses the information to their advantage. That is, unless Bradley gives permission to Clay and waives its rights to her wireless report, Clay would be in violation of Standard IV(A) if she were to immediately recommend to Winston the same transactions recommended in the report to Bradley. Furthermore, Clay must not take from Bradley any research file material or other property that she may have used.

***Example 5 (Ownership of Completed Prior Work):***

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

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

***Example 6 (Soliciting Former Clients):***

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

*Comment:* Because client records are the property of the firm, contacting former clients for any reason through the use of client lists or other information taken from a former employer without permission would be a

violation of Standard IV(A). In addition, the nature and extent of the contact with former clients may be governed by the terms of any noncompete agreement signed by the employee and the former employer that covers contact with former clients after employment.

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

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

***Example 7 (Starting a New Firm):***

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

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

***Example 8 (Competing with Current Employer):***

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

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

**Example 9 (Externally Compensated Assignments):**

Alfonso Mota is a research analyst with Tyson Investments. He works part time as a mayor for his hometown, a position for which he receives compensation. Must Mota seek permission from Tyson to serve as mayor?

*Comment:* If Mota's mayoral duties are so extensive and time-consuming that they might detract from his ability to fulfill his responsibilities at Tyson, he should discuss his outside activities with his employer and come to a mutual agreement regarding how to manage his personal commitments with his responsibilities to his employer.

**Example 10 (Soliciting Former Clients):**

After leaving her employer, Shawna McQuillen establishes her own money management business. While with her former employer, she did not sign a noncompete agreement that would have prevented her from soliciting former clients. Upon her departure, she does not take any of her client lists or contact information and she clears her personal computer of any employer records, including client contact information. She obtains the phone numbers of her former clients through public records and contacts them to solicit their business.

*Comment:* McQuillen is not in violation of Standard IV(A) because she has not used information or records from her former employer and is not prevented by an agreement with her former employer from soliciting her former clients.

**Example 11 (Whistleblowing Actions):**

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

*Comment:* Rasmussen has clearly come upon an error in policies, procedures, and compliance practices in the firm's operations. Having been unsuccessful in finding a resolution with her supervisor and the compliance officer, Rasmussen should consult the firm's whistleblowing policy to determine the appropriate next step toward informing management of her concerns. The potentially unethical actions of the investment management division are appropriate grounds for further disclosure, so Rasmussen's whistleblowing would not represent a violation of Standard IV(A).

See also Standard I(D)–Misconduct and Standard IV(C)–Responsibilities of Supervisors.

**Example 12 (Soliciting Former Clients):**

Angel Crome has been a private banker for YBSafe Bank for the past eight years. She has been very successful and built a considerable client portfolio during that time but is extremely frustrated by the recent loss of reputation by her current employer and subsequent client insecurity. A locally renowned headhunter contacted Crome a few days ago and offered her an interesting job with a competing private bank. This bank offers a substantial signing bonus for advisers with their own client portfolios. Crome figures that she can solicit at least 70% of her clients to follow her and gladly enters into the new employment contract.

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

**Example 13 (Notification of Code and Standards):**

Krista Smith is a relatively new assistant trader for the fixed-income desk of a major investment bank. She is on a team responsible for structuring collateralized debt obligations (CDOs) made up of securities in the inventory of the trading desk. At a meeting of the team, senior executives explain the opportunity to eventually separate the CDO into various risk-rated tranches to be sold to the clients of the firm. After the senior executives leave the meeting, the head trader announces various responsibilities of each member of the team and then says, "This is a good time to unload some of the junk we have been stuck with for a while and disguise it with ratings and a thick, unreadable prospectus, so don't be shy in putting this CDO together. Just kidding." Smith is worried by this remark and asks some of her colleagues what the head trader meant. They all respond that he was just kidding but that there is some truth in the remark because the CDO is seen by management as an opportunity to improve the quality of the securities in the firm's inventory.

Concerned about the ethical environment of the workplace, Smith decides to talk to her supervisor about her concerns and provides the head trader with a copy of the Code and Standards. Smith discusses the principle of placing the client above the interest of the firm and the possibility that the development of the new CDO will not adhere to this responsibility. The head trader assures Smith that the appropriate analysis will be conducted when determining the appropriate securities for collateral. Furthermore, the ratings are assigned by an independent firm and the prospectus will include full and factual disclosures. Smith is reassured by the meeting, but she also reviews the company's procedures and requirements for reporting potential violations of company policy and securities laws.

*Comment:* Smith's review of the company policies and procedures for reporting violations allows her to be prepared to report through the appropriate whistleblower process if she decides that the CDO development process involves unethical actions by others. Smith's actions comply with the Code and Standards principles of placing the client's interests first and being loyal to her employer. In providing her supervisor with a copy of the Code and Standards, Smith is highlighting the high level of ethical conduct she is required to adhere to in her professional activities.

**Example 14 (Leaving an Employer):**

Laura Webb just left her position as portfolio analyst at Research Systems, Inc. (RSI). Her employment contract included a non-solicitation agreement that requires her to wait two years before soliciting RSI clients for any investment-related services. Upon leaving, Webb was informed that RSI would contact clients immediately about her departure and introduce her replacement.

While working at RSI, Webb connected with clients, other industry associates, and friends through her LinkedIn network. Her business and personal relationships were intermingled because she considered many of her clients to be personal friends. Realizing that her LinkedIn network would be a valuable resource for new employment opportunities, she updated her profile several days following her departure from RSI. LinkedIn automatically sent a notification to Webb's entire network that her employment status had been changed in her profile.

*Comment:* Prior to her departure, Webb should have discussed any client information contained in her social media networks. By updating her LinkedIn profile after RSI notified clients and after her employment ended, she has appropriately placed her employer's interests ahead of her own personal interests. In addition, she has not violated the non-solicitation agreement with RSI, unless it prohibited any contact with clients during the two-year period.

**Example 15 (Confidential Firm Information):**

Sanjay Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process to develop recommendations on investment opportunities covered by the team members. Gupta, like others, provides commentary for NIM's clients through the company blog, which is posted weekly on the NIM password-protected website. According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting. Any opinions expressed on the website are disclosed as representing the perspective of NIM.

Gupta also writes a personal blog to share his experiences with friends and family. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.

*Comment:* Gupta is in violation of Standard IV(A) for disclosing confidential firm information through his personal blog. The recommendations on the firm's blog to clients are not freely available across the internet, but his personal blog post indirectly provides the firm's recommendations.

Additionally, by posting research commentary on his personal blog, Gupta is using firm resources for his personal advantage. To comply with Standard IV(A), members and candidates must receive consent from their employer prior to using company resources.

## Standard IV(B) Additional Compensation Arrangements



Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

### Guidance

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

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

There may be instances in which a member or candidate is hired by an employer on a "part-time" basis. "Part-time" status applies to employees who do not commit the full number of hours required for a normal work week. Members and candidates should discuss possible limitations to their abilities to provide services that may be competitive with their employer during the negotiation and hiring process. The requirements of Standard IV(B) would be applicable to limitations identified at that time.

### Recommended Procedures for Compliance

Members and candidates should make an immediate written report to their supervisor and compliance officer specifying any compensation they propose to receive for services in addition to the compensation or benefits received from their employer. The details of the report should be confirmed by the party offering the additional compensation, including performance incentives offered by clients. This written report should state the terms of any agreement under which a member or candidate will receive additional compensation; "terms" include the nature of the compensation, the approximate amount of compensation, and the duration of the agreement.

### Application of the Standard

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

Geoff Whitman, a portfolio analyst for Adams Trust Company, manages the account of Carol Cochran, a client. Whitman is paid a salary by his employer, and Cochran pays the trust company a standard fee based on the market value of assets in her portfolio. Cochran proposes to Whitman that "any year that my portfolio achieves at least a 15% return before taxes, you and your wife can fly to Monaco at my expense

and use my condominium during the third week of January.” Whitman does not inform his employer of the arrangement and vacations in Monaco the following January as Cochran’s guest.

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

**Example 2 (Notification of Outside Compensation):**

Terry Jones sits on the board of directors of Exercise Unlimited, Inc. In return for his services on the board, Jones receives unlimited membership privileges for his family at all Exercise Unlimited facilities. Jones purchases Exercise Unlimited stock for the client accounts for which it is appropriate. Jones does not disclose this arrangement to his employer because he does not receive monetary compensation for his services to the board.

*Comment:* Jones has violated Standard IV(B) by failing to disclose to his employer benefits received in exchange for his services on the board of directors. The nonmonetary compensation may create a conflict of interest in the same manner as being paid to serve as a director.

**Example 3 (Prior Approval for Outside Compensation):**

Jonathan Hollis is an analyst of oil-and-gas companies for Specialty Investment Management. He is currently recommending the purchase of ABC Oil Company shares and has published a long, well-thought-out research report to substantiate his recommendation. Several weeks after publishing the report, Hollis receives a call from the investor-relations office of ABC Oil saying that Thomas Andrews, CEO of the company, saw the report and really liked the analyst’s grasp of the business and his company. The investor-relations officer invites Hollis to visit ABC Oil to discuss the industry further. ABC Oil offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after gaining the appropriate approvals, accepts the meeting with the CEO but declines the offered travel arrangements.

Several weeks later, Andrews and Hollis meet to discuss the oil business and Hollis’s report. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC Oil’s headquarters.

Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.

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

## Standard IV(C) Responsibilities of Supervisors



Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

### Guidance

#### Highlights:

- *System for Supervision*
- *Supervision Includes Detection*

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

Any investment professional who has employees subject to her or his control or influence—whether or not the employees are CFA Institute members, CFA charterholders, or candidates in the CFA Program—exercises supervisory responsibility. Members and candidates acting as supervisors must also have in-depth knowledge of the Code and Standards so that they can apply this knowledge in discharging their supervisory responsibilities.

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

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

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

Often, especially in large organizations, members and candidates may have supervisory responsibility but not the authority to establish or modify firm-wide compliance policies and procedures or incentive structures. Such limitations should not prevent

a member or candidate from working with his or her own superiors and within the firm structure to develop and implement effective compliance tools, including but not limited to:

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

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

#### ***System for Supervision***

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

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

Once a supervisor learns that an employee has violated or may have violated the law or the Code and Standards, the supervisor must promptly initiate an assessment to determine the extent of the wrongdoing. Relying on an employee's statements about the extent of the violation or assurances that the wrongdoing will not reoccur is not enough. Reporting the misconduct up the chain of command and warning the employee to cease the activity are also not enough. Pending the outcome of the investigation, a supervisor should take steps to ensure that the violation will not be repeated, such as placing limits on the employee's activities or increasing the monitoring of the employee's activities.

#### ***Supervision Includes Detection***

Members and candidates with supervisory responsibility must also make reasonable efforts to detect violations of laws, rules, regulations, firm policies, and the Code and Standards. The supervisors exercise reasonable supervision by establishing and implementing written compliance procedures and ensuring that those procedures are followed through periodic review. If a member or candidate has adopted reasonable procedures and taken steps to institute an effective compliance program, then the member or candidate may not be in violation of Standard IV(C) if he or she does not detect violations that occur despite these efforts. The fact that violations do occur may

indicate, however, that the compliance procedures are inadequate. In addition, in some cases, merely enacting such procedures may not be sufficient to fulfill the duty required by Standard IV(C). A member or candidate may be in violation of Standard IV(C) if he or she knows or should know that the procedures designed to promote compliance, including detecting and preventing violations, are not being followed.

## Recommended Procedures for Compliance

### *Codes of Ethics or Compliance Procedures*

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

There is a distinction, however, between codes of ethics and the specific policies and procedures needed to ensure compliance with the codes and with securities laws and regulations. Although both are important, codes of ethics should consist of fundamental, principle-based ethical and fiduciary concepts that are applicable to all of the firm's employees. In this way, firms can best convey to employees and clients the ethical ideals that investment advisers strive to achieve. These concepts need to be implemented, however, by detailed, firm-wide compliance policies and procedures. Compliance procedures assist the firm's personnel in fulfilling the responsibilities enumerated in the code of ethics and make probable that the ideals expressed in the code of ethics will be adhered to in the day-to-day operation of the firm.

Stand-alone codes of ethics should be written in plain language and should address general fiduciary concepts. They should be unencumbered by numerous detailed procedures. Codes presented in this way are the most effective in stressing to employees that they are in positions of trust and must act with integrity at all times. Mingling compliance procedures in the firm's code of ethics goes against the goal of reinforcing the ethical obligations of employees.

Separating the code of ethics from compliance procedures will also reduce, if not eliminate, the legal terminology and "boilerplate" language that can make the underlying ethical principles incomprehensible to the average person. Above all, to ensure the creation of a culture of ethics and integrity rather than one that merely focuses on following the rules, the principles in the code of ethics must be stated in a way that is accessible and understandable to everyone in the firm.

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

### *Adequate Compliance Procedures*

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

- be contained in a clearly written and accessible manual that is tailored to the firm's operations,
- be drafted so that the procedures are easy to understand,

- designate a compliance officer whose authority and responsibility are clearly defined and who has the necessary resources and authority to implement the firm's compliance procedures,
- describe the hierarchy of supervision and assign duties among supervisors,
- implement a system of checks and balances,
- outline the scope of the procedures,
- outline procedures to document the monitoring and testing of compliance procedures,
- outline permissible conduct, and
- delineate procedures for reporting violations and sanctions.

Once a compliance program is in place, a supervisor should

- disseminate the contents of the program to appropriate personnel,
- periodically update procedures to ensure that the measures are adequate under the law,
- continually educate personnel regarding the compliance procedures,
- issue periodic reminders of the procedures to appropriate personnel,
- incorporate a professional conduct evaluation as part of an employee's performance review,
- review the actions of employees to ensure compliance and identify violators, and
- take the necessary steps to enforce the procedures once a violation has occurred.

Once a violation is discovered, a supervisor should

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

#### ***Implementation of Compliance Education and Training***

No amount of ethics education and awareness will deter someone determined to commit fraud for personal enrichment. But the vast majority of investment professionals strive to achieve personal success with dedicated service to their clients and employers.

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

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

### ***Establish an Appropriate Incentive Structure***

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

Supervisors and firms must look closely at their incentive structure to determine whether the structure encourages profits and returns at the expense of ethically appropriate conduct. Reward structures may turn a blind eye to how desired outcomes are achieved and encourage dysfunctional or counterproductive behavior. Only when compensation and incentives are firmly tied to client interests and *how* outcomes are achieved, rather than *how much* is generated for the firm, will employees work to achieve a culture of integrity.

## **Application of the Standard**

### ***Example 1 (Supervising Research Activities):***

Jane Mattock, senior vice president and head of the research department of H&V, Inc., a regional brokerage firm, has decided to change her recommendation for Timber Products from buy to sell. In line with H&V’s procedures, she orally advises certain other H&V executives of her proposed actions before the report is prepared for publication. As a result of Mattock’s conversation with Dieter Frampton, one of the H&V executives accountable to Mattock, Frampton immediately sells Timber’s stock from his own account and from certain discretionary client accounts. In addition, other personnel inform certain institutional customers of the changed recommendation before it is printed and disseminated to all H&V customers who have received previous Timber reports.

*Comment:* Mattock has violated Standard IV(C) by failing to reasonably and adequately supervise the actions of those accountable to her. She did not prevent or establish reasonable procedures designed to prevent dissemination of or trading on the information by those who knew of her changed recommendation. She must ensure that her firm has procedures for reviewing or recording any trading in the stock of a corporation that has been the subject of an unpublished change in recommendation. Adequate procedures would have informed the subordinates of their duties and detected sales by Frampton and selected customers.

### ***Example 2 (Supervising Research Activities):***

Deion Miller is the research director for Jamestown Investment Programs. The portfolio managers have become critical of Miller and his staff because the Jamestown portfolios do not include any stock that has been the subject of a merger or tender offer. Georgia Ginn, a member of Miller’s staff, tells Miller that she has been studying a local company, Excelsior, Inc., and recommends its purchase. Ginn adds that the company has been widely rumored to be the subject of a merger study by a well-known conglomerate and discussions between them are under way. At Miller’s request, Ginn prepares a memo recommending the stock. Miller passes along Ginn’s memo to the portfolio managers prior to leaving for vacation, and he notes that he has not reviewed the memo. As a result of the memo, the portfolio managers buy Excelsior stock immediately. The day Miller returns to the office, he learns that Ginn’s only sources for the report were her brother, who is an acquisitions analyst with Acme Industries, the “well-known conglomerate,” and that the merger discussions were planned but not held.

*Comment:* Miller violated Standard IV(C) by not exercising reasonable supervision when he disseminated the memo without checking to ensure that Ginn had a reasonable and adequate basis for her recommendations and that Ginn was not relying on material nonpublic information.

**Example 3 (Supervising Trading Activities):**

David Edwards, a trainee trader at Wheeler & Company, a major national brokerage firm, assists a customer in paying for the securities of Highland, Inc., by using anticipated profits from the immediate sale of the same securities. Despite the fact that Highland is not on Wheeler's recommended list, a large volume of its stock is traded through Wheeler in this manner. Roberta Ann Mason is a Wheeler vice president responsible for supervising compliance with the securities laws in the trading department. Part of her compensation from Wheeler is based on commission revenues from the trading department. Although she notices the increased trading activity, she does nothing to investigate or halt it.

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

**Example 4 (Supervising Trading Activities and Record Keeping):**

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

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

**Example 5 (Accepting Responsibility):**

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

*Comment:* Rasmussen has clearly come upon an error in policies, procedures, and compliance practices within the firm's operations. According to Standard IV(C), the supervisor and the compliance officer have the responsibility to review the concerns brought forth by Rasmussen. Supervisors have the responsibility of establishing and encouraging an ethical culture in the firm. The dismissal of Rasmussen's question violates Standard IV(C) and undermines the firm's ethical operations.

See also Standard I(D)–Misconduct and, for guidance on whistleblowing, Standard IV(A)–Loyalty.

**Example 6 (Inadequate Procedures):**

Brendan Witt, a former junior sell-side technology analyst, decided to return to school to earn an MBA. To keep his research skills and industry knowledge sharp, Witt accepted a position with On-line and Informed, an independent internet-based research company. The position requires the publication of a recommendation and report on a different company every month. Initially, Witt is a regular contributor of new research and a participant in the associated discussion boards that generally have positive comments on the technology sector. Over time, his ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.

*Comment:* Allowing the report submitted by Witt to be posted highlights a lack of compliance procedures by the research firm. Witt's supervisor needs to work with the management of On-line to develop an appropriate review process to ensure that all contracted analysts comply with the requirements.

See also Standard V(A)–Diligence and Reasonable Basis because it relates to Witt's responsibility for substantiating a recommendation.

**Example 7 (Inadequate Supervision):**

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance

of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

*Comment:* Papis's actions highlight the need for supervision and review at all levels in an organization. His responsibilities may include the selection of external advisers, but the decision to change advisers appears arbitrary. Members and candidates should ensure that their firm has appropriate policies and procedures in place to detect inappropriate actions, such as the action taken by Papis.

See also Standard V(A)–Diligence and Reasonable Basis, Standard V(B)–Communication with Clients and Prospective Clients, and Standard VI(A)–Disclosure of Conflicts.

**Example 8 (Supervising Research Activities):**

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

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

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

See Standard III(B) for additional guidance.

**Example 9 (Supervising Research Activities):**

Chen Wang leads the research department at YYRA Retirement Planning Specialists. Chen supervises a team of 10 analysts in a fast-paced and understaffed organization. He is responsible for coordinating the firm's approved process to review all reports before they are provided to the portfolio management team for use in rebalancing client portfolios.

One of Chen's direct reports, Huang Mei, covers the banking industry. Chen must submit the latest updates to the portfolio management team tomorrow morning. Huang has yet to submit her research report on ZYX Bank because she is uncomfortable providing a "buy" or "sell" opinion of ZYX on the basis of the completed analysis. Pressed for time and concerned that Chen will reject a "hold" recommendation, she researches various websites and blogs on the banking sector for whatever she can find on ZYX. One independent blogger provides a new interpretation of the recently reported data Huang has analyzed and concludes with a strong "sell" recommendation for ZYX. She is impressed by the originality and resourcefulness of this blogger's report.

Very late in the evening, Huang submits her report and “sell” recommendation to Chen without any reference to the independent blogger’s report. Given the late time of the submission and the competence of Huang’s prior work, Chen compiles this report with the recommendations from each of the other analysts and meets with the portfolio managers to discuss implementation.

*Comment:* Chen has violated Standard IV(C) by neglecting to reasonably and adequately follow the firm’s approved review process for Huang’s research report. The delayed submission and the quality of prior work do not remove Chen’s requirement to uphold the designated review process. A member or candidate with supervisory responsibility must make reasonable efforts to see that appropriate procedures are established, documented, communicated to covered personnel, and followed.

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## STANDARD V: INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

### Standard V(A) Diligence and Reasonable Basis



Members and Candidates must:

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

### Guidance

#### Highlights:

- *Defining Diligence and Reasonable Basis*
- *Using Secondary or Third-Party Research*
- *Using Quantitatively Oriented Research*
- *Developing Quantitatively Oriented Techniques*
- *Selecting External Advisers and Subadvisers*
- *Group Research and Decision Making*

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

The requirements for issuing conclusions based on research will vary in relation to the member’s or candidate’s role in the investment decision-making process, but the member or candidate must make reasonable efforts to cover all pertinent issues

when arriving at a recommendation. Members and candidates enhance transparency by providing or offering to provide supporting information to clients when recommending a purchase or sale or when changing a recommendation.

### ***Defining Diligence and Reasonable Basis***

Every investment decision is based on a set of facts known and understood at the time. Clients turn to members and candidates for advice and expect these advisers to have more information and knowledge than they do. This information and knowledge is the basis from which members and candidates apply their professional judgment in taking investment actions and making recommendations.

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

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

The following list provides some, but definitely not all, examples of attributes to consider while forming the basis for a recommendation:

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

Even though an investment recommendation may be well informed, downside risk remains for any investment. Members and candidates can base their decisions only on the information available at the time decisions are made. The steps taken in developing a diligent and reasonable recommendation should minimize unexpected downside events.

### ***Using Secondary or Third-Party Research***

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

Members and candidates should make reasonable enquiries into the source and accuracy of all data used in completing their investment analysis and recommendations. The sources of the information and data will influence the level of the review a member or candidate must undertake. Information and data taken from internet

sources, such as personal blogs, independent research aggregation websites, or social media websites, likely require a greater level of review than information from more established research organizations.

Criteria that a member or candidate can use in forming an opinion on whether research is sound include the following:

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

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

A member or candidate should verify that the firm has a policy about the timely and consistent review of approved research providers to ensure that the quality of the research continues to meet the necessary standards. If such a policy is not in place at the firm, the member or candidate should encourage the development and adoption of a formal review practice.

#### ***Using Quantitatively Oriented Research***

Standard V(A) applies to the rapidly expanding use of quantitatively oriented research models and processes, such as computer-generated modeling, screening, and ranking of investment securities; the creation or valuation of derivative instruments; and quantitative portfolio construction techniques. These models and processes are being used for much more than the back testing of investment strategies, especially with continually advancing technology and techniques. The continued broad development of quantitative methods and models is an important part of capital market developments.

Members and candidates need to have an understanding of the parameters used in models and quantitative research that are incorporated into their investment recommendations. Although they are not required to become experts in every technical aspect of the models, they must understand the assumptions and limitations inherent in any model and how the results were used in the decision-making process.

The reliance on and potential limitations of financial models became clear through the investment crisis that unfolded in 2007 and 2008. In some cases, the financial models used to value specific securities and related derivative products did not adequately demonstrate the level of associated risks. Members and candidates should make reasonable efforts to test the output of investment models and other pre-programmed analytical tools they use. Such validation should occur before incorporating the process into their methods, models, or analyses.

Although not every model can test for every factor or outcome, members and candidates should ensure that their analyses incorporate a broad range of assumptions sufficient to capture the underlying characteristics of investments. The omission from the analysis of potentially negative outcomes or of levels of risk outside the norm may misrepresent the true economic value of an investment. The possible scenarios for analysis should include factors that are likely to have a substantial influence on the investment value and may include extremely positive and negative scenarios.

### ***Developing Quantitatively Oriented Techniques***

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

Members and candidates need to consider the source and time horizon of the data used as inputs in financial models. The information from many commercially available databases may not effectively incorporate both positive and negative market cycles. In the development of a recommendation, the member or candidate may need to test the models by using volatility and performance expectations that represent scenarios outside the observable databases. In reviewing the computer models or the resulting output, members and candidates need to pay particular attention to the assumptions used in the analysis and the rigor of the analysis to ensure that the model incorporates a wide range of possible input expectations, including negative market events.

### ***Selecting External Advisers and Subadvisers***

Financial instruments and asset allocation techniques continue to develop and evolve. This progression has led to the use of specialized managers to invest in specific asset classes or diversification strategies that complement a firm's in-house expertise. Standard V(A) applies to the level of review necessary in selecting an external adviser or subadviser to manage a specifically mandated allocation. Members and candidates must review managers as diligently as they review individual funds and securities.

Members and candidates who are directly involved with the use of external advisers need to ensure that their firms have standardized criteria for reviewing these selected external advisers and managers. Such criteria would include, but would not be limited to, the following:

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

Codes, standards, and guides to best practice published by CFA Institute provide members and candidates with examples of acceptable practices for external advisers and advice in selecting a new adviser. The following guides are available at the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)): Asset Manager Code of Professional Conduct, Global Investment Performance Standards, and Model Request for Proposal (for equity, credit, or real estate managers).

### ***Group Research and Decision Making***

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

## Recommended Procedures for Compliance

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

- Establish a policy requiring that research reports, credit ratings, and investment recommendations have a basis that can be substantiated as reasonable and adequate. An individual employee (a supervisory analyst) or a group of employees (a review committee) should be appointed to review and approve such items prior to external circulation to determine whether the criteria established in the policy have been met.
- Develop detailed, written guidance for analysts (research, investment, or credit), supervisory analysts, and review committees that establishes the due diligence procedures for judging whether a particular recommendation has a reasonable and adequate basis.
- Develop measurable criteria for assessing the quality of research, the reasonableness and adequacy of the basis for any recommendation or rating, and the accuracy of recommendations over time. In some cases, firms may consider implementing compensation arrangements that depend on these measurable criteria and that are applied consistently to all related analysts.
- Develop detailed, written guidance that establishes minimum levels of scenario testing of all computer-based models used in developing, rating, and evaluating financial instruments. The policy should contain criteria related to the breadth of the scenarios tested, the accuracy of the output over time, and the analysis of cash flow sensitivity to inputs.
- Develop measurable criteria for assessing outside providers, including the quality of information being provided, the reasonableness and adequacy of the provider's collection practices, and the accuracy of the information over time. The established policy should outline how often the provider's products are reviewed.
- Adopt a standardized set of criteria for evaluating the adequacy of external advisers. The policy should include how often and on what basis the allocation of funds to the adviser will be reviewed.

## Application of the Standard

### *Example 1 (Sufficient Due Diligence):*

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

*Comment:* Sarkozi should have taken on only the work that it could adequately handle. By categorizing the issuers by general size, Hawke has bypassed researching all the other relevant aspects that should be considered when pricing new issues and thus has not performed sufficient due diligence. Such an omission can result in investors purchasing shares at prices that have no actual basis. Hawke has violated Standard V(A).

**Example 2 (Sufficient Scenario Testing):**

Babu Dhaliwal works for Heinrich Brokerage in the corporate finance group. He has just persuaded Feggans Resources, Ltd., to allow his firm to do a secondary equity financing at Feggans Resources' current stock price. Because the stock has been trading at higher multiples than similar companies with equivalent production, Dhaliwal presses the Feggans Resources managers to project what would be the maximum production they could achieve in an optimal scenario. Based on these numbers, he is able to justify the price his firm will be asking for the secondary issue. During a sales pitch to the brokers, Dhaliwal then uses these numbers as the base-case production levels that Feggans Resources will achieve.

*Comment:* When presenting information to the brokers, Dhaliwal should have given a range of production scenarios and the probability of Feggans Resources achieving each level. By giving the maximum production level as the likely level of production, he has misrepresented the chances of achieving that production level and seriously misled the brokers. Dhaliwal has violated Standard V(A).

**Example 3 (Developing a Reasonable Basis):**

Brendan Witt, a former junior sell-side technology analyst, decided to return to school to earn an MBA. To keep his research skills and industry knowledge sharp, Witt accepted a position with On-line and Informed, an independent internet-based research company. The position requires the publication of a recommendation and report on a different company every month. Initially, Witt is a regular contributor of new research and a participant in the associated discussion boards that generally have positive comments on the technology sector. Over time, his ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the "hot" security of the day.

*Comment:* Witt's knowledge of and exuberance for technology stocks, a few news articles, and the conventional wisdom of the markets do not constitute, without more information, a reasonable and adequate basis for a stock recommendation that is supported by appropriate research and investigation. Therefore, Witt has violated Standard V(A).

See also Standard IV(C)—Responsibilities of Supervisors because it relates to the firm's inadequate procedures.

**Example 4 (Timely Client Updates):**

Kristen Chandler is an investment consultant in the London office of Dalton Securities, a major global investment consultant firm. One of her UK pension funds has decided to appoint a specialist US equity manager. Dalton's global manager of research relies on local consultants to cover managers within their regions and, after conducting thorough due diligence, puts their views and ratings in Dalton's manager database. Chandler accesses Dalton's global manager research database and conducts a screen of all US equity managers on the basis of a match with the client's desired philosophy/style, performance, and tracking-error targets. She selects the five managers that meet these criteria and puts them in a briefing report that is delivered to the client 10 days later. Between the time of Chandler's database search and the delivery of the report to the client, Chandler is told that Dalton has updated the database with the information that one of the firms that Chandler has recommended for consideration

lost its chief investment officer, the head of its US equity research, and the majority of its portfolio managers on the US equity product—all of whom have left to establish their own firm. Chandler does not revise her report with this updated information.

*Comment:* Chandler has failed to satisfy the requirement of Standard V(A). Although Dalton updated the manager ratings to reflect the personnel turnover at one of the firms, Chandler did not update her report to reflect the new information.

**Example 5 (Group Research Opinions):**

Evelyn Mastakis is a junior analyst who has been asked by her firm to write a research report predicting the expected interest rate for residential mortgages over the next six months. Mastakis submits her report to the fixed-income investment committee of her firm for review, as required by firm procedures. Although some committee members support Mastakis's conclusion, the majority of the committee disagrees with her conclusion, and the report is significantly changed to indicate that interest rates are likely to increase more than originally predicted by Mastakis. Should Mastakis ask that her name be taken off the report when it is disseminated?

*Comment:* The results of research are not always clear, and different people may have different opinions based on the same factual evidence. In this case, the committee may have valid reasons for issuing a report that differs from the analyst's original research. The firm can issue a report that is different from the original report of an analyst as long as there is a reasonable and adequate basis for its conclusions.

Generally, analysts must write research reports that reflect their own opinion and can ask the firm not to put their name on reports that ultimately differ from that opinion. When the work is a group effort, however, not all members of the team may agree with all aspects of the report. Ultimately, members and candidates can ask to have their names removed from the report, but if they are satisfied that the process has produced results or conclusions that have a reasonable and adequate basis, members and candidates do not have to dissociate from the report even when they do not agree with its contents. If Mastakis is confident in the process, she does not need to dissociate from the report even if it does not reflect her opinion.

**Example 6 (Reliance on Third-Party Research):**

Gary McDermott runs a two-person investment management firm. McDermott's firm subscribes to a service from a large investment research firm that provides research reports. McDermott's firm makes investment recommendations on the basis of these reports.

*Comment:* Members and candidates can rely on third-party research but must make reasonable and diligent efforts to determine that such research is sound. If McDermott undertakes due diligence efforts on a regular basis to ensure that the research produced by the large firm is objective and reasonably based, McDermott can rely on that research when making investment recommendations to clients.

**Example 7 (Due Diligence in Submanager Selection):**

Paul Ostrowski's business has grown significantly over the past couple of years, and some clients want to diversify internationally. Ostrowski decides to find a submanager to handle the expected international investments. Because this will be his

first subadviser, Ostrowski uses the CFA Institute model “request for proposal” to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm’s bottom line.

*Comment:* The selection of an external adviser or subadviser should be based on a full and complete review of the adviser’s services, performance history, and cost structure. In basing the decision on the fee structure alone, Ostrowski may be violating Standard V(A).

See also Standard III(C)–Suitability because it relates to the ability of the selected adviser to meet the needs of the clients.

**Example 8 (Sufficient Due Diligence):**

Michael Papis is the chief investment officer of his state’s retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis’s business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund’s allocation. In the previous few years, the performance of the retirement fund’s real estate investments was in line with the fund’s benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

*Comment:* Papis violated Standard V(A). His responsibilities may include the selection of the external advisers, but the decision to change advisers appears to have been arbitrary. If Papis was dissatisfied with the current real estate adviser, he should have conducted a proper solicitation to select the most appropriate adviser.

See also Standard IV(C)–Responsibilities of Supervisors, Standard V(B)–Communication with Clients and Prospective Clients, and Standard VI(A)–Disclosure of Conflicts.

**Example 9 (Sufficient Due Diligence):**

Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

*Comment:* Shrub violated Standard V(A) by not conducting a thorough analysis of the funds managed by Reed before developing the new Conduit fund. Shrub’s reliance on his personal relationship with Reed and his prior knowledge of Elite are insufficient justification for the investments. The funds may be appropriately considered, but a full review of their operating procedures, reporting practices, and transparency are some elements of the necessary due diligence.

See also Standard III(C)–Suitability.

**Example 10 (Sufficient Due Diligence):**

Bob Thompson has been doing research for the portfolio manager of the fixed-income department. His assignment is to do sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives “prepays” (prepayments of mortgages) and losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. Thompson insists that the analysis should include a scenario run with –10% for Year 1, –5% for Year 2, and then (to project a worst-case scenario) 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative.

Thompson conducts his research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, a less likely but possible environment. Based on the results of the enhanced scenarios, Thompson does not recommend the purchase of the securitization. Against the general market trends, the manager follows Thompson’s recommendation and does not invest. The following year, the housing market collapses. In avoiding the subprime investments, the manager’s portfolio outperforms its peer group that year.

*Comment:* Thompson’s actions in running the scenario test with inputs beyond the historical trends available in the firm’s databases adhere to the principles of Standard V(A). His concerns over recent trends provide a sound basis for further analysis. Thompson understands the limitations of his model, when combined with the limited available historical information, to accurately predict the performance of the funds if market conditions change negatively.

See also Standard I(B)–Independence and Objectivity.

**Example 11 (Use of Quantitatively Oriented Models):**

Espacia Liakos works in sales for Hellenica Securities, a firm specializing in developing intricate derivative strategies to profit from particular views on market expectations. One of her clients is Eugenie Carapalis, who has become convinced that commodity prices will become more volatile over the coming months. Carapalis asks Liakos to quickly engineer a strategy that will benefit from this expectation. Liakos turns to Hellenica’s modeling group to fulfill this request. Because of the tight deadline, the modeling group outsources parts of the work to several trusted third parties. Liakos implements the disparate components of the strategy as the firms complete them.

Within a month, Carapalis is proven correct: Volatility across a range of commodities increases sharply. But her derivatives position with Hellenica returns huge losses, and the losses increase daily. Liakos investigates and realizes that although each of the various components of the strategy had been validated, they had never been evaluated as an integrated whole. In extreme conditions, portions of the model worked at cross-purposes with other portions, causing the overall strategy to fail dramatically.

*Comment:* Liakos violated Standard V(A). Members and candidates must understand the statistical significance of the results of the models they recommend and must be able to explain them to clients. Liakos did not take adequate care to ensure a thorough review of the whole model; its components were evaluated only individually. Because Carapalis clearly

intended to implement the strategy as a whole rather than as separate parts, Liakos should have tested how the components of the strategy interacted as well as how they performed individually.

**Example 12 (Successful Due Diligence/Failed Investment):**

Alton Newbury is an investment adviser to high-net-worth clients. A client with an aggressive risk profile in his investment policy statement asks about investing in the Top Shelf hedge fund. This fund, based in Calgary, Alberta, Canada, has reported 20% returns for the first three years. The fund prospectus states that its strategy involves long and short positions in the energy sector and extensive leverage. Based on his analysis of the fund's track record, the principals involved in managing the fund, the fees charged, and the fund's risk profile, Newbury recommends the fund to the client and secures a position in it. The next week, the fund announces that it has suffered a loss of 60% of its value and is suspending operations and redemptions until after a regulatory review. Newbury's client calls him in a panic and asks for an explanation.

*Comment:* Newbury's actions were consistent with Standard V(A). Analysis of an investment that results in a reasonable basis for recommendation does not guarantee that the investment has no downside risk. Newbury should discuss the analysis process with the client while reminding him or her that past performance does not lead to guaranteed future gains and that losses in an aggressive investment portfolio should be expected.

**Example 13 (Quantitative Model Diligence):**

Barry Cannon is the lead quantitative analyst at CityCenter Hedge Fund. He is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Cannon reads several high-level mathematical publications and blogs to stay informed of current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Cannon is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

*Comment:* Cannon has violated Standard V(A) by failing to have a reasonable basis for the new recommendations made to the portfolio managers. He needed to diligently research the effect of incorporating the new factors before offering the output recommendations. Cannon may use the blog for ideas, but it is his responsibility to determine the effect on the firm's proprietary models.

See Standard VII(B) regarding the violation by "Expert CFA" in the use of the CFA designation.

**Example 14 (Selecting a Service Provider):**

Ellen Smith is a performance analyst at Artic Global Advisors, a firm that manages global equity mandates for institutional clients. She was asked by her supervisor to review five new performance attribution systems and recommend one that would more appropriately explain the firm's investment strategy to clients. On the list was a system she recalled learning about when visiting an exhibitor booth at a recent conference. The system is highly quantitative and something of a "black box" in how it calculates the attribution values. Smith recommended this option without researching the others because the sheer complexity of the process was sure to impress the clients.

*Comment:* Smith's actions do not demonstrate a sufficient level of diligence in reviewing this product to make a recommendation for selecting the service. Besides not reviewing or considering the other four potential systems, she did not determine whether the "black box" attribution process aligns with the investment practices of the firm, including its investments in different countries and currencies. Smith must review and understand the process of any software or system before recommending its use as the firm's attribution system.

**Example 15 (Subadviser Selection):**

Craig Jackson is working for Adams Partners, Inc., and has been assigned to select a hedge fund subadviser to improve the diversification of the firm's large fund-of-funds product. The allocation must be in place before the start of the next quarter. Jackson uses a consultant database to find a list of suitable firms that claim compliance with the GIPS standards. He calls more than 20 firms on the list to confirm their potential interest and to determine their most recent quarterly and annual total return values. Because of the short turnaround, Jackson recommends the firm with the greatest total return values for selection.

*Comment:* By considering only performance and GIPS compliance, Jackson has not conducted sufficient review of potential firms to satisfy the requirements of Standard V(A). A thorough investigation of the firms and their operations should be conducted to ensure that their addition would increase the diversity of clients' portfolios and that they are suitable for the fund-of-funds product.

**Example 16 (Manager Selection):**

Timothy Green works for Peach Asset Management, where he creates proprietary models that analyze data from the firm request for proposal questionnaires to identify managers for possible inclusion in the firm's fund-of-funds investment platform. Various criteria must be met to be accepted to the platform. Because of the number of respondents to the questionnaires, Green uses only the data submitted to make a recommendation for adding a new manager.

*Comment:* By failing to conduct any additional outside review of the information to verify what was submitted through the request for proposal, Green has likely not satisfied the requirements of Standard V(A). The amount of information requested from outside managers varies among firms. Although the requested information may be comprehensive, Green should ensure sufficient effort is undertaken to verify the submitted information before recommending a firm for inclusion. This requires that he go beyond the information provided by the manager on the request for proposal questionnaire and may include interviews with interested managers, reviews of regulatory filings, and discussions with the managers' custodian or auditor.

**Example 17 (Technical Model Requirements):**

Jérôme Dupont works for the credit research group of XYZ Asset Management, where he is in charge of developing and updating credit risk models. In order to perform accurately, his models need to be regularly updated with the latest market data.

Dupont does not interact with or manage money for any of the firm's clients. He is in contact with the firm's US corporate bond fund manager, John Smith, who has only very superficial knowledge of the model and who from time to time asks very basic questions regarding the output recommendations. Smith does not consult Dupont with respect to finalizing his clients' investment strategies.

Dupont's recently assigned objective is to develop a new emerging market corporate credit risk model. The firm is planning to expand into emerging credit, and the development of such a model is a critical step in this process. Because Smith seems to follow the model's recommendations without much concern for its quality as he develops his clients' investment strategies, Dupont decides to focus his time on the development of the new emerging market model and neglects to update the US model.

After several months without regular updates, Dupont's diagnostic statistics start to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick "fix." He thinks this change will address the issue without needing to complete the full data update, so he continues working on the new emerging market model.

Several months following the quick "fix," another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith rebalances the portfolio to remove the securities purchased on the basis of the questionable results without reporting the issue to anyone else.

*Comment:* Smith violated standard V(A) because exercising "diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions" means that members and candidates must understand the technical aspects of the products they provide to clients. Smith does not understand the model he is relying on to manage money. Members and candidates should also make reasonable enquiries into the source and accuracy of all data used in completing their investment analysis and recommendations.

Dupont violated V(A) even if he does not trade securities or make investment decisions. Dupont's models give investment recommendations, and Dupont is accountable for the quality of those recommendations. Members and candidates should make reasonable efforts to test the output of pre-programmed analytical tools they use. Such validation should occur before incorporating the tools into their decision-making process.

See also Standard V(B)—Communication with Clients and Prospective Clients.

## Standard V(B) Communication with Clients and Prospective Clients

Members and Candidates must:

- 1 Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

- 2 Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
- 3 Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
- 4 Distinguish between fact and opinion in the presentation of investment analyses and recommendations.

## Guidance

### Highlights:

- *Informing Clients of the Investment Process*
- *Different Forms of Communication*
- *Identifying Risk and Limitations*
- *Report Presentation*
- *Distinction between Facts and Opinions in Reports*

Standard V(B) addresses member and candidate conduct with respect to communicating with clients. Developing and maintaining clear, frequent, and thorough communication practices is critical to providing high-quality financial services to clients. When clients understand the information communicated to them, they also can understand exactly how members and candidates are acting on their behalf, which gives clients the opportunity to make well-informed decisions about their investments. Such understanding can be accomplished only through clear communication.

Standard V(B) states that members and candidates should communicate in a recommendation the factors that were instrumental in making the investment recommendation. A critical part of this requirement is to distinguish clearly between opinions and facts. In preparing a research report, the member or candidate must present the basic characteristics of the security(ies) being analyzed, which will allow the reader to evaluate the report and incorporate information the reader deems relevant to his or her investment decision-making process.

Similarly, in preparing a recommendation about, for example, an asset allocation strategy, alternative investment vehicle, or structured investment product, the member or candidate should include factors that are relevant to the asset classes that are being discussed. Follow-up communication of significant changes in the risk characteristics of a security or asset strategy is required. Providing regular updates to any changes in the risk characteristics is recommended.

### *Informing Clients of the Investment Process*

Members and candidates must adequately describe to clients and prospective clients the manner in which they conduct the investment decision-making process. Such disclosure should address factors that have positive and negative influences on the recommendations, including significant risks and limitations of the investment process used. The member or candidate must keep clients and other interested parties informed on an ongoing basis about changes to the investment process, especially newly identified significant risks and limitations. Only by thoroughly understanding the nature of the investment product or service can a client determine whether changes to that product or service could materially affect his or her investment objectives.

Understanding the basic characteristics of an investment is of great importance in judging the suitability of that investment on a standalone basis, but it is especially important in determining the impact each investment will have on the characteristics

of a portfolio. Although the risk and return characteristics of a common stock might seem to be essentially the same for any investor when the stock is viewed in isolation, the effects of those characteristics greatly depend on the other investments held. For instance, if the particular stock will represent 90% of an individual's investments, the stock's importance in the portfolio is vastly different from what it would be to an investor with a highly diversified portfolio for whom the stock will represent only 2% of the holdings.

A firm's investment policy may include the use of outside advisers to manage various portions of clients' assets under management. Members and candidates should inform the clients about the specialization or diversification expertise provided by the external adviser(s). This information allows clients to understand the full mix of products and strategies being applied that may affect their investment objectives.

### ***Different Forms of Communication***

For purposes of Standard V(B), communication is not confined to a written report of the type traditionally generated by an analyst researching a security, company, or industry. A presentation of information can be made via any means of communication, including in-person recommendation or description, telephone conversation, media broadcast, or transmission by computer (e.g., on the internet).

Computer and mobile device communications have rapidly evolved over the past few years. Members and candidates using any social media service to communicate business information must be diligent in their efforts to avoid unintended problems because these services may not be available to all clients. When providing information to clients through new technologies, members and candidates should take reasonable steps to ensure that such delivery would treat all clients fairly and, if necessary, be considered publicly disseminated.

The nature of client communications is highly diverse—from one word (“buy” or “sell”) to in-depth reports of more than 100 pages. A communication may contain a general recommendation about the market, asset allocations, or classes of investments (e.g., stocks, bonds, real estate) or may relate to a specific security. If recommendations are contained in capsule form (such as a recommended stock list), members and candidates should notify clients that additional information and analyses are available from the producer of the report.

### ***Identifying Risks and Limitations***

Members and candidates must outline to clients and prospective clients significant risks and limitations of the analysis contained in their investment products or recommendations. The type and nature of significant risks will depend on the investment process that members and candidates are following and on the personal circumstances of the client. In general, the use of leverage constitutes a significant risk and should be disclosed.

Members and candidates must adequately disclose the general market-related risks and the risks associated with the use of complex financial instruments that are deemed significant. Other types of risks that members and candidates may consider disclosing include, but are not limited to, counterparty risk, country risk, sector or industry risk, security-specific risk, and credit risk.

Investment securities and vehicles may have limiting factors that influence a client's or potential client's investment decision. Members and candidates must report to clients and prospective clients the existence of limitations significant to the decision-making process. Examples of such factors and attributes include, but are not limited to, investment liquidity and capacity. Liquidity is the ability to liquidate an investment on a timely basis at a reasonable cost. Capacity is the investment amount beyond which returns will be negatively affected by new investments.

The appropriateness of risk disclosure should be assessed on the basis of what was known at the time the investment action was taken (often called an *ex ante* basis). Members and candidates must disclose significant risks known to them at the time of the disclosure. Members and candidates cannot be expected to disclose risks they are unaware of at the time recommendations or investment actions are made. In assessing compliance with Standard V(B), it is important to establish knowledge of a purported significant risk or limitation. A one-time investment loss that occurs after the disclosure does not constitute a pertinent factor in assessing whether significant risks and limitations were properly disclosed. Having no knowledge of a risk or limitation that subsequently triggers a loss may reveal a deficiency in the diligence and reasonable basis of the research of the member or candidate but may not reveal a breach of Standard V(B).

### ***Report Presentation***

Once the analytical process has been completed, the member or candidate who prepares the report must include those elements that are important to the analysis and conclusions of the report so that the reader can follow and challenge the report's reasoning. A report writer who has done adequate investigation may emphasize certain areas, touch briefly on others, and omit certain aspects deemed unimportant. For instance, a report may dwell on a quarterly earnings release or new-product introduction and omit other matters as long as the analyst clearly stipulates the limits to the scope of the report.

Investment advice based on quantitative research and analysis must be supported by readily available reference material and should be applied in a manner consistent with previously applied methodology. If changes in methodology are made, they should be highlighted.

### ***Distinction between Facts and Opinions in Reports***

Standard V(B) requires that opinion be separated from fact. Violations often occur when reports fail to separate the past from the future by not indicating that earnings estimates, changes in the outlook for dividends, or future market price information are *opinions* subject to future circumstances.

In the case of complex quantitative analyses, members and candidates must clearly separate fact from statistical conjecture and should identify the known limitations of an analysis. Members and candidates may violate Standard V(B) by failing to identify the limits of statistically developed projections because such omission leaves readers unaware of the limits of the published projections.

Members and candidates should explicitly discuss with clients and prospective clients the assumptions used in the investment models and processes to generate the analysis. Caution should be used in promoting the perceived accuracy of any model or process to clients because the ultimate output is merely an estimate of future results and not a certainty.

## **Recommended Procedures for Compliance**

Because the selection of relevant factors is an analytical skill, determination of whether a member or candidate has used reasonable judgment in excluding and including information in research reports depends heavily on case-by-case review rather than a specific checklist.

Members and candidates should encourage their firms to have a rigorous methodology for reviewing research that is created for publication and dissemination to clients.

To assist in the after-the-fact review of a report, the member or candidate must maintain records indicating the nature of the research and should, if asked, be able to supply additional information to the client (or any user of the report) covering factors not included in the report.

## Application of the Standard

### *Example 1 (Sufficient Disclosure of Investment System):*

Sarah Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technicians' income and diversifying its product base. Williamson plans to build on Country Technicians' reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technicians' investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio construction rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top five "buy" and "sell" recommendations and to leave out details of the valuation models and the portfolio structuring scheme.

*Comment:* Williamson's plans for the newsletter violate Standard V(B). Williamson need not describe the investment system in detail in order to implement the advice effectively, but she must inform clients of Country Technicians' basic process and logic. Without understanding the basis for a recommendation, clients cannot possibly understand its limitations or its inherent risks.

### *Example 2 (Providing Opinions as Facts):*

Richard Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation on the basis of the core samples from the company's latest drilling. According to Dox's calculations, the company has more than 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong BUY."

*Comment:* If Dox issues the report as written, he will violate Standard V(B). His calculation of the total gold reserves for the property based on the company's recent sample drilling is a quantitative opinion, not a fact. Opinion must be distinguished from fact in research reports.

### *Example 3 (Proper Description of a Security):*

Olivia Thomas, an analyst at Government Brokers, Inc., which is a brokerage firm specializing in government bond trading, has produced a report that describes an investment strategy designed to benefit from an expected decline in US interest rates. The firm's derivative products group has designed a structured product that will allow the firm's clients to benefit from this strategy. Thomas's report describing the strategy indicates that high returns are possible if various scenarios for declining interest rates are assumed. Citing the proprietary nature of the structured product underlying the strategy, the report does not describe in detail how the firm is able to offer such returns or the related risks in the scenarios, nor does the report address the likely returns of the strategy if, contrary to expectations, interest rates rise.

*Comment:* Thomas has violated Standard V(B) because her report fails to describe properly the basic characteristics of the actual and implied risks of the investment strategy, including how the structure was created and the degree to which leverage was embedded in the structure. The report should include a balanced discussion of how the strategy would perform in the case of rising as well as falling interest rates, preferably illustrating how the strategies might be expected to perform in the event of a reasonable variety of interest rate and credit risk–spread scenarios. If liquidity issues are relevant with regard to the valuation of either the derivatives or the underlying securities, provisions the firm has made to address those risks should also be disclosed.

**Example 4 (Notification of Fund Mandate Change):**

May & Associates is an aggressive growth manager that has represented itself since its inception as a specialist at investing in small-cap US stocks. One of May's selection criteria is a maximum capitalization of US\$250 million for any given company. After a string of successful years of superior performance relative to its peers, May has expanded its client base significantly, to the point at which assets under management now exceed US\$3 billion. For liquidity purposes, May's chief investment officer (CIO) decides to lift the maximum permissible market-cap ceiling to US\$500 million and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

*Comment:* Although May's CIO is correct about informing potentially interested parties as to the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap and large-cap specialists in a multiple-manager approach. Such clients could regard May's change of criteria as a style change that distorts their overall asset allocations.

**Example 5 (Notification of Fund Mandate Change):**

Rather than lifting the ceiling for its universe from US\$250 million to US\$500 million, May & Associates extends its small-cap universe to include a number of non-US companies.

*Comment:* Standard V(B) requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in US small-cap stocks. Other changes that require client notification are introducing derivatives to emulate a certain market sector or relaxing various other constraints, such as portfolio beta. In all such cases, members and candidates must disclose changes to all interested parties.

**Example 6 (Notification of Changes to the Investment Process):**

RJZ Capital Management is an active value-style equity manager that selects stocks by using a combination of four multifactor models. The firm has found favorable results when back testing the most recent 10 years of available market data in a new dividend discount model (DDM) designed by the firm. This model is based on projected inflation rates, earnings growth rates, and interest rates. The president of RJZ decides to replace its simple model that uses price to trailing 12-month earnings with the new DDM.

*Comment:* Because the introduction of a new and different valuation model represents a material change in the investment process, RJZ's president must communicate the change to the firm's clients. RJZ is moving away from a model based on hard data toward a new model that is at least partly dependent on the firm's forecasting skills. Clients would likely view such a model as a significant change rather than a mere refinement of RJZ's process.

**Example 7 (Notification of Changes to the Investment Process):**

RJZ Capital Management loses the chief architect of its multifactor valuation system. Without informing its clients, the president of RJZ decides to redirect the firm's talents and resources toward developing a product for passive equity management—a product that will emulate the performance of a major market index.

*Comment:* By failing to disclose to clients a substantial change to its investment process, the president of RJZ has violated Standard V(B).

**Example 8 (Notification of Changes to the Investment Process):**

At Fundamental Asset Management, Inc., the responsibility for selecting stocks for addition to the firm's "approved" list has just shifted from individual security analysts to a committee consisting of the research director and three senior portfolio managers. Eleanor Morales, a portfolio manager with Fundamental Asset Management, thinks this change is not important enough to communicate to her clients.

*Comment:* Morales must disclose the process change to all her clients. Some of Fundamental's clients might be concerned about the morale and motivation among the firm's best research analysts after such a change. Moreover, clients might challenge the stock-picking track record of the portfolio managers and might even want to monitor the situation closely.

**Example 9 (Sufficient Disclosure of Investment System):**

Amanda Chinn is the investment director for Diversified Asset Management, which manages the endowment of a charitable organization. Because of recent staff departures, Diversified has decided to limit its direct investment focus to large-cap securities and supplement the needs for small-cap and mid-cap management by hiring outside fund managers. In describing the planned strategy change to the charity, Chinn's update letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have to be considered.

*Comment:* Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is one example of information that needs to be communicated to clients. Chinn and her firm have embraced the principles of Standard V(B) by providing their client with relevant information. The charity can now make a reasonable decision about whether Diversified Asset Management remains the appropriate manager for its fund.

**Example 10 (Notification of Changes to the Investment Process):**

Michael Papis is the chief investment officer of his state’s retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis’s business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund’s allocation. In the previous few years, the performance of the retirement fund’s real estate investments was in line with the fund’s benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

*Comment:* Papis has violated Standard V(B). He attempted to hide the nature of his decision to change external managers by making only a limited disclosure. The plan recipients and the fund’s trustees need to be aware when changes are made to ensure that operational procedures are being followed.

See also Standard IV(C)–Responsibilities of Supervisors, Standard V(A)–Diligence and Reasonable Basis, and Standard VI(A)–Disclosure of Conflicts.

**Example 11 (Notification of Errors):**

Jérôme Dupont works for the credit research group of XYZ Asset Management, where he is in charge of developing and updating credit risk models. In order to perform accurately, his models need to be regularly updated with the latest market data.

Dupont does not interact with or manage money for any of the firm’s clients. He is in contact with the firm’s US corporate bond fund manager, John Smith, who has only very superficial knowledge of the model and who from time to time asks very basic questions regarding the output recommendations. Smith does not consult Dupont with respect to finalizing his clients’ investment strategies.

Dupont’s recently assigned objective is to develop a new emerging market corporate credit risk model. The firm is planning to expand into emerging credit, and the development of such a model is a critical step in this process. Because Smith seems to follow the model’s recommendations without much concern for its quality as he develops his clients’ investment strategies, Dupont decides to focus his time on the development of the new emerging market model and neglects to update the US model.

After several months without regular updates, Dupont’s diagnostic statistics start to show alarming signs with respect to the quality of the US credit model. Instead of conducting the long and complicated data update, Dupont introduces new codes into his model with some limited new data as a quick “fix.” He thinks this change will address the issue without needing to complete the full data update, so he continues working on the new emerging market model.

Several months following the quick “fix,” another set of diagnostic statistics reveals nonsensical results and Dupont realizes that his earlier change contained an error. He quickly corrects the error and alerts Smith. Smith realizes that some of the prior trades he performed were due to erroneous model results. Smith rebalances the portfolio to remove the securities purchased on the basis of the questionable results without reporting the issue to anyone else.

*Comment:* Smith violated V(B) by not disclosing a material error in the investment process. Clients should have been informed about the error and the corrective actions the firm was undertaking on their behalf.

See also Standard V(A)–Diligence and Reasonable Basis.

**Example 12 (Notification of Risks and Limitations):**

Quantitative analyst Yuri Yakovlev has developed an investment strategy that selects small-cap stocks on the basis of quantitative signals. Yakovlev's strategy typically identifies only a small number of stocks (10–20) that tend to be illiquid, but according to his backtests, the strategy generates significant risk-adjusted returns. The partners at Yakovlev's firm, QSC Capital, are impressed by these results. After a thorough examination of the strategy's risks, stress testing, historical back testing, and scenario analysis, QSC decides to seed the strategy with US\$10 million of internal capital in order for Yakovlev to create a track record for the strategy.

After two years, the strategy has generated performance returns greater than the appropriate benchmark and the Sharpe ratio of the fund is close to 1.0. On the basis of these results, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. The extent of the limitation is difficult to ascertain with precision; it depends on market liquidity and other factors in his model that can evolve over time. Yakovlev indicates that given the current market conditions, investments in the fund beyond US\$100 million of capital could become more difficult and negatively affect expected fund returns.

Alan Wellard, the manager of the marketing team, is a partner with 30 years of marketing experience and explains to Yakovlev that these are complex technical issues that will muddy the marketing message. According to Wellard, the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund has only US\$12 million of capital, very far from the US\$100 million threshold.

*Comment:* Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund. Although the fund is currently far from the US\$100 million mark, current and prospective investors must be made aware of this capacity issue. If significant limitations are complicated to grasp and clients do not have the technical background required to understand them, Yakovlev and Wellard should either educate the clients or ascertain whether the fund is suitable for each client.

**Example 13 (Notification of Risks and Limitations):**

Brickell Advisers offers investment advisory services mainly to South American clients. Julietta Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an *ex ante* Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.

*Comment:* Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B). The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts. Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.

**Example 14 (Notification of Risks and Limitations):**

Lily Smith attended an industry conference and noticed that John Baker, an investment manager with Baker Associates, attracted a great deal of attention from the conference participants. On the basis of her knowledge of Baker’s reputation and the interest he received at the conference, Smith recommends adding Baker Associates to the approved manager platform. Her recommendation to the approval committee included the statement “John Baker is well respected in the industry, and his insights are consistently sought after by investors. Our clients are sure to benefit from investing with Baker Associates.”

*Comment:* Smith is not appropriately separating facts from opinions in her recommendation to include the manager within the platform. Her actions conflict with the requirements of Standard V(B). Smith is relying on her opinions about Baker’s reputation and the fact that many attendees were talking with him at the conference. Smith should also review the requirements of Standard V(A) regarding reasonable basis to determine the level of review necessary to recommend Baker Associates.

**Standard V(C) Record Retention**


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

**Guidance****Highlights:**

- *New Media Records*
- *Records Are Property of the Firm*
- *Local Requirements*

Members and candidates must retain records that substantiate the scope of their research and reasons for their actions or conclusions. The retention requirement applies to decisions to buy or sell a security as well as reviews undertaken that do not lead to a change in position. Which records are required to support recommendations or investment actions depends on the role of the member or candidate in the investment decision-making process. Records may be maintained either in hard copy or electronic form.

Some examples of supporting documentation that assists the member or candidate in meeting the requirements for retention are as follows:

- personal notes from meetings with the covered company,
- press releases or presentations issued by the covered company,
- computer-based model outputs and analyses,
- computer-based model input parameters,
- risk analyses of securities’ impacts on a portfolio,
- selection criteria for external advisers,

- notes from clients from meetings to review investment policy statements, and
- outside research reports.

### ***New Media Records***

The increased use of new and evolving technological formats (e.g., social media) for gathering and sharing information creates new challenges in maintaining the appropriate records and files. The nature or format of the information does not remove a member's or candidate's responsibility to maintain a record of information used in his or her analysis or communicated to clients.

Members and candidates should understand that although employers and local regulators are developing digital media retention policies, these policies may lag behind the advent of new communication channels. Such lag places greater responsibility on the individual for ensuring that all relevant information is retained. Examples of non-print media formats that should be retained include, but are not limited to,

- e-mails,
- text messages,
- blog posts, and
- Twitter posts.

### ***Records Are Property of the Firm***

As a general matter, records created as part of a member's or candidate's professional activity on behalf of his or her employer are the property of the firm. When a member or candidate leaves a firm to seek other employment, the member or candidate cannot take the property of the firm, including original forms or copies of supporting records of the member's or candidate's work, to the new employer without the express consent of the previous employer. The member or candidate cannot use historical recommendations or research reports created at the previous firm because the supporting documentation is unavailable. For future use, the member or candidate must re-create the supporting records at the new firm with information gathered through public sources or directly from the covered company and not from memory or sources obtained at the previous employer.

### ***Local Requirements***

Local regulators often impose requirements on members, candidates, and their firms related to record retention that must be followed. Firms may also implement policies detailing the applicable time frame for retaining research and client communication records. Fulfilling such regulatory and firm requirements satisfies the requirements of Standard V(C). In the absence of regulatory guidance or firm policies, CFA Institute recommends maintaining records for at least seven years.

## **Recommended Procedures for Compliance**

The responsibility to maintain records that support investment action generally falls with the firm rather than individuals. Members and candidates must, however, archive research notes and other documents, either electronically or in hard copy, that support their current investment-related communications. Doing so will assist their firms in complying with requirements for preservation of internal or external records.

## Application of the Standard

### **Example 1 (Record Retention and IPS Objectives and Recommendations):**

One of Nikolas Lindstrom's clients is upset by the negative investment returns of his equity portfolio. The investment policy statement for the client requires that the portfolio manager follow a benchmark-oriented approach. The benchmark for the client includes a 35% investment allocation in the technology sector. The client acknowledges that this allocation was appropriate, but over the past three years, technology stocks have suffered severe losses. The client complains to the investment manager for allocating so much money to this sector.

*Comment:* For Lindstrom, having appropriate records is important to show that over the past three years, the portion of technology stocks in the benchmark index was 35%, as called for in the IPS. Lindstrom should also have the client's IPS stating that the benchmark was appropriate for the client's investment objectives. He should also have records indicating that the investment has been explained appropriately to the client and that the IPS was updated on a regular basis. Taking these actions, Lindstrom would be in compliance with Standard V(C).

### **Example 2 (Record Retention and Research Process):**

Malcolm Young is a research analyst who writes numerous reports rating companies in the luxury retail industry. His reports are based on a variety of sources, including interviews with company managers, manufacturers, and economists; on-site company visits; customer surveys; and secondary research from analysts covering related industries.

*Comment:* Young must carefully document and keep copies of all the information that goes into his reports, including the secondary or third-party research of other analysts. Failure to maintain such files would violate Standard V(C).

### **Example 3 (Records as Firm, Not Employee, Property):**

Martin Blank develops an analytical model while he is employed by Green Partners Investment Management, LLP (GPIM). While at the firm, he systematically documents the assumptions that make up the model as well as his reasoning behind the assumptions. As a result of the success of his model, Blank is hired to be the head of the research department of one of GPIM's competitors. Blank takes copies of the records supporting his model to his new firm.

*Comment:* The records created by Blank supporting the research model he developed at GPIM are the records of GPIM. Taking the documents with him to his new employer without GPIM's permission violates Standard V(C). To use the model in the future, Blank must re-create the records supporting his model at the new firm.

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## STANDARD VI: CONFLICTS OF INTEREST

### Standard VI(A) Disclosure of Conflicts



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

### Guidance

#### Highlights:

- *Disclosure of Conflicts to Employers*
- *Disclosure to Clients*
- *Cross-Departmental Conflicts*
- *Conflicts with Stock Ownership*
- *Conflicts as a Director*

Best practice is to avoid actual conflicts or the appearance of conflicts of interest when possible. Conflicts of interest often arise in the investment profession. Conflicts can occur between the interests of clients, the interests of employers, and the member's or candidate's own personal interests. Common sources for conflict are compensation structures, especially incentive and bonus structures that provide immediate returns for members and candidates with little or no consideration of long-term value creation.

Identifying and managing these conflicts is a critical part of working in the investment industry and can take many forms. When conflicts cannot be reasonably avoided, clear and complete disclosure of their existence is necessary.

Standard VI(A) protects investors and employers by requiring members and candidates to fully disclose to clients, potential clients, and employers all actual and potential conflicts of interest. Once a member or candidate has made full disclosure, the member's or candidate's employer, clients, and prospective clients will have the information needed to evaluate the objectivity of the investment advice or action taken on their behalf.

To be effective, disclosures must be prominent and must be made in plain language and in a manner designed to effectively communicate the information. Members and candidates have the responsibility of determining how often, in what manner, and in what particular circumstances the disclosure of conflicts must be made. Best practices dictate updating disclosures when the nature of a conflict of interest changes materially—for example, if the nature of a conflict of interest worsens through the introduction of bonuses based on each quarter's profits as to opposed annual profits. In making and updating disclosures of conflicts of interest, members and candidates should err on the side of caution to ensure that conflicts are effectively communicated.

### ***Disclosure of Conflicts to Employers***

Disclosure of conflicts to employers may be appropriate in many instances. When reporting conflicts of interest to employers, members and candidates must give their employers enough information to assess the impact of the conflict. By complying with employer guidelines, members and candidates allow their employers to avoid potentially embarrassing and costly ethical or regulatory violations.

Reportable situations include conflicts that would interfere with rendering unbiased investment advice and conflicts that would cause a member or candidate to act not in the employer's best interest. The same circumstances that generate conflicts to be reported to clients and prospective clients also would dictate reporting to employers. Ownership of stocks analyzed or recommended, participation on outside boards, and financial or other pressures that could influence a decision are to be promptly reported to the employer so that their impact can be assessed and a decision on how to resolve the conflict can be made.

The mere appearance of a conflict of interest may create problems for members, candidates, and their employers. Therefore, many of the conflicts previously mentioned could be explicitly prohibited by an employer. For example, many employers restrict personal trading, outside board membership, and related activities to prevent situations that might not normally be considered problematic from a conflict-of-interest point of view but that could give the appearance of a conflict of interest. Members and candidates must comply with these restrictions. Members and candidates must take reasonable steps to avoid conflicts and, if they occur inadvertently, must report them promptly so that the employer and the member or candidate can resolve them as quickly and effectively as possible.

Standard VI(A) also deals with a member's or candidate's conflicts of interest that might be detrimental to the employer's business. Any potential conflict situation that could prevent clear judgment about or full commitment to the execution of a member's or candidate's duties to the employer should be reported to the member's or candidate's employer and promptly resolved.

### ***Disclosure to Clients***

Members and candidates must maintain their objectivity when rendering investment advice or taking investment action. Investment advice or actions may be perceived to be tainted in numerous situations. Can a member or candidate remain objective if, on behalf of the firm, the member or candidate obtains or assists in obtaining fees for services? Can a member or candidate give objective advice if he or she owns stock in the company that is the subject of an investment recommendation or if the member or candidate has a close personal relationship with the company managers? Requiring members and candidates to disclose all matters that reasonably could be expected to impair the member's or candidate's objectivity allows clients and prospective clients to judge motives and possible biases for themselves.

Often in the investment industry, a conflict, or the perception of a conflict, cannot be avoided. The most obvious conflicts of interest, which should always be disclosed, are relationships between an issuer and the member, the candidate, or his or her firm (such as a directorship or consultancy by a member; investment banking, underwriting, and financial relationships; broker/dealer market-making activities; and material beneficial ownership of stock). For the purposes of Standard VI(A), members and candidates beneficially own securities or other investments if they have a direct or indirect pecuniary interest in the securities, have the power to vote or direct the voting of the shares of the securities or investments, or have the power to dispose or direct the disposition of the security or investment.

A member or candidate must take reasonable steps to determine whether a conflict of interest exists and disclose to clients any known conflicts of the member's or candidate's firm. Disclosure of broker/dealer market-making activities alerts clients that a purchase or sale might be made from or to the firm's principal account and that the firm has a special interest in the price of the stock.

Additionally, disclosures should be made to clients regarding fee arrangements, subadvisory agreements, or other situations involving nonstandard fee structures. Equally important is the disclosure of arrangements in which the firm benefits directly from investment recommendations. An obvious conflict of interest is the rebate of a portion of the service fee some classes of mutual funds charge to investors. Members and candidates should ensure that their firms disclose such relationships so clients can fully understand the costs of their investments and the benefits received by their investment manager's employer.

### ***Cross-Departmental Conflicts***

Other circumstances can give rise to actual or potential conflicts of interest. For instance, a sell-side analyst working for a broker/dealer may be encouraged, not only by members of her or his own firm but by corporate issuers themselves, to write research reports about particular companies. The buy-side analyst is likely to be faced with similar conflicts as banks exercise their underwriting and security-dealing powers. The marketing division may ask an analyst to recommend the stock of a certain company in order to obtain business from that company.

The potential for conflicts of interest also exists with broker-sponsored limited partnerships formed to invest venture capital. Increasingly, members and candidates are expected not only to follow issues from these partnerships once they are offered to the public but also to promote the issues in the secondary market after public offerings. Members, candidates, and their firms should attempt to resolve situations presenting potential conflicts of interest or disclose them in accordance with the principles set forth in Standard VI(A).

### ***Conflicts with Stock Ownership***

The most prevalent conflict requiring disclosure under Standard VI(A) is a member's or candidate's ownership of stock in companies that he or she recommends to clients or that clients hold. Clearly, the easiest method for preventing a conflict is to prohibit members and candidates from owning any such securities, but this approach is overly burdensome and discriminates against members and candidates.

Therefore, sell-side members and candidates should disclose any materially beneficial ownership interest in a security or other investment that the member or candidate is recommending. Buy-side members and candidates should disclose their procedures for reporting requirements for personal transactions. Conflicts arising from personal investing are discussed more fully in the guidance for Standard VI(B).

### ***Conflicts as a Director***

Service as a director poses three basic conflicts of interest. First, a conflict may exist between the duties owed to clients and the duties owed to shareholders of the company. Second, investment personnel who serve as directors may receive the securities or options to purchase securities of the company as compensation for serving on the board, which could raise questions about trading actions that might increase the value of those securities. Third, board service creates the opportunity to receive material nonpublic information involving the company. Even though the information is confidential, the perception could be that information not available to the public is being communicated to a director's firm—whether a broker, investment adviser, or other

type of organization. When members or candidates providing investment services also serve as directors, they should be isolated from those making investment decisions by the use of firewalls or similar restrictions.

## Recommended Procedures for Compliance

Members or candidates should disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees. If the member's or candidate's firm does not permit such disclosure, the member or candidate should document the request and may consider dissociating from the activity.

Members' and candidates' firms are encouraged to include information on compensation packages in firms' promotional literature. If a member or candidate manages a portfolio for which the fee is based on capital gains or capital appreciation (a performance fee), this information should be disclosed to clients. If a member, a candidate, or a member's or candidate's firm has outstanding agent options to buy stock as part of the compensation package for corporate financing activities, the amount and expiration date of these options should be disclosed as a footnote to any research report published by the member's or candidate's firm.

## Application of the Standard

### *Example 1 (Conflict of Interest and Business Relationships):*

Hunter Weiss is a research analyst with Farmington Company, a broker and investment banking firm. Farmington's merger and acquisition department has represented Vimco, a conglomerate, in all of Vimco's acquisitions for 20 years. From time to time, Farmington officers sit on the boards of directors of various Vimco subsidiaries. Weiss is writing a research report on Vimco.

*Comment:* Weiss must disclose in his research report Farmington's special relationship with Vimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company entails a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report writer and must be disclosed.

### *Example 2 (Conflict of Interest and Business Stock Ownership):*

The investment management firm of Dover & Roe sells a 25% interest in its partnership to a multinational bank holding company, First of New York. Immediately after the sale, Margaret Hobbs, president of Dover & Roe, changes her recommendation for First of New York's common stock from "sell" to "buy" and adds First of New York's commercial paper to Dover & Roe's approved list for purchase.

*Comment:* Hobbs must disclose the new relationship with First of New York to all Dover & Roe clients. This relationship must also be disclosed to clients by the firm's portfolio managers when they make specific investment recommendations or take investment actions with respect to First of New York's securities.

**Example 3 (Conflict of Interest and Personal Stock Ownership):**

Carl Fargmon, a research analyst who follows firms producing office equipment, has been recommending purchase of Kincaid Printing because of its innovative new line of copiers. After his initial report on the company, Fargmon's wife inherits from a distant relative US\$3 million of Kincaid stock. He has been asked to write a follow-up report on Kincaid.

*Comment:* Fargmon must disclose his wife's ownership of the Kincaid stock to his employer and in his follow-up report. Best practice would be to avoid the conflict by asking his employer to assign another analyst to draft the follow-up report.

**Example 4 (Conflict of Interest and Personal Stock Ownership):**

Betty Roberts is speculating in penny stocks for her own account and purchases 100,000 shares of Drew Mining, Inc., for US\$0.30 a share. She intends to sell these shares at the sign of any substantial upward price movement of the stock. A week later, her employer asks her to write a report on penny stocks in the mining industry to be published in two weeks. Even without owning the Drew stock, Roberts would recommend it in her report as a "buy." A surge in the price of the stock to the US\$2 range is likely to result once the report is issued.

*Comment:* Although this holding may not be material, Roberts must disclose it in the report and to her employer before writing the report because the gain for her will be substantial if the market responds strongly to her recommendation. The fact that she has only recently purchased the stock adds to the appearance that she is not entirely objective.

**Example 5 (Conflict of Interest and Compensation Arrangements):**

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indexes. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

*Comment:* Snead has violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her employer, which created a conflict of interest between her compensation and her clients' IPSs. Firms may pay employees on the basis of performance, but pressure by Thomas Investment Counsel to achieve short-term performance goals is in basic conflict with the objectives of Snead's accounts.

See also Standard III(C)—Suitability.

**Example 6 (Conflict of Interest, Options, and Compensation Arrangements):**

Wayland Securities works with small companies doing IPOs or secondary offerings. Typically, these deals are in the US\$10 million to US\$50 million range, and as a result, the corporate finance fees are quite small. To compensate for the small fees, Wayland Securities usually takes “agent options”—that is, rights (exercisable within a two-year time frame) to acquire up to an additional 10% of the current offering. Following an IPO performed by Wayland for Falk Resources, Ltd., Darcy Hunter, the head of corporate finance at Wayland, is concerned about receiving value for her Falk Resources options. The options are due to expire in one month, and the stock is not doing well. She contacts John Fitzpatrick in the research department of Wayland Securities, reminds him that he is eligible for 30% of these options, and indicates that now would be a good time to give some additional coverage to Falk Resources. Fitzpatrick agrees and immediately issues a favorable report.

*Comment:* For Fitzpatrick to avoid being in violation of Standard VI(A), he must indicate in the report the volume and expiration date of agent options outstanding. Furthermore, because he is personally eligible for some of the options, Fitzpatrick must disclose the extent of this compensation. He also must be careful to not violate his duty of independence and objectivity under Standard I(B).

**Example 7 (Conflict of Interest and Compensation Arrangements):**

Gary Carter is a representative with Bengal International, a registered broker/dealer. Carter is approached by a stock promoter for Badger Company, who offers to pay Carter additional compensation for sales of Badger Company’s stock to Carter’s clients. Carter accepts the stock promoter’s offer but does not disclose the arrangements to his clients or to his employer. Carter sells shares of the stock to his clients.

*Comment:* Carter has violated Standard VI(A) by failing to disclose to clients that he is receiving additional compensation for recommending and selling Badger stock. Because he did not disclose the arrangement with Badger to his clients, the clients were unable to evaluate whether Carter’s recommendations to buy Badger were affected by this arrangement. Carter’s conduct also violated Standard VI(A) by failing to disclose to his employer monetary compensation received in addition to the compensation and benefits conferred by his employer. Carter was required by Standard VI(A) to disclose the arrangement with Badger to his employer so that his employer could evaluate whether the arrangement affected Carter’s objectivity and loyalty.

**Example 8 (Conflict of Interest and Directorship):**

Carol Corky, a senior portfolio manager for Universal Management, recently became involved as a trustee with the Chelsea Foundation, a large not-for-profit foundation in her hometown. Universal is a small money manager (with assets under management of approximately US\$100 million) that caters to individual investors. Chelsea has assets in excess of US\$2 billion. Corky does not believe informing Universal of her involvement with Chelsea is necessary.

*Comment:* By failing to inform Universal of her involvement with Chelsea, Corky violated Standard VI(A). Given the large size of the endowment at Chelsea, Corky’s new role as a trustee can reasonably be expected to be time consuming, to the possible detriment of Corky’s portfolio responsibilities with Universal. Also, as a trustee, Corky may become involved in the investment decisions at Chelsea. Therefore, Standard VI(A) obligates Corky to discuss becoming a trustee at Chelsea with her compliance officer

or supervisor at Universal before accepting the position, and she should have disclosed the degree to which she would be involved in investment decisions at Chelsea.

**Example 9 (Conflict of Interest and Personal Trading):**

Bruce Smith covers eastern European equities for Marlborough Investments, an investment management firm with a strong presence in emerging markets. While on a business trip to Russia, Smith learns that investing in Russian equities directly is difficult but that equity-linked notes that replicate the performance of underlying Russian equities can be purchased from a New York–based investment bank. Believing that his firm would not be interested in such a security, Smith purchases a note linked to a Russian telecommunications company for his own account without informing Marlborough. A month later, Smith decides that the firm should consider investing in Russian equities by way of the equity-linked notes. He prepares a write-up on the market that concludes with a recommendation to purchase several of the notes. One note he recommends is linked to the same Russian telecom company that Smith holds in his personal account.

*Comment:* Smith has violated Standard VI(A) by failing to disclose his purchase and ownership of the note linked to the Russian telecom company. Smith is required by the standard to disclose the investment opportunity to his employer and look to his company’s policies on personal trading to determine whether it was proper for him to purchase the note for his own account. By purchasing the note, Smith may or may not have impaired his ability to make an unbiased and objective assessment of the appropriateness of the derivative instrument for his firm, but Smith’s failure to disclose the purchase to his employer impaired his employer’s ability to decide whether his ownership of the security is a conflict of interest that might affect Smith’s future recommendations. Then, when he recommended the particular telecom notes to his firm, Smith compounded his problems by not disclosing that he owned the notes in his personal account—a clear conflict of interest.

**Example 10 (Conflict of Interest and Requested Favors):**

Michael Papis is the chief investment officer of his state’s retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis’s business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund’s allocation. In the previous few years, the performance of the retirement fund’s real estate investments was in line with the fund’s benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

*Comment:* Papis has violated Standard VI(A) by not disclosing to his employer his personal relationship with Nagle. Disclosure of his past history with Nagle would allow his firm to determine whether the conflict may have impaired Papis’s independence in deciding to change managers.

See also Standard IV(C)—Responsibilities of Supervisors, Standard V(A)—Diligence and Reasonable Basis, and Standard V(B)—Communication with Clients and Prospective Clients.

**Example 11 (Conflict of Interest and Business Relationships):**

Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review the Western Funds family of funds to determine whether they were suitable for clients of Central. The manager completed the normal due diligence review and determined that the funds were fairly valued in the market with fee structures on a par with their competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments. So as to not influence the investment managers, Wade did not disclose the fee offer and allowed that income to flow directly to the bank.

*Comment:* Wade is violating Standard VI(A) by not disclosing the portion of the service fee being paid to Central. Although the investment managers may not be influenced by the fee, neither they nor the client have the proper information about Wade's decision to exclusively market this fund family and class of investments. Central may come to rely on the new fee as a component of the firm's profitability and may be unwilling to offer other products in the future that could affect the fees received.

See also Standard I(B)—Independence and Objectivity.

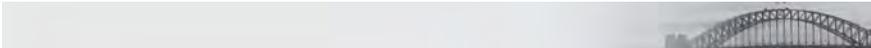
**Example 12 (Disclosure of Conflicts to Employers):**

Yehudit Dagan is a portfolio manager for Risk Management Bank (RMB), whose clients include retirement plans and corporations. RMB provides a defined contribution retirement plan for its employees that offers 20 large diversified mutual fund investment options, including a mutual fund managed by Dagan's RMB colleagues. After being employed for six months, Dagan became eligible to participate in the retirement plan, and she intends to allocate her retirement plan assets in six of the investment options, including the fund managed by her RMB colleagues. Dagan is concerned that joining the plan will lead to a potentially significant amount of paperwork for her (e.g., disclosure of her retirement account holdings and needing preclearance for her transactions), especially with her investing in the in-house fund.

*Comment:* Standard VI(A) would not require Dagan to disclose her personal or retirement investments in large diversified mutual funds, unless specifically required by her employer. For practical reasons, the standard does not require Dagan to gain preclearance for ongoing payroll deduction contributions to retirement plan account investment options.

Dagan should ensure that her firm does not have a specific policy regarding investment—whether personal or in the retirement account—for funds managed by the company's employees. These mutual funds may be subject to the company's disclosure, preclearance, and trading restriction procedures to identify possible conflicts prior to the execution of trades.

## Standard VI(B) Priority of Transactions



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

### Guidance

#### Highlights:

- *Avoiding Potential Conflicts*
- *Personal Trading Secondary to Trading for Clients*
- *Standards for Nonpublic Information*
- *Impact on All Accounts with Beneficial Ownership*

Standard VI(B) reinforces the responsibility of members and candidates to give the interests of their clients and employers priority over their personal financial interests. This standard is designed to prevent any potential conflict of interest or the appearance of a conflict of interest with respect to personal transactions. Client interests have priority. Client transactions must take precedence over transactions made on behalf of the member's or candidate's firm or personal transactions.

#### *Avoiding Potential Conflicts*

Conflicts between the client's interest and an investment professional's personal interest may occur. Although conflicts of interest exist, nothing is inherently unethical about individual managers, advisers, or mutual fund employees making money from personal investments as long as (1) the client is not disadvantaged by the trade, (2) the investment professional does not benefit personally from trades undertaken for clients, and (3) the investment professional complies with applicable regulatory requirements.

Some situations occur where a member or candidate may need to enter a personal transaction that runs counter to current recommendations or what the portfolio manager is doing for client portfolios. For example, a member or candidate may be required at some point to sell an asset to make a college tuition payment or a down payment on a home, to meet a margin call, or so on. The sale may be contrary to the long-term advice the member or candidate is currently providing to clients. In these situations, the same three criteria given in the preceding paragraph should be applied in the transaction so as to not violate Standard VI(B).

#### *Personal Trading Secondary to Trading for Clients*

Standard VI(B) states that transactions for clients and employers must have priority over transactions in securities or other investments for which a member or candidate is the beneficial owner. The objective of the standard is to prevent personal transactions from adversely affecting the interests of clients or employers. A member or candidate having the same investment positions or being co-invested with clients does not always create a conflict. Some clients in certain investment situations require members or candidates to have aligned interests. Personal investment positions or transactions of members or candidates or their firm should never, however, adversely affect client investments.

### ***Standards for Nonpublic Information***

Standard VI(B) covers the activities of members and candidates who have knowledge of pending transactions that may be made on behalf of their clients or employers, who have access to nonpublic information during the normal preparation of research recommendations, or who take investment actions. Members and candidates are prohibited from conveying nonpublic information to any person whose relationship to the member or candidate makes the member or candidate a beneficial owner of the person's securities. Members and candidates must not convey this information to any other person if the nonpublic information can be deemed material.

### ***Impact on All Accounts with Beneficial Ownership***

Members or candidates may undertake transactions in accounts for which they are a beneficial owner only after their clients and employers have had adequate opportunity to act on a recommendation. Personal transactions include those made for the member's or candidate's own account, for family (including spouse, children, and other immediate family members) accounts, and for accounts in which the member or candidate has a direct or indirect pecuniary interest, such as a trust or retirement account. Family accounts that are client accounts should be treated like any other firm account and should neither be given special treatment nor be disadvantaged because of the family relationship. If a member or candidate has a beneficial ownership in the account, however, the member or candidate may be subject to preclearance or reporting requirements of the employer or applicable law.

## **Recommended Procedures for Compliance**

Policies and procedures designed to prevent potential conflicts of interest, and even the appearance of a conflict of interest, with respect to personal transactions are critical to establishing investor confidence in the securities industry. Therefore, members and candidates should urge their firms to establish such policies and procedures. Because investment firms vary greatly in assets under management, types of clients, number of employees, and so on, each firm should have policies regarding personal investing that are best suited to the firm. Members and candidates should then prominently disclose these policies to clients and prospective clients.

The specific provisions of each firm's standards will vary, but all firms should adopt certain basic procedures to address the conflict areas created by personal investing. These procedures include the following:

- ***Limited participation in equity IPOs:*** Some eagerly awaited IPOs rise significantly in value shortly after the issue is brought to market. Because the new issue may be highly attractive and sought after, the opportunity to participate in the IPO may be limited. Therefore, purchases of IPOs by investment personnel create conflicts of interest in two principal ways. First, participation in an IPO may have the appearance of taking away an attractive investment opportunity from clients for personal gain—a clear breach of the duty of loyalty to clients. Second, personal purchases in IPOs may have the appearance that the investment opportunity is being bestowed as an incentive to make future investment decisions for the benefit of the party providing the opportunity. Members and candidates can avoid these conflicts or appearances of conflicts of interest by not participating in IPOs.

Reliable and systematic review procedures should be established to ensure that conflicts relating to IPOs are identified and appropriately dealt with by supervisors. Members and candidates should preclear their participation in IPOs, even in situations without any conflict of interest between a member's or candidate's participation in an IPO and the client's interests. Members and

candidates should not benefit from the position that their clients occupy in the marketplace—through preferred trading, the allocation of limited offerings, or oversubscription.

- *Restrictions on private placements:* Strict limits should be placed on investment personnel acquiring securities in private placements, and appropriate supervisory and review procedures should be established to prevent noncompliance.

Firms do not routinely use private placements for clients (e.g., venture capital deals) because of the high risk associated with them. Conflicts related to private placements are more significant to members and candidates who manage large pools of assets or act as plan sponsors because these managers may be offered special opportunities, such as private placements, as a reward or an enticement for continuing to do business with a particular broker.

Participation in private placements raises conflict-of-interest issues that are similar to issues surrounding IPOs. Investment personnel should not be involved in transactions, including (but not limited to) private placements, that could be perceived as favors or gifts that seem designed to influence future judgment or to reward past business deals.

Whether the venture eventually proves to be good or bad, managers have an immediate conflict concerning private placement opportunities. If and when the investments go public, participants in private placements have an incentive to recommend the investments to clients regardless of the suitability of the investments for their clients. Doing so increases the value of the participants' personal portfolios.

- *Establish blackout/restricted periods:* Investment personnel involved in the investment decision-making process should establish blackout periods prior to trades for clients so that managers cannot take advantage of their knowledge of client activity by “front-running” client trades (trading for one’s personal account before trading for client accounts).

Individual firms must decide who within the firm should be required to comply with the trading restrictions. At a minimum, all individuals who are involved in the investment decision-making process should be subject to the same restricted period. Each firm must determine specific requirements related to blackout and restricted periods that are most relevant to the firm while ensuring that the procedures are governed by the guiding principles set forth in the Code and Standards. Size of firm and type of securities purchased are relevant factors. For example, in a large firm, a blackout requirement is, in effect, a total trading ban because the firm is continually trading in most securities. In a small firm, the blackout period is more likely to prevent the investment manager from front-running.

- *Reporting requirements:* Supervisors should establish reporting procedures for investment personnel, including disclosure of personal holdings/beneficial ownerships, confirmations of trades to the firm and the employee, and preclearance procedures. Once trading restrictions are in place, they must be enforced. The best method for monitoring and enforcing procedures to eliminate conflicts of interest in personal trading is through reporting requirements, including the following:

- **Disclosure of holdings in which the employee has a beneficial interest.**  
Disclosure by investment personnel to the firm should be made upon commencement of the employment relationship and at least annually thereafter. To address privacy considerations, disclosure of personal holdings should be handled in a confidential manner by the firm.

- **Providing duplicate confirmations of transactions.** Investment personnel should be required to direct their brokers to supply to firms duplicate copies or confirmations of all their personal securities transactions and copies of periodic statements for all securities accounts. The duplicate confirmation requirement has two purposes: (1) The requirement sends a message that there is independent verification, which reduces the likelihood of unethical behavior, and (2) it enables verification of the accounting of the flow of personal investments that cannot be determined from merely looking at holdings.
- **Preclearance procedures.** Investment personnel should examine all planned personal trades to identify possible conflicts prior to the execution of the trades. Preclearance procedures are designed to identify possible conflicts before a problem arises.
- *Disclosure of policies:* Members and candidates should fully disclose to investors their firm’s policies regarding personal investing. The information about employees’ personal investment activities and policies will foster an atmosphere of full and complete disclosure and calm the public’s legitimate concerns about the conflicts of interest posed by investment personnel’s personal trading. The disclosure must provide helpful information to investors; it should not be simply boilerplate language, such as “investment personnel are subject to policies and procedures regarding their personal trading.”

## Application of the Standard

### *Example 1 (Personal Trading):*

Research analyst Marlon Long does not recommend purchase of a common stock for his employer’s account because he wants to purchase the stock personally and does not want to wait until the recommendation is approved and the stock is purchased by his employer.

*Comment:* Long has violated Standard VI(B) by taking advantage of his knowledge of the stock’s value before allowing his employer to benefit from that information.

### *Example 2 (Trading for Family Member Account):*

Carol Baker, the portfolio manager of an aggressive growth mutual fund, maintains an account in her husband’s name at several brokerage firms with which the fund and a number of Baker’s other individual clients do a substantial amount of business. Whenever a hot issue becomes available, she instructs the brokers to buy it for her husband’s account. Because such issues normally are scarce, Baker often acquires shares in hot issues but her clients are not able to participate in them.

*Comment:* To avoid violating Standard VI(B), Baker must acquire shares for her mutual fund first and acquire them for her husband’s account only after doing so, even though she might miss out on participating in new issues via her husband’s account. She also must disclose the trading for her husband’s account to her employer because this activity creates a conflict between her personal interests and her employer’s interests.

**Example 3 (Family Accounts as Equals):**

Erin Toffler, a portfolio manager at Esposito Investments, manages the retirement account established with the firm by her parents. Whenever IPOs become available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place any remaining portion in her parents' account, if the issue is appropriate for them. She has adopted this procedure so that no one can accuse her of favoring her parents.

*Comment:* Toffler has violated Standard VI(B) by breaching her duty to her parents by treating them differently from her other accounts simply because of the family relationship. As fee-paying clients of Esposito Investments, Toffler's parents are entitled to the same treatment as any other client of the firm. If Toffler has beneficial ownership in the account, however, and Esposito Investments has preclearance and reporting requirements for personal transactions, she may have to preclear the trades and report the transactions to Esposito.

**Example 4 (Personal Trading and Disclosure):**

Gary Michaels is an entry-level employee who holds a low-paying job serving both the research department and the investment management department of an active investment management firm. He purchases a sports car and begins to wear expensive clothes after only a year of employment with the firm. The director of the investment management department, who has responsibility for monitoring the personal stock transactions of all employees, investigates and discovers that Michaels has made substantial investment gains by purchasing stocks just before they were put on the firm's recommended "buy" list. Michaels was regularly given the firm's quarterly personal transaction form but declined to complete it.

*Comment:* Michaels violated Standard VI(B) by placing personal transactions ahead of client transactions. In addition, his supervisor violated Standard IV(C)—Responsibilities of Supervisors by permitting Michaels to continue to perform his assigned tasks without having signed the quarterly personal transaction form. Note also that if Michaels had communicated information about the firm's recommendations to a person who traded the security, that action would be a misappropriation of the information and a violation of Standard II(A)—Material Nonpublic Information.

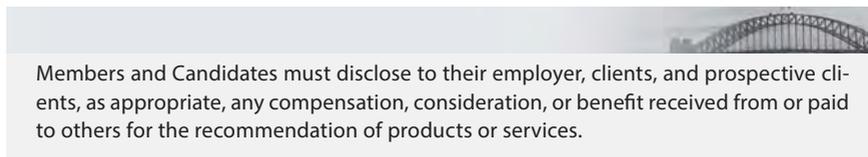
**Example 5 (Trading Prior to Report Dissemination):**

A brokerage's insurance analyst, Denise Wilson, makes a closed-circuit TV report to her firm's branches around the country. During the broadcast, she includes negative comments about a major company in the insurance industry. The following day, Wilson's report is printed and distributed to the sales force and public customers. The report recommends that both short-term traders and intermediate investors take profits by selling that insurance company's stock. Seven minutes after the broadcast, however, Ellen Riley, head of the firm's trading department, had closed out a long "call" position in the stock. Shortly thereafter, Riley established a sizable "put" position in the stock. When asked about her activities, Riley claimed she took the actions to facilitate anticipated sales by institutional clients.

*Comment:* Riley did not give customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Riley's firm may have depressed the price of the calls and increased the price of the puts. The firm could have avoided a conflict

of interest if it had waited to trade for its own account until its clients had an opportunity to receive and assimilate Wilson's recommendations. As it is, Riley's actions violated Standard VI(B).

## Standard VI(C) Referral Fees



### Guidance

Standard VI(C) states the responsibility of members and candidates to inform their employer, clients, and prospective clients of any benefit received for referrals of customers and clients. Such disclosures allow clients or employers to evaluate (1) any partiality shown in any recommendation of services and (2) the full cost of the services. Members and candidates must disclose when they pay a fee or provide compensation to others who have referred prospective clients to the member or candidate.

Appropriate disclosure means that members and candidates must advise the client or prospective client, before entry into any formal agreement for services, of any benefit given or received for the recommendation of any services provided by the member or candidate. In addition, the member or candidate must disclose the nature of the consideration or benefit—for example, flat fee or percentage basis, one-time or continuing benefit, based on performance, benefit in the form of provision of research or other noncash benefit—together with the estimated dollar value. Consideration includes all fees, whether paid in cash, in soft dollars, or in kind.

### Recommended Procedures for Compliance

Members and candidates should encourage their employers to develop procedures related to referral fees. The firm may completely restrict such fees. If the firm does not adopt a strict prohibition of such fees, the procedures should indicate the appropriate steps for requesting approval.

Employers should have investment professionals provide to the clients notification of approved referral fee programs and provide the employer regular (at least quarterly) updates on the amount and nature of compensation received.

### Application of the Standard

#### *Example 1 (Disclosure of Referral Arrangements and Outside Parties):*

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment counseling firm. In this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral accounts to Brady Securities.

Willard White, a partner in Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities are US\$20,000 annually.

Referrals from Brady Securities last year resulted in fee income of US\$200,000 for Lewis Brothers, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of US\$10,000.

Diane Branch, the chief financial officer of Maxwell Inc., contacts White and says that she is seeking an investment manager for Maxwell's profit-sharing plan. She adds, "My friend Harold Hill at Brady Securities recommended your firm without qualification, and that's good enough for me. Do we have a deal?" White accepts the new account but does not disclose his firm's referral arrangement with Brady Securities.

*Comment:* White has violated Standard VI(C) by failing to inform the prospective customer of the referral fee payable in services and commissions for an indefinite period to Brady Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

**Example 2 (Disclosure of Interdepartmental Referral Arrangements):**

James Handley works for the trust department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage department and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement within Central Trust to his clients.

*Comment:* Handley has violated Standard VI(C) by not disclosing the referral arrangement at Central Trust Bank to his clients. Standard VI(C) does not distinguish between referral payments paid by a third party for referring clients to the third party and internal payments paid within the firm to attract new business to a subsidiary. Members and candidates must disclose all such referral fees. Therefore, Handley is required to disclose, at the time of referral, any referral fee agreement in place among Central Trust Bank's departments. The disclosure should include the nature and the value of the benefit and should be made in writing.

**Example 3 (Disclosure of Referral Arrangements and Informing Firm):**

Katherine Roberts is a portfolio manager at Katama Investments, an advisory firm specializing in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients. Roberts asks the trading desk to direct a large portion of its commissions to Naushon, Inc., a small broker/dealer run by one of Roberts' business school classmates. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research to be not especially useful. Nevertheless, the traders do as Roberts asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment services of Roberts and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

*Comment:* Roberts is violating Standard VI(C) by failing to inform her employer of the referral arrangement.

**Example 4 (Disclosure of Referral Arrangements and Outside Organizations):**

Alex Burl is a portfolio manager at Helpful Investments, a local investment advisory firm. Burl is on the advisory board of his child's school, which is looking for ways to raise money to purchase new playground equipment for the school. Burl discusses a plan with his supervisor in which he will donate to the school a portion of his service fee from new clients referred by the parents of students at the school. Upon getting the approval from Helpful, Burl presents the idea to the school's advisory board and directors. The school agrees to announce the program at the next parent event and asks Burl to provide the appropriate written materials to be distributed. A week following the distribution of the flyers, Burl receives the first school-related referral. In establishing the client's investment policy statement, Burl clearly discusses the school's referral and outlines the plans for distributing the donation back to the school.

*Comment:* Burl has not violated Standard VI(C) because he secured the permission of his employer, Helpful Investments, and the school prior to beginning the program and because he discussed the arrangement with the client at the time the investment policy statement was designed.

**Example 5 (Disclosure of Referral Arrangements and Outside Parties):**

The sponsor of a state employee pension is seeking to hire a firm to manage the pension plan's emerging market allocation. To assist in the review process, the sponsor has hired Thomas Arrow as a consultant to solicit proposals from various advisers. Arrow is contracted by the sponsor to represent its best interest in selecting the most appropriate new manager. The process runs smoothly, and Overseas Investments is selected as the new manager.

The following year, news breaks that Arrow is under investigation by the local regulator for accepting kickbacks from investment managers after they are awarded new pension allocations. Overseas Investments is included in the list of firms allegedly making these payments. Although the sponsor is happy with the performance of Overseas since it has been managing the pension plan's emerging market funds, the sponsor still decides to have an independent review of the proposals and the selection process to ensure that Overseas was the appropriate firm for its needs. This review confirms that, even though Arrow was being paid by both parties, the recommendation of Overseas appeared to be objective and appropriate.

*Comment:* Arrow has violated Standard VI(C) because he did not disclose the fee being paid by Overseas. Withholding this information raises the question of a potential lack of objectivity in the recommendation of Overseas by Arrow; this aspect is in addition to questions about the legality of having firms pay to be considered for an allocation.

Regulators and governmental agencies may adopt requirements concerning allowable consultant activities. Local regulations sometimes include having a consultant register with the regulatory agency's ethics board. Regulator policies may include a prohibition on acceptance of payments from investment managers receiving allocations and require regular reporting of contributions made to political organizations and candidates. Arrow would have to adhere to these requirements as well as the Code and Standards.

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## STANDARD VII: RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

### Standard VII(A) Conduct as Participants in CFA Institute Programs



Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

#### Guidance

##### Highlights:

- *Confidential Program Information*
- *Additional CFA Program Restrictions*
- *Expressing an Opinion*

Standard VII(A) covers the conduct of CFA Institute members and candidates involved with the CFA Program and prohibits any conduct that undermines the public's confidence that the CFA charter represents a level of achievement based on merit and ethical conduct. There is an array of CFA Institute programs beyond the CFA Program that provide additional educational and credentialing opportunities, including the Certificate in Investment Performance Measurement (CIPM) Program and the CFA Institute Investment Foundations™ Program. The standard's function is to hold members and candidates to a high ethical criterion while they are participating in or involved with any CFA Institute program. Conduct covered includes but is not limited to

- giving or receiving assistance (cheating) on any CFA Institute examinations;
- violating the rules, regulations, and testing policies of CFA Institute programs;
- providing confidential program or exam information to candidates or the public;
- disregarding or attempting to circumvent security measures established for any CFA Institute examinations;
- improperly using an association with CFA Institute to further personal or professional goals; and
- misrepresenting information on the Professional Conduct Statement or in the CFA Institute Continuing Education Program.

##### *Confidential Program Information*

CFA Institute is vigilant about protecting the integrity of CFA Institute programs' content and examination processes. CFA Institute program rules, regulations, and policies prohibit candidates from disclosing confidential material gained during the exam process.

Examples of information that cannot be disclosed by candidates sitting for an exam include but are not limited to

- specific details of questions appearing on the exam and
- broad topical areas and formulas tested or not tested on the exam.

All aspects of the exam, including questions, broad topical areas, and formulas, tested or not tested, are considered confidential until such time as CFA Institute elects to release them publicly. This confidentiality requirement allows CFA Institute to maintain the integrity and rigor of exams for future candidates. Standard VII(A) does not prohibit candidates from discussing nonconfidential information or curriculum material with others or in study groups in preparation for the exam.

Candidates increasingly use online forums and new technology as part of their exam preparations. CFA Institute actively polices blogs, forums, and related social networking groups for information considered confidential. The organization works with both individual candidates and the sponsors of online or offline services to promptly remove any and all violations. As noted in the discussion of Standard I(A)—Knowledge of the Law, candidates, members, and the public are encouraged to report suspected violations to CFA Institute.

#### ***Additional CFA Program Restrictions***

The CFA Program rules, regulations, and policies define additional allowed and disallowed actions concerning the exams. Violating any of the testing policies, such as the calculator policy, personal belongings policy, or the Candidate Pledge, constitutes a violation of Standard VII(A). Candidates will find all of these policies on the CFA Program portion of the CFA Institute website ([www.cfainstitute.org](http://www.cfainstitute.org)). Exhibit 2 provides the Candidate Pledge, which highlights the respect candidates must have for the integrity, validity, and security of the CFA exam.

Members may participate as volunteers in various aspects of the CFA Program. Standard VII(A) prohibits members from disclosing and/or soliciting confidential material gained prior to or during the exam and grading processes with those outside the CFA exam development process.

Examples of information that cannot be shared by members involved in developing, administering, or grading the exams include but are not limited to

- questions appearing on the exam or under consideration,
- deliberation related to the exam process, and
- information related to the scoring of questions.

Members may also be asked to offer assistance with other CFA Institute programs, including but not limited to the CIPM and Investment Foundations programs. Members participating in any CFA Institute program should do so with the same level of integrity and confidentiality as is required of participation in the CFA Program.

#### ***Expressing an Opinion***

Standard VII(A) does *not* cover expressing opinions regarding CFA Institute, the CFA Program, or other CFA Institute programs. Members and candidates are free to disagree and express their disagreement with CFA Institute on its policies, its procedures, or any advocacy positions taken by the organization. When expressing a personal opinion, a candidate is prohibited from disclosing content-specific information, including any actual exam question and the information as to subject matter covered or not covered in the exam.

**Exhibit 2 Sample of CFA Program Testing Policies**

Candidate Pledge	<p>As a candidate in the CFA Program, I am obligated to follow Standard VII(A) of the CFA Institute Standards of Professional Conduct, which states that members and candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA exam.</p> <ul style="list-style-type: none"> <li>■ Prior to this exam, I have not given or received information regarding the content of this exam. During this exam, I will not give or receive any information regarding the content of this exam.</li> <li>■ After this exam, I will not disclose <b>ANY</b> portion of this exam and I will not remove <b>ANY</b> exam materials from the testing room in original or copied form. I understand that all exam materials, including my answers, are the property of CFA Institute and will not be returned to me in any form.</li> <li>■ I will follow <b>ALL</b> rules of the CFA Program as stated on the CFA Institute website and the back cover of the exam book. My violation of any rules of the CFA Program will result in CFA Institute voiding my exam results and may lead to suspension or termination of my candidacy in the CFA Program.</li> </ul>
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**Application of the Standard****Example 1 (Sharing Exam Questions):**

Travis Nero serves as a proctor for the administration of the CFA examination in his city. In the course of his service, he reviews a copy of the Level II exam on the evening prior to the exam's administration and provides information concerning the exam questions to two candidates who use it to prepare for the exam.

*Comment:* Nero and the two candidates have violated Standard VII(A). By giving information about the exam questions to two candidates, Nero provided an unfair advantage to the two candidates and undermined the integrity and validity of the Level II exam as an accurate measure of the knowledge, skills, and abilities necessary to earn the right to use the CFA designation. By accepting the information, the candidates also compromised the integrity and validity of the Level II exam and undermined the ethical framework that is a key part of the designation.

**Example 2 (Bringing Written Material into Exam Room):**

Loren Sullivan is enrolled to take the Level II CFA examination. He has been having difficulty remembering a particular formula, so prior to entering the exam room, he writes the formula on the palm of his hand. During the afternoon section of the exam, a proctor notices Sullivan looking at the palm of his hand. She asks to see his hand and finds the formula.

*Comment:* Because Sullivan wrote down information from the Candidate Body of Knowledge (CBOK) and took that written information into the exam room, his conduct compromised the validity of his exam performance and violated Standard VII(A). Sullivan's conduct was also in direct contradiction with the rules and regulations of the CFA Program, the Candidate Pledge, and the CFA Institute Code and Standards.

**Example 3 (Writing after Exam Period End):**

At the conclusion of the morning section of the Level I CFA examination, the proctors announce, “Stop writing now.” John Davis has not completed the exam, so he continues to randomly fill in ovals on his answer sheet. A proctor approaches Davis’s desk and reminds him that he should stop writing immediately. Davis, however, continues to complete the answer sheet. After the proctor asks him to stop writing two additional times, Davis finally puts down his pencil.

*Comment:* By continuing to complete his exam after time was called, Davis has violated Standard VII(A). By continuing to write, Davis took an unfair advantage over other candidates, and his conduct compromised the validity of his exam performance. Additionally, by not heeding the proctor’s repeated instructions, Davis violated the rules and regulations of the CFA Program.

**Example 4 (Sharing Exam Content):**

After completing Level II of the CFA exam, Annabelle Rossi posts on her blog about her experience. She posts the following: “Level II is complete! I think I did fairly well on the exam. It was really difficult, but fair. I think I did especially well on the derivatives questions. And there were tons of them! I think I counted 18! The ethics questions were really hard. I’m glad I spent so much time on the Code and Standards. I was surprised to see there were no questions at all about IPO allocations. I expected there to be a couple. Well, off to celebrate getting through it. See you tonight?”

*Comment:* Rossi did not violate Standard VII(A) when she wrote about how difficult she found the exam or how well she thinks she may have done. By revealing portions of the CBOK covered on the exam and areas not covered, however, she did violate Standard VII(A) and the Candidate Pledge. Depending on the time frame in which the comments were posted, Rossi not only may have assisted future candidates but also may have provided an unfair advantage to candidates yet to sit for the same exam, thereby undermining the integrity and validity of the Level II exam.

**Example 5 (Sharing Exam Content):**

Level I candidate Etienne Gagne has been a frequent visitor to an internet forum designed specifically for CFA Program candidates. The week after completing the Level I examination, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.

*Comment:* Gagne has violated Standard VII(A) by providing and soliciting confidential exam information, which compromises the integrity of the exam process and violates the Candidate Pledge. In trying to determine correct answers to specific questions, the group’s discussion included question-specific details considered to be confidential to the CFA Program.

**Example 6 (Sharing Exam Content):**

CFA4Sure is a company that produces test-preparation materials for CFA Program candidates. Many candidates register for and use the company’s products. The day after the CFA examination, CFA4Sure sends an e-mail to all its customers asking them to share with the company the hardest questions from the exam so that CFA4Sure can better prepare its customers for the next exam administration. Marisol Pena e-mails a summary of the questions she found most difficult on the exam.

*Comment:* Pena has violated Standard VII(A) by disclosing a portion of the exam questions. The information provided is considered confidential until publicly released by CFA Institute. CFA4Sure is likely to use such feedback to refine its review materials for future candidates. Pena's sharing of the specific questions undermines the integrity of the exam while potentially making the exam easier for future candidates.

If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also have violated Standard VII(A).

***Example 7 (Discussion of Exam Grading Guidelines and Results):***

Prior to participating in grading CFA examinations, Wesley Whitcomb is required to sign a CFA Institute Grader Agreement. As part of the Grader Agreement, Whitcomb agrees not to reveal or discuss the exam materials with anyone except CFA Institute staff or other graders. Several weeks after the conclusion of the CFA exam grading, Whitcomb tells several colleagues who are candidates in the CFA Program which question he graded. He also discusses the guideline answer and adds that few candidates scored well on the question.

*Comment:* Whitcomb violated Standard VII(A) by breaking the Grader Agreement and disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

***Example 8 (Compromising CFA Institute Integrity as a Volunteer):***

Jose Ramirez is an investor-relations consultant for several small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute society in the city where he works. Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies.

*Comment:* Ramirez, by using his volunteer position at CFA Institute to benefit himself and his clients, compromises the reputation and integrity of CFA Institute and thus violates Standard VII(A).

***Example 9 (Compromising CFA Institute Integrity as a Volunteer):***

Marguerite Warrenski is a member of the CFA Institute GIPS Executive Committee, which oversees the creation, implementation, and revision of the GIPS standards. As a member of the Executive Committee, she has advance knowledge of confidential information regarding the GIPS standards, including any new or revised standards the committee is considering. She tells her clients that her Executive Committee membership will allow her to better assist her clients in keeping up with changes to the Standards and facilitating their compliance with the changes.

*Comment:* Warrenski is using her association with the GIPS Executive Committee to promote her firm's services to clients and potential clients. In defining her volunteer position at CFA Institute as a strategic business advantage over competing firms and implying to clients that she would use confidential information to further their interests, Warrenski is compromising the reputation and integrity of CFA Institute and thus violating Standard VII(A). She may factually state her involvement with the Executive Committee but cannot infer any special advantage to her clients from such participation.

## Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program



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

### Guidance

#### Highlights:

- *CFA Institute Membership*
- *Using the CFA Designation*
- *Referring to Candidacy in the CFA Program*

Standard VII(B) is intended to prevent promotional efforts that make promises or guarantees that are tied to the CFA designation. Individuals must not exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

Standard VII(B) is not intended to prohibit factual statements related to the positive benefit of earning the CFA designation. However, statements referring to CFA Institute, the CFA designation, or the CFA Program that overstate the competency of an individual or imply, either directly or indirectly, that superior performance can be expected from someone with the CFA designation are not allowed under the standard.

Statements that highlight or emphasize the commitment of CFA Institute members, CFA charterholders, and CFA candidates to ethical and professional conduct or mention the thoroughness and rigor of the CFA Program are appropriate. Members and candidates may make claims about the relative merits of CFA Institute, the CFA Program, or the Code and Standards as long as those statements are implicitly or explicitly stated as the opinion of the speaker. Statements that do not express opinions have to be supported by facts.

Standard VII(B) applies to any form of communication, including but not limited to communications made in electronic or written form (such as on firm letterhead, business cards, professional biographies, directory listings, printed advertising, firm brochures, or personal resumes) and oral statements made to the public, clients, or prospects.

#### *CFA Institute Membership*

The term “CFA Institute member” refers to “regular” and “affiliate” members of CFA Institute who have met the membership requirements as defined in the CFA Institute Bylaws. Once accepted as a CFA Institute member, the member must satisfy the following requirements to maintain his or her status:

- remit annually to CFA Institute a completed Professional Conduct Statement, which renews the commitment to abide by the requirements of the Code and Standards and the CFA Institute Professional Conduct Program, and
- pay applicable CFA Institute membership dues on an annual basis.

If a CFA Institute member fails to meet any of these requirements, the individual is no longer considered an active member. Until membership is reactivated, individuals must not present themselves to others as active members. They may state, however, that they were CFA Institute members in the past or refer to the years when their membership was active.

### ***Using the CFA Designation***

Those who have earned the right to use the Chartered Financial Analyst designation are encouraged to do so but only in a manner that does not misrepresent or exaggerate the meaning or implications of the designation. The use of the designation may be accompanied by an accurate explanation of the requirements that have been met to earn the right to use the designation.

“CFA charterholders” are those individuals who have earned the right to use the CFA designation granted by CFA Institute. These people have satisfied certain requirements, including completion of the CFA Program and required years of acceptable work experience. Once granted the right to use the designation, individuals must also satisfy the CFA Institute membership requirements (see above) to maintain their right to use the designation.

If a CFA charterholder fails to meet any of the membership requirements, he or she forfeits the right to use the CFA designation. Until membership is reactivated, individuals must not present themselves to others as CFA charterholders. They may state, however, that they were charterholders in the past.

Given the growing popularity of social media, where individuals may anonymously express their opinions, pseudonyms or online profile names created to hide a member’s identity should not be tagged with the CFA designation.

Use of the CFA designation by a CFA charterholder is governed by the terms and conditions of the annual Professional Conduct Statement Agreement, entered into between CFA Institute and its membership prior to commencement of use of the CFA designation and reaffirmed annually.

### ***Referring to Candidacy in the CFA Program***

Candidates in the CFA Program may refer to their participation in the CFA Program, but such references must clearly state that an individual is a *candidate* in the CFA Program and must not imply that the candidate has achieved any type of partial designation. A person is a candidate in the CFA Program if

- the person’s application for registration in the CFA Program has been accepted by CFA Institute, as evidenced by issuance of a notice of acceptance, and the person is enrolled to sit for a specified examination or
- the registered person has sat for a specified examination but exam results have not yet been received.

If an individual is registered for the CFA Program but declines to sit for an exam or otherwise does not meet the definition of a candidate as described in the CFA Institute Bylaws, then that individual is no longer considered an active candidate. Once the person is enrolled to sit for a future examination, his or her CFA Program candidacy resumes.

CFA Program candidates must never state or imply that they have a partial designation as a result of passing one or more levels or cite an expected completion date of any level of the CFA Program. Final award of the charter is subject to meeting the CFA Program requirements and approval by the CFA Institute Board of Governors.

If a candidate passes each level of the exam in consecutive years and wants to state that he or she did so, that is not a violation of Standard VII(B) because it is a statement of fact. If the candidate then goes on to claim or imply superior ability by obtaining the designation in only three years, however, he or she is in violation of Standard VII(B).

Exhibit 3 provides examples of proper and improper references to the CFA designation.

### Exhibit 3 Proper and Improper References to the CFA Designation

Proper References	Improper References
“Completion of the CFA Program has enhanced my portfolio management skills.”	“CFA charterholders achieve better performance results.”
“John Smith passed all three CFA Program examinations in three consecutive years.”	“John Smith is among the elite, having passed all three CFA examinations in three consecutive attempts.”
“The CFA designation is globally recognized and attests to a charterholder’s success in a rigorous and comprehensive study program in the field of investment management and research analysis.”	“As a CFA charterholder, I am the most qualified to manage client investments.”
“The credibility that the CFA designation affords and the skills the CFA Program cultivates are key assets for my future career development.”	“As a CFA charterholder, Jane White provides the best value in trade execution.”
“I enrolled in the CFA Program to obtain the highest set of credentials in the global investment management industry.”	“Enrolling as a candidate in the CFA Program ensures one of becoming better at valuing debt securities.”
“I passed Level I of the CFA Program.”	“CFA, Level II”
“I am a 2010 Level III candidate in the CFA Program.”	“CFA, Expected 2011”
“I passed all three levels of the CFA Program and may be eligible for the CFA charter upon completion of the required work experience.”	“CFA, Expected 2011” “John Smith, Charter Pending”

## Recommended Procedures for Compliance

Misuse of a member’s CFA designation or CFA candidacy or improper reference to it is common by those in a member’s or candidate’s firm who do not possess knowledge of the requirements of Standard VII(B). As an appropriate step to reduce this risk, members and candidates should disseminate written information about Standard VII(B) and the accompanying guidance to their firm’s legal, compliance, public relations, and marketing departments (see [www.cfainstitute.org](http://www.cfainstitute.org)).

For materials that refer to employees’ affiliation with CFA Institute, members and candidates should encourage their firms to create templates that are approved by a central authority (such as the compliance department) as being consistent with Standard VII(B). This practice promotes consistency and accuracy in the firm of references to CFA Institute membership, the CFA designation, and CFA candidacy.

## Application of the Standard

### **Example 1 (Passing Exams in Consecutive Years):**

An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.

*Comment:* AZ may state that all principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try may be more successful than those who do not violates Standard VII(B).

### **Example 2 (Right to Use CFA Designation):**

Five years after receiving his CFA charter, Louis Vasseur resigns his position as an investment analyst and spends the next two years traveling abroad. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. At the conclusion of his travels, Vasseur becomes a self-employed analyst accepting assignments as an independent contractor. Without reinstating his CFA Institute membership by filing his Professional Conduct Statement and paying his dues, he prints business cards that display "CFA" after his name.

*Comment:* Vasseur has violated Standard VII(B) because his right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues. Therefore, he no longer is able to state or imply that he is an active CFA charterholder. When Vasseur files his Professional Conduct Statement, resumes paying CFA Institute dues to activate his membership, and completes the CFA Institute reinstatement procedures, he will be eligible to use the CFA designation.

### **Example 3 ("Retired" CFA Institute Membership Status):**

After a 25-year career, James Simpson retires from his firm. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. Simpson designs a plain business card (without a corporate logo) to hand out to friends with his new contact details, and he continues to put "CFA" after his name.

*Comment:* Simpson has violated Standard VII(B). Because he failed to file his Professional Conduct Statement and ceased paying dues, his membership has been suspended and he has given up the right to use the CFA designation. CFA Institute has procedures, however, for reclassifying a member and charterholder as "retired" and reducing the annual dues. If he wants to obtain retired status, he needs to file the appropriate paperwork with CFA Institute. When Simpson receives his notification from CFA Institute that his membership has been reclassified as retired and he resumes paying reduced dues, his membership will be reactivated and his right to use the CFA designation will be reinstated.

**Example 4 (Stating Facts about CFA Designation and Program):**

Rhonda Reese has been a CFA charterholder since 2000. In a conversation with a friend who is considering enrolling in the CFA Program, she states that she has learned a great deal from the CFA Program and that many firms require their employees to be CFA charterholders. She would recommend the CFA Program to anyone pursuing a career in investment management.

*Comment:* Reese's comments comply with Standard VII(B). Her statements refer to facts: The CFA Program enhanced her knowledge, and many firms require the CFA designation for their investment professionals.

**Example 5 (Order of Professional and Academic Designations):**

Tatiana Prittima has earned both her CFA designation and a PhD in finance. She would like to cite both her accomplishments on her business card but is unsure of the proper method for doing so.

*Comment:* The order of designations cited on such items as resumes and business cards is a matter of personal preference. Prittima is free to cite the CFA designation either before or after citing her PhD. Multiple designations must be separated by a comma.

**Example 6 (Use of Fictitious Name):**

Barry Glass is the lead quantitative analyst at CityCenter Hedge Fund. Glass is responsible for the development, maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Glass reads several high-level mathematical publications and blogs to stay informed on current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Glass is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

*Comment:* "Expert CFA" has violated Standard VII(B) by using the CFA designation inappropriately. As with any research report, authorship of online comments must include the charterholder's full name along with any reference to the CFA designation.

See also Standard V(A), which Glass has violated for guidance on diligence and reasonable basis.

## PRACTICE PROBLEMS

Unless otherwise stated in the question, all individuals in the following questions are CFA Institute members or candidates in the CFA Program and, therefore, are subject to the CFA Institute Code of Ethics and Standards of Professional Conduct.

- 1 Smith, a research analyst with a brokerage firm, decides to change his recommendation for the common stock of Green Company, Inc., from a “buy” to a “sell.” He mails this change in investment advice to all the firm’s clients on Wednesday. The day after the mailing, a client calls with a buy order for 500 shares of Green Company. In this circumstance, Smith should:
  - A Accept the order.
  - B Advise the customer of the change in recommendation before accepting the order.
  - C Not accept the order because it is contrary to the firm’s recommendation.
- 2 Which statement about a manager’s use of client brokerage commissions violates the Code and Standards?
  - A A client may direct a manager to use that client’s brokerage commissions to purchase goods and services for that client.
  - B Client brokerage commissions should be used to benefit the client and should be commensurate with the value of the brokerage and research services received.
  - C Client brokerage commissions may be directed to pay for the investment manager’s operating expenses.
- 3 Jamison is a junior research analyst with Howard & Howard, a brokerage and investment banking firm. Howard & Howard’s mergers and acquisitions department has represented the Britland Company in all of its acquisitions for the past 20 years. Two of Howard & Howard’s senior officers are directors of various Britland subsidiaries. Jamison has been asked to write a research report on Britland. What is the best course of action for her to follow?
  - A Jamison may write the report but must refrain from expressing any opinions because of the special relationships between the two companies.
  - B Jamison should not write the report because the two Howard & Howard officers serve as directors for subsidiaries of Britland.
  - C Jamison may write the report if she discloses the special relationships with the company in the report.
- 4 Which of the following statements clearly *conflicts* with the recommended procedures for compliance presented in the CFA Institute *Standards of Practice Handbook*?
  - A Firms should disclose to clients the personal investing policies and procedures established for their employees.
  - B Prior approval must be obtained for the personal investment transactions of all employees.
  - C For confidentiality reasons, personal transactions and holdings should not be reported to employers unless mandated by regulatory organizations.
- 5 Bronson provides investment advice to the board of trustees of a private university endowment fund. The trustees have provided Bronson with the fund’s financial information, including planned expenditures. Bronson receives a

phone call on Friday afternoon from Murdock, a prominent alumnus, requesting that Bronson fax him comprehensive financial information about the fund. According to Murdock, he has a potential contributor but needs the information that day to close the deal and cannot contact any of the trustees. Based on the CFA Institute Standards, Bronson should:

- A** Send Murdock the information because disclosure would benefit the client.
  - B** Not send Murdock the information to preserve confidentiality.
  - C** Send Murdock the information, provided Bronson promptly notifies the trustees.
- 6** Miller heads the research department of a large brokerage firm. The firm has many analysts, some of whom are subject to the Code and Standards. If Miller delegates some supervisory duties, which statement best describes her responsibilities under the Code and Standards?
- A** Miller’s supervisory responsibilities do not apply to those subordinates who are not subject to the Code and Standards.
  - B** Miller no longer has supervisory responsibility for those duties delegated to her subordinates.
  - C** Miller retains supervisory responsibility for all subordinates despite her delegation of some duties.
- 7** Willier is the research analyst responsible for following Company X. All the information he has accumulated and documented suggests that the outlook for the company’s new products is poor, so the stock should be rated a weak “hold.” During lunch, however, Willier overhears a financial analyst from another firm whom he respects offer opinions that conflict with Willier’s forecasts and expectations. Upon returning to his office, Willier releases a strong “buy” recommendation to the public. Willier:
- A** Violated the Standards by failing to distinguish between facts and opinions in his recommendation.
  - B** Violated the Standards because he did not have a reasonable and adequate basis for his recommendation.
  - C** Was in full compliance with the Standards.
- 8** An investment management firm has been hired by ETV Corporation to work on an additional public offering for the company. The firm’s brokerage unit now has a “sell” recommendation on ETV, but the head of the investment banking department has asked the head of the brokerage unit to change the recommendation from “sell” to “buy.” According to the Standards, the head of the brokerage unit would be permitted to:
- A** Increase the recommendation by no more than one increment (in this case, to a “hold” recommendation).
  - B** Place the company on a restricted list and give only factual information about the company.
  - C** Assign a new analyst to decide if the stock deserves a higher rating.
- 9** Albert and Tye, who recently started their own investment advisory business, have registered to take the Level III CFA examination. Albert’s business card reads, “Judy Albert, CFA Level II.” Tye has not put anything about the CFA designation on his business card, but promotional material that he designed for the business describes the CFA requirements and indicates that Tye participates in the CFA Program and has completed Levels I and II. According to the Standards:
- A** Albert has violated the Standards, but Tye has not.

- B** Tye has violated the Standards, but Albert has not.
- C** Both Albert and Tye have violated the Standards.
- 10** Scott works for a regional brokerage firm. He estimates that Walkton Industries will increase its dividend by US\$1.50 a share during the next year. He realizes that this increase is contingent on pending legislation that would, if enacted, give Walkton a substantial tax break. The US representative for Walkton's home district has told Scott that, although she is lobbying hard for the bill and prospects for its passage are favorable, concern of the US Congress over the federal deficit could cause the tax bill to be voted down. Walkton Industries has not made any statements about a change in dividend policy. Scott writes in his research report, "We expect Walkton's stock price to rise by at least US\$8.00 a share by the end of the year because the dividend will increase by US\$1.50 a share. Investors buying the stock at the current time should expect to realize a total return of at least 15% on the stock." According to the Standards:
- A** Scott violated the Standards because he used material inside information.
- B** Scott violated the Standards because he failed to separate opinion from fact.
- C** Scott violated the Standards by basing his research on uncertain predictions of future government action.
- 11** Which one of the following actions will help to ensure the fair treatment of brokerage firm clients when a new investment recommendation is made?
- A** Informing all people in the firm in advance that a recommendation is to be disseminated.
- B** Distributing recommendations to institutional clients prior to individual accounts.
- C** Minimizing the time between the decision and the dissemination of a recommendation.
- 12** The mosaic theory holds that an analyst:
- A** Violates the Code and Standards if the analyst fails to have knowledge of and comply with applicable laws.
- B** Can use material public information and nonmaterial nonpublic information in the analyst's analysis.
- C** Should use all available and relevant information in support of an investment recommendation.
- 13** Jurgen is a portfolio manager. One of her firm's clients has told Jurgen that he will compensate her beyond the compensation provided by her firm on the basis of the capital appreciation of his portfolio each year. Jurgen should:
- A** Turn down the additional compensation because it will result in conflicts with the interests of other clients' accounts.
- B** Turn down the additional compensation because it will create undue pressure on her to achieve strong short-term performance.
- C** Obtain permission from her employer prior to accepting the compensation arrangement.
- 14** One of the discretionary accounts managed by Farnsworth is the Jones Corporation employee profit-sharing plan. Jones, the company president, recently asked Farnsworth to vote the shares in the profit-sharing plan in favor of the slate of directors nominated by Jones Corporation and against the directors sponsored by a dissident stockholder group. Farnsworth does not want to lose this account because he directs all the account's trades to a brokerage firm that provides Farnsworth with useful information about tax-free investments. Although this information is not of value in managing the Jones Corporation

account, it does help in managing several other accounts. The brokerage firm providing this information also offers the lowest commissions for trades and provides best execution. Farnsworth investigates the director issue, concludes that the management-nominated slate is better for the long-run performance of the company than the dissident group's slate, and votes accordingly. Farnsworth:

- A Violated the Standards in voting the shares in the manner requested by Jones but not in directing trades to the brokerage firm.
  - B Did not violate the Standards in voting the shares in the manner requested by Jones or in directing trades to the brokerage firm.
  - C Violated the Standards in directing trades to the brokerage firm but not in voting the shares as requested by Jones.
- 15 Brown works for an investment counseling firm. Green, a new client of the firm, is meeting with Brown for the first time. Green used another counseling firm for financial advice for years, but she has switched her account to Brown's firm. After spending a few minutes getting acquainted, Brown explains to Green that she has discovered a highly undervalued stock that offers large potential gains. She recommends that Green purchase the stock. Brown has committed a violation of the Standards. What should she have done differently?
- A Brown should have determined Green's needs, objectives, and tolerance for risk before making a recommendation of any type of security.
  - B Brown should have thoroughly explained the characteristics of the company to Green, including the characteristics of the industry in which the company operates.
  - C Brown should have explained her qualifications, including her education, training, and experience and the meaning of the CFA designation.
- 16 Grey recommends the purchase of a mutual fund that invests solely in long-term US Treasury bonds. He makes the following statements to his clients:
- I. "The payment of the bonds is guaranteed by the US government; therefore, the default risk of the bonds is virtually zero."
  - II. "If you invest in the mutual fund, you will earn a 10% rate of return each year for the next several years based on historical performance of the market."
- Did Grey's statements violate the CFA Institute Code and Standards?
- A Neither statement violated the Code and Standards.
  - B Only statement I violated the Code and Standards.
  - C Only statement II violated the Code and Standards.
- 17 Anderb, a portfolio manager for XYZ Investment Management Company—a registered investment organization that advises investment firms and private accounts—was promoted to that position three years ago. Bates, her supervisor, is responsible for reviewing Anderb's portfolio account transactions and her required monthly reports of personal stock transactions. Anderb has been using Jonelli, a broker, almost exclusively for brokerage transactions for the portfolio account. For securities in which Jonelli's firm makes a market, Jonelli has been giving Anderb lower prices for personal purchases and higher prices for personal sales than Jonelli gives to Anderb's portfolio accounts and other investors. Anderb has been filing monthly reports with Bates only for those months in which she has no personal transactions, which is about every fourth month. Which of the following is *most likely* to be a violation of the Code and Standards?
- A Anderb failed to disclose to her employer her personal transactions.

- B Anderb owned the same securities as those of her clients.
- C Bates allowed Anderb to use Jonelli as her broker for personal trades.
- 18 Which of the following is a correct statement of a member's or candidate's duty under the Code and Standards?
- A In the absence of specific applicable law or other regulatory requirements, the Code and Standards govern the member's or candidate's actions.
- B A member or candidate is required to comply only with applicable local laws, rules, regulations, or customs, even though the Code and Standards may impose a higher degree of responsibility or a higher duty on the member or candidate.
- C A member or candidate who trades securities in a securities market where no applicable local laws or stock exchange rules regulate the use of material nonpublic information may take investment action based on material nonpublic information.
- 19 Ward is scheduled to visit the corporate headquarters of Evans Industries. Ward expects to use the information he obtains there to complete his research report on Evans stock. Ward learns that Evans plans to pay all of Ward's expenses for the trip, including costs of meals, hotel room, and air transportation. Which of the following actions would be the *best* course for Ward to take under the Code and Standards?
- A Accept the expense-paid trip and write an objective report.
- B Pay for all travel expenses, including costs of meals and incidental items.
- C Accept the expense-paid trip but disclose the value of the services accepted in the report.
- 20 Which of the following statements is *correct* under the Code and Standards?
- A CFA Institute members and candidates are prohibited from undertaking independent practice in competition with their employer.
- B Written consent from the employer is necessary to permit independent practice that could result in compensation or other benefits in competition with a member's or candidate's employer.
- C Members and candidates are prohibited from making arrangements or preparations to go into a competitive business before terminating their relationship with their employer.
- 21 Smith is a financial analyst with XYZ Brokerage Firm. She is preparing a purchase recommendation on JNI Corporation. Which of the following situations is *most likely* to represent a conflict of interest for Smith that would have to be disclosed?
- A Smith frequently purchases items produced by JNI.
- B XYZ holds for its own account a substantial common stock position in JNI.
- C Smith's brother-in-law is a supplier to JNI.
- 22 Michelieu tells a prospective client, "I may not have a long-term track record yet, but I'm sure that you'll be very pleased with my recommendations and service. In the three years that I've been in the business, my equity-oriented clients have averaged a total return of more than 26% a year." The statement is true, but Michelieu only has a few clients, and one of his clients took a large position in a penny stock (against Michelieu's advice) and realized a huge gain. This large return caused the average of all of Michelieu's clients to exceed 26% a year. Without this one investment, the average gain would have been 8% a year. Has Michelieu violated the Standards?

- A No, because Michelieu is not promising that he can earn a 26% return in the future.
  - B No, because the statement is a true and accurate description of Michelieu's track record.
  - C Yes, because the statement misrepresents Michelieu's track record.
- 23 An investment banking department of a brokerage firm often receives material nonpublic information that could have considerable value if used in advising the firm's brokerage clients. In order to conform to the Code and Standards, which one of the following is the best policy for the brokerage firm?
- A Permanently prohibit both "buy" and "sell" recommendations of the stocks of clients of the investment banking department.
  - B Establish physical and informational barriers within the firm to prevent the exchange of information between the investment banking and brokerage operations.
  - C Monitor the exchange of information between the investment banking department and the brokerage operation.
- 24 Stewart has been hired by Goodner Industries, Inc., to manage its pension fund. Stewart's duty of loyalty, prudence, and care is owed to:
- A The management of Goodner.
  - B The participants and beneficiaries of Goodner's pension plan.
  - C The shareholders of Goodner.
- 25 Which of the following statements is a stated purpose of disclosure in Standard VI(C)—Referral Fees?
- A Disclosure will allow the client to request discounted service fees.
  - B Disclosure will help the client evaluate any possible partiality shown in the recommendation of services.
  - C Disclosure means advising a prospective client about the referral arrangement once a formal client relationship has been established.
- 26 Rose, a portfolio manager for a local investment advisory firm, is planning to sell a portion of his personal investment portfolio to cover the costs of his child's academic tuition. Rose wants to sell a portion of his holdings in Household Products, but his firm recently upgraded the stock to "strong buy." Which of the following describes Rose's options under the Code and Standards?
- A Based on his firm's "buy" recommendation, Rose cannot sell the shares because he would be improperly prospering from the inflated recommendation.
  - B Rose is free to sell his personal holdings once his firm is properly informed of his intentions.
  - C Rose can sell his personal holdings but only when a client of the firm places an order to buy shares of Household.
- 27 A former hedge fund manager, Jackman, has decided to launch a new private wealth management firm. From his prior experiences, he believes the new firm needs to achieve US\$1 million in assets under management in the first year. Jackman offers a \$10,000 incentive to any adviser who joins his firm with the minimum of \$200,000 in committed investments. Jackman places notice of the opening on several industry web portals and career search sites. Which of the following is *correct* according to the Code and Standards?

- A** A member or candidate is eligible for the new position and incentive if he or she can arrange for enough current clients to switch to the new firm and if the member or candidate discloses the incentive fee.
- B** A member or candidate may not accept employment with the new firm because Jackman's incentive offer violates the Code and Standards.
- C** A member or candidate is not eligible for the new position unless he or she is currently unemployed because soliciting the clients of the member's or candidate's current employer is prohibited.
- 28** Carter works for Invest Today, a local asset management firm. A broker that provides Carter with proprietary research through client brokerage arrangements is offering a new trading service. The broker is offering low-fee, execution-only trades to complement its traditional full-service, execution-and-research trades. To entice Carter and other asset managers to send additional business its way, the broker will apply the commissions paid on the new service toward satisfying the brokerage commitment of the prior full-service arrangements. Carter has always been satisfied with the execution provided on the full-service trades, and the new low-fee trades are comparable to the fees of other brokers currently used for the accounts that prohibit soft dollar arrangements.
- A** Carter can trade for his accounts that prohibit soft dollar arrangements under the new low-fee trading scheme.
- B** Carter cannot use the new trading scheme because the commissions are prohibited by the soft dollar restrictions of the accounts.
- C** Carter should trade only through the new low-fee scheme and should increase his trading volume to meet his required commission commitment.
- 29** Rule has worked as a portfolio manager for a large investment management firm for the past 10 years. Rule earned his CFA charter last year and has decided to open his own investment management firm. After leaving his current employer, Rule creates some marketing material for his new firm. He states in the material, "In earning the CFA charter, a highly regarded credential in the investment management industry, I further enhanced the portfolio management skills learned during my professional career. While completing the examination process in three consecutive years, I consistently received the highest possible scores on the topics of Ethics, Alternative Investments, and Portfolio Management." Has Rule violated Standard VII(B)—Reference to CFA Institute, the CFA Designation, and the CFA Program in his marketing material?
- A** Rule violated Standard VII(B) in stating that he completed the exams in three consecutive years.
- B** Rule violated Standard VII(B) in stating that he received the highest scores in the topics of Ethics, Alternative Investments, and Portfolio Management.
- C** Rule did not violate Standard VII(B).
- 30** Stafford is a portfolio manager for a specialized real estate mutual fund. Her firm clearly describes in the fund's prospectus its soft dollar policies. Stafford decides that entering the CFA Program will enhance her investment decision-making skill and decides to use the fund's soft dollar account to pay the registration and exam fees for the CFA Program. Which of the following statements is *most likely* correct?
- A** Stafford did not violate the Code and Standards because the prospectus informed investors of the fund's soft dollar policies.
- B** Stafford violated the Code and Standards because improving her investment skills is not a reasonable use of the soft dollar account.

- C Stafford violated the Code and Standards because the CFA Program does not meet the definition of research allowed to be purchased with brokerage commissions.
- 31 Long has been asked to be the keynote speaker at an upcoming investment conference. The event is being hosted by one of the third-party investment managers currently used by his pension fund. The manager offers to cover all conference and travel costs for Long and make the conference registrations free for three additional members of his investment management team. To ensure that the conference obtains the best speakers, the host firm has arranged for an exclusive golf outing for the day following the conference on a local championship-caliber course. Which of the following is *least likely* to violate Standard I(B)?
- A Long may accept only the offer to have his conference-related expenses paid by the host firm.
  - B Long may accept the offer to have his conference-related expenses paid and may attend the exclusive golf outing at the expense of the hosting firm.
  - C Long may accept the entire package of incentives offered to speak at this conference.
- 32 Andrews, a private wealth manager, is conducting interviews for a new research analyst for his firm. One of the candidates is Wright, an analyst with a local investment bank. During the interview, while Wright is describing his analytical skills, he mentions a current merger in which his firm is acting as the adviser. Andrews has heard rumors of a possible merger between the two companies, but no releases have been made by the companies concerned. Which of the following actions by Andrews is *least likely* a violation of the Code and Standards?
- A Waiting until the next day before trading on the information to allow time for it to become public.
  - B Notifying all investment managers in his firm of the new information so none of their clients are disadvantaged.
  - C Placing the securities mentioned as part of the merger on the firm's restricted trading list.
- 33 Pietro, president of Local Bank, has hired the bank's market maker, Vogt, to seek a merger partner. Local is currently not listed on a stock exchange and has not reported that it is seeking strategic alternatives. Vogt has discussed the possibility of a merger with several firms, but they have all decided to wait until after the next period's financial data are available. The potential buyers believe the results will be worse than the results of prior periods and will allow them to pay less for Local Bank.
- Pietro wants to increase the likelihood of structuring a merger deal quickly. Which of the following actions would *most likely* be a violation of the Code and Standards?
- A Pietro could instruct Local Bank to issue a press release announcing that it has retained Vogt to find a merger partner.
  - B Pietro could place a buy order for 2,000 shares (or four times the average weekly volume) through Vogt for his personal account.
  - C After confirming with Local's chief financial officer, Pietro could instruct Local to issue a press release reaffirming the firm's prior announced earnings guidance for the full fiscal year.
- 34 ABC Investment Management acquires a new, very large account with two concentrated positions. The firm's current policy is to add new accounts for the purpose of performance calculation after the first full month of management.

Cupp is responsible for calculating the firm's performance returns. Before the end of the initial month, Cupp notices that one of the significant holdings of the new accounts is acquired by another company, causing the value of the investment to double. Because of this holding, Cupp decides to account for the new portfolio as of the date of transfer, thereby allowing ABC Investment to reap the positive impact of that month's portfolio return.

- A** Cupp did not violate the Code and Standards because the GIPS standards allow composites to be updated on the date of large external cash flows.
  - B** Cupp did not violate the Code and Standards because companies are allowed to determine when to incorporate new accounts into their composite calculation.
  - C** Cupp violated the Code and Standards because the inclusion of the new account produces an inaccurate calculation of the monthly results according to the firm's stated policies.
- 35** Cannan has been working from home on weekends and occasionally saves correspondence with clients and completed work on her home computer. Because of worsening market conditions, Cannan is one of several employees released by her firm. While Cannan is looking for a new job, she uses the files she saved at home to request letters of recommendation from former clients. She also provides to prospective clients some of the reports as examples of her abilities.
- A** Cannan violated the Code and Standards because she did not receive permission from her former employer to keep or use the files after her employment ended.
  - B** Cannan did not violate the Code and Standards because the files were created and saved on her own time and computer.
  - C** Cannan violated the Code and Standards because she is prohibited from saving files on her home computer.
- 36** Quinn sat for the Level III CFA exam this past weekend. He updates his resume with the following statement: "In finishing the CFA Program, I improved my skills related to researching investments and managing portfolios. I will be eligible for the CFA charter upon completion of the required work experience."
- A** Quinn violated the Code and Standards by claiming he improved his skills through the CFA Program.
  - B** Quinn violated the Code and Standards by incorrectly stating that he is eligible for the CFA charter.
  - C** Quinn did not violate the Code and Standards with his resume update.
- 37** During a round of golf, Rodriguez, chief financial officer of Mega Retail, mentions to Hart, a local investment adviser and long-time personal friend, that Mega is having an exceptional sales quarter. Rodriguez expects the results to be almost 10% above the current estimates. The next day, Hart initiates the purchase of a large stake in the local exchange-traded retail fund for her personal account.
- A** Hart violated the Code and Standards by investing in the exchange-traded fund that included Mega Retail.
  - B** Hart did not violate the Code and Standards because she did not invest directly in securities of Mega Retail.
  - C** Rodriguez did not violate the Code and Standards because the comments made to Hart were not intended to solicit an investment in Mega Retail.

- 38 Park is very frustrated after taking her Level II exam. While she was studying for the exam, to supplement the curriculum provided, she ordered and used study material from a third-party provider. Park believes the additional material focused her attention on specific topic areas that were not tested while ignoring other areas. She posts the following statement on the provider's discussion board: "I am very dissatisfied with your firm's CFA Program Level II material. I found the exam extremely difficult and myself unprepared for specific questions after using your product. How could your service provide such limited instructional resources on the analysis of inventories and taxes when the exam had multiple questions about them? I will not recommend your products to other candidates."
- A Park violated the Code and Standards by purchasing third-party review material.
  - B Park violated the Code and Standards by providing her opinion on the difficulty of the exam.
  - C Park violated the Code and Standards by providing specific information on topics tested on the exam.
- 39 Paper was recently terminated as one of a team of five managers of an equity fund. The fund had two value-focused managers and terminated one of them to reduce costs. In a letter sent to prospective employers, Paper presents, with written permission of the firm, the performance history of the fund to demonstrate his past success.
- A Paper did not violate the Code and Standards.
  - B Paper violated the Code and Standards by claiming the performance of the entire fund as his own.
  - C Paper violated the Code and Standards by including the historical results of his prior employer.
- 40 Townsend was recently appointed to the board of directors of a youth golf program that is the local chapter of a national not-for-profit organization. The program is beginning a new fund-raising campaign to expand the number of annual scholarships it provides. Townsend believes many of her clients make annual donations to charity. The next week in her regular newsletter to all clients, she includes a small section discussing the fund-raising campaign and her position on the organization's board.
- A Townsend did not violate the Code and Standards.
  - B Townsend violated the Code and Standards by soliciting donations from her clients through the newsletter.
  - C Townsend violated the Code and Standards by not getting approval of the organization before soliciting her clients.

## SOLUTIONS

- 1 The correct answer is B. This question involves Standard III(B)—Fair Dealing. Smith disseminated a change in the stock recommendation to his clients but then received a request contrary to that recommendation from a client who probably had not yet received the recommendation. Prior to executing the order, Smith should take additional steps to ensure that the customer has received the change of recommendation. Answer A is incorrect because the client placed the order prior to receiving the recommendation and, therefore, does not have the benefit of Smith's most recent recommendation. Answer C is also incorrect; simply because the client request is contrary to the firm's recommendation does not mean a member can override a direct request by a client. After Smith contacts the client to ensure that the client has received the changed recommendation, if the client still wants to place a buy order for the shares, Smith is obligated to comply with the client's directive.
- 2 The correct answer is C. This question involves Standard III(A)—Loyalty, Prudence, and Care and the specific topic of soft dollars or soft commissions. Answer C is the correct choice because client brokerage commissions may not be directed to pay for the investment manager's operating expenses. Answer B describes how members and candidates should determine how to use brokerage commissions—that is, if the use is in the best interests of clients and is commensurate with the value of the services provided. Answer A describes a practice that is commonly referred to as "directed brokerage." Because brokerage is an asset of the client and is used to benefit the client, not the manager, such practice does not violate a duty of loyalty to the client. Members and candidates are obligated in all situations to disclose to clients their practices in the use of client brokerage commissions.
- 3 The correct answer is C. This question involves Standard VI(A)—Disclosure of Conflicts. The question establishes a conflict of interest in which an analyst, Jamison, is asked to write a research report on a company that is a client of the analyst's employer. In addition, two directors of the company are senior officers of Jamison's employer. Both facts establish that there are conflicts of interest that must be disclosed by Jamison in her research report. Answer B is incorrect because an analyst is not prevented from writing a report simply because of the special relationship the analyst's employer has with the company as long as that relationship is disclosed. Answer A is incorrect because whether or not Jamison expresses any opinions in the report is irrelevant to her duty to disclose a conflict of interest. Not expressing opinions does not relieve the analyst of the responsibility to disclose the special relationships between the two companies.
- 4 The correct answer is C. This question asks about compliance procedures relating to personal investments of members and candidates. The statement in answer C clearly conflicts with the recommended procedures in the *Standards of Practice Handbook*. Employers should compare personal transactions of employees with those of clients on a regular basis regardless of the existence of a requirement by any regulatory organization. Such comparisons ensure that employees' personal trades do not conflict with their duty to their clients, and the comparisons can be conducted in a confidential manner. The statement in answer A does not conflict with the procedures in the *Handbook*. Disclosure of such policies will give full information to clients regarding potential conflicts of interest on the part of those entrusted to manage their money. Answer B is incorrect because firms are encouraged to establish policies whereby employees clear their personal holdings and transactions with their employers.

- 5 The correct answer is B. This question relates to Standard III(A)–Loyalty, Prudence, and Care and Standard III(E)–Preservation of Confidentiality. In this case, the member manages funds of a private endowment. Clients, who are, in this case, the trustees of the fund, must place some trust in members and candidates. Bronson cannot disclose confidential financial information to anyone without the permission of the fund, regardless of whether the disclosure may benefit the fund. Therefore, answer A is incorrect. Answer C is incorrect because Bronson must notify the fund and obtain the fund’s permission before publicizing the information.
- 6 The correct answer is C. Under Standard IV(C)–Responsibilities of Supervisors, members and candidates may delegate supervisory duties to subordinates but such delegation does not relieve members or candidates of their supervisory responsibilities. As a result, answer B is incorrect. Moreover, whether or not Miller’s subordinates are subject to the Code and Standards is irrelevant to her supervisory responsibilities. Therefore, answer A is incorrect.
- 7 The correct answer is B. This question relates to Standard V(A)–Diligence and Reasonable Basis. The opinion of another financial analyst is not an adequate basis for Willier’s action in changing the recommendation. Answer C is thus incorrect. So is answer A because, although it is true that members and candidates must distinguish between facts and opinions in recommendations, the question does not illustrate a violation of that nature. If the opinion overheard by Willier had sparked him to conduct additional research and investigation that justified a change of opinion, then a changed recommendation would be appropriate.
- 8 The correct answer is B. This question relates to Standard I(B)–Independence and Objectivity. When asked to change a recommendation on a company stock to gain business for the firm, the head of the brokerage unit must refuse in order to maintain his independence and objectivity in making recommendations. He must not yield to pressure by the firm’s investment banking department. To avoid the appearance of a conflict of interest, the firm should discontinue issuing recommendations about the company. Answer A is incorrect; changing the recommendation in any manner that is contrary to the analyst’s opinion violates the duty to maintain independence and objectivity. Answer C is incorrect because merely assigning a new analyst to decide whether the stock deserves a higher rating will not address the conflict of interest.
- 9 The correct answer is A. Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program is the subject of this question. The reference on Albert’s business card implies that there is a “CFA Level II” designation; Tye merely indicates in promotional material that he is participating in the CFA Program and has completed Levels I and II. Candidates may not imply that there is some sort of partial designation earned after passing a level of the CFA exam. Therefore, Albert has violated Standard VII(B). Candidates may communicate that they are participating in the CFA Program, however, and may state the levels that they have completed. Therefore, Tye has not violated Standard VII(B).
- 10 The correct answer is B. This question relates to Standard V(B)–Communication with Clients and Prospective Clients. Scott has issued a research report stating that he expects the price of Walkton Industries stock to rise by US\$8 a share “because the dividend will increase” by US\$1.50 per share. He has made this statement knowing that the dividend will increase only if Congress enacts certain legislation, an uncertain prospect. By stating that the dividend will increase, Scott failed to separate fact from opinion.

The information regarding passage of legislation is not material nonpublic information because it is conjecture, and the question does not state whether the US representative gave Scott her opinion on the passage of the legislation in confidence. She could have been offering this opinion to anyone who asked. Therefore, statement A is incorrect. It may be acceptable to base a recommendation, in part, on an expectation of future events, even though they may be uncertain. Therefore, answer C is incorrect.

- 11 The correct answer is C. This question, which relates to Standard III(B)—Fair Dealing, tests the knowledge of the procedures that will assist members and candidates in treating clients fairly when making investment recommendations. The step listed in C will help ensure the fair treatment of clients. Answer A may have negative effects on the fair treatment of clients. The more people who know about a pending change, the greater the chance that someone will inform some clients before the information's release. The firm should establish policies that limit the number of people who are aware in advance that a recommendation is to be disseminated. Answer B, distributing recommendations to institutional clients before distributing them to individual accounts, discriminates among clients on the basis of size and class of assets and is a violation of Standard III(B).
- 12 The correct answer is B. This question deals with Standard II(A)—Material Nonpublic Information. The mosaic theory states that an analyst may use material public information and nonmaterial nonpublic information in creating a larger picture than shown by any individual piece of information and the conclusions the analyst reaches become material only after the pieces are assembled. Answers A and C are accurate statements relating to the Code and Standards but do not describe the mosaic theory.
- 13 The correct answer is C. This question involves Standard IV(B)—Additional Compensation Arrangements. The arrangement described in the question—whereby Jurgen would be compensated beyond the compensation provided by her firm, on the basis of an account's performance—is not a violation of the Standards as long as Jurgen discloses the arrangement in writing to her employer and obtains permission from her employer prior to entering into the arrangement. Answers A and B are incorrect; although the private compensation arrangement could conflict with the interests of other clients and lead to short-term performance pressures, members and candidates may enter into such agreements as long as they have disclosed the arrangements to their employer and obtained permission for the arrangement from their employer.
- 14 The correct answer is B. This question relates to Standard III(A)—Loyalty, Prudence, and Care—specifically, a member's or candidate's responsibility for voting proxies and the use of client brokerage. According to the facts stated in the question, Farnsworth did not violate Standard III(A). Although the company president asked Farnsworth to vote the shares of the Jones Corporation profit-sharing plan a certain way, Farnsworth investigated the issue and concluded, independently, the best way to vote. Therefore, even though his decision coincided with the wishes of the company president, Farnsworth is not in violation of his responsibility to be loyal and to provide care to his clients. In this case, the participants and the beneficiaries of the profit-sharing plan are the clients, not the company's management. Had Farnsworth not investigated the issue or had he yielded to the president's wishes and voted for a slate of directors that he had determined was not in the best interest of the company, Farnsworth would have violated his responsibilities to the beneficiaries of the plan. In addition, because the brokerage firm provides the lowest commissions and best execution for securities transactions, Farnsworth has met his obligations to the client

in using this brokerage firm. It does not matter that the brokerage firm also provides research information that is not useful for the account generating the commission because Farnsworth is not paying extra money of the client's for that information.

- 15 The correct answer is A. In this question, Brown is providing investment recommendations before making inquiries about the client's financial situation, investment experience, or investment objectives. Brown is thus violating Standard III(C)–Suitability. Answers B and C provide examples of information members and candidates should discuss with their clients at the outset of the relationship, but these answers do not constitute a complete list of those factors. Answer A is the best answer.
- 16 The correct answer is C. This question involves Standard I(C)–Misrepresentation. Statement I is a factual statement that discloses to clients and prospects accurate information about the terms of the investment instrument. Statement II, which guarantees a specific rate of return for a mutual fund, is an opinion stated as a fact and, therefore, violates Standard I(C). If statement II were rephrased to include a qualifying statement, such as “in my opinion, investors may earn . . .,” it would not be in violation of the Standards.
- 17 The correct answer is A. This question involves three of the Standards. Anderb, the portfolio manager, has been obtaining more favorable prices for her personal securities transactions than she gets for her clients, which is a breach of Standard III(A)–Loyalty, Prudence, and Care. In addition, she violated Standard I(D)–Misconduct by failing to adhere to company policy and by hiding her personal transactions from her firm. Anderb's supervisor, Bates, violated Standard IV(C)–Responsibilities of Supervisors; although the company had requirements for reporting personal trading, Bates failed to adequately enforce those requirements. Answer B does not represent a violation because Standard VI(B)–Priority of Transactions requires that personal trading in a security be conducted after the trading in that security of clients and the employer. The Code and Standards do not prohibit owning such investments, although firms may establish policies that limit the investment opportunities of members and candidates. Answer C does not represent a violation because the Code and Standards do not contain a prohibition against employees using the same broker for their personal accounts that they use for their client accounts. This arrangement should be disclosed to the employer so that the employer may determine whether a conflict of interest exists.
- 18 The correct answer is A because this question relates to Standard I(A)–Knowledge of the Law—specifically, global application of the Code and Standards. Members and candidates who practice in multiple jurisdictions may be subject to various securities laws and regulations. If applicable law is more strict than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, members and candidates must adhere to the Code and Standards. Therefore, answer A is correct. Answer B is incorrect because members and candidates must adhere to the higher standard set by the Code and Standards if local applicable law is less strict. Answer C is incorrect because when no applicable law exists, members and candidates are required to adhere to the Code and Standards, and the Code and Standards prohibit the use of material nonpublic information.
- 19 The correct answer is B. The best course of action under Standard I(B)–Independence and Objectivity is to avoid a conflict of interest whenever possible. Therefore, for Ward to pay for all his expenses is the correct answer. Answer C details a course of action in which the conflict would be disclosed, but the solution is not as appropriate as avoiding the conflict of interest.

Answer A would not be the best course because it would not remove the appearance of a conflict of interest; even though the report would not be affected by the reimbursement of expenses, it could appear to be.

- 20** The correct answer is B. Under Standard IV(A)—Loyalty, members and candidates may undertake independent practice that may result in compensation or other benefit in competition with their employer as long as they obtain consent from their employer. Answer C is not consistent with the Standards because the Standards allow members and candidates to make arrangements or preparations to go into competitive business as long as those arrangements do not interfere with their duty to their current employer. Answer A is not consistent with the Standards because the Standards do not include a complete prohibition against undertaking independent practice.
- 21** The correct answer is B. This question involves Standard VI(A)—Disclosure of Conflicts—specifically, the holdings of an analyst’s employer in company stock. Answers A and C do not describe conflicts of interest that Smith would have to disclose. Answer A describes the use of a firm’s products, which would not be a required disclosure. In answer C, the relationship between the analyst and the company through a relative is so tangential that it does not create a conflict of interest necessitating disclosure.
- 22** The correct answer is C. This question relates to Standard I(C)—Misrepresentation. Although Michelieu’s statement about the total return of his clients’ accounts on average may be technically true, it is misleading because the majority of the gain resulted from one client’s large position taken against Michelieu’s advice. Therefore, this statement misrepresents the investment performance the member is responsible for. He has not taken steps to present a fair, accurate, and complete presentation of performance. Answer B is thus incorrect. Answer A is incorrect because although Michelieu is not guaranteeing future results, his words are still a misrepresentation of his performance history.
- 23** The correct answer is B. The best policy to prevent violation of Standard II(A)—Material Nonpublic Information is the establishment of firewalls in a firm to prevent exchange of insider information. The physical and informational barrier of a firewall between the investment banking department and the brokerage operation prevents the investment banking department from providing information to analysts on the brokerage side who may be writing recommendations on a company stock. Prohibiting recommendations of the stock of companies that are clients of the investment banking department is an alternative, but answer A states that this prohibition would be permanent, which is not the best answer. Once an offering is complete and the material nonpublic information obtained by the investment banking department becomes public, resuming publishing recommendations on the stock is not a violation of the Code and Standards because the information of the investment banking department no longer gives the brokerage operation an advantage in writing the report. Answer C is incorrect because no exchange of information should be occurring between the investment banking department and the brokerage operation, so monitoring of such exchanges is not an effective compliance procedure for preventing the use of material nonpublic information.
- 24** The correct answer is B. Under Standard III(A)—Loyalty, Prudence, and Care, members and candidates who manage a company’s pension fund owe these duties to the participants and beneficiaries of the pension plan, not the management of the company or the company’s shareholders.

- 25 The correct answer is B. Answer B gives one of the two primary reasons listed in the *Handbook* for disclosing referral fees to clients under Standard VI(C)–Referral Fees. (The other is to allow clients and employers to evaluate the full cost of the services.) Answer A is incorrect because Standard VI(C) does not require members or candidates to discount their fees when they receive referral fees. Answer C is inconsistent with Standard VI(C) because disclosure of referral fees, to be effective, should be made to prospective clients before entering into a formal client relationship with them.
- 26 The correct answer is B. Standard VI(B)–Priority of Transactions does not limit transactions of company employees that differ from current recommendations as long as the sale does not disadvantage current clients. Thus, answer A is incorrect. Answer C is incorrect because the Standard does not require the matching of personal and client trades.
- 27 Answer C is correct. Standard IV(A)–Loyalty discusses activities permissible to members and candidates when they are leaving their current employer; soliciting clients is strictly prohibited. Thus, answer A is inconsistent with the Code and Standards even with the required disclosure. Answer B is incorrect because the offer does not directly violate the Code and Standards. There may be out-of-work members and candidates who can arrange the necessary commitments without violating the Code and Standards.
- 28 Answer A is correct. The question relates to Standard III(A)–Loyalty, Prudence, and Care. Carter believes the broker offers effective execution at a fee that is comparable with those of other brokers, so he is free to use the broker for all accounts. Answer B is incorrect because the accounts that prohibit soft dollar arrangements do not want to fund the purchase of research by Carter. The new trading scheme does not incur additional commissions from clients, so it would not go against the prohibitions. Answer C is incorrect because Carter should not incur unnecessary or excessive “churning” of the portfolios (excessive trading) for the purpose of meeting the brokerage commitments of soft dollar arrangements.
- 29 Answer B is correct according to Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program. CFA Program candidates do not receive their actual scores on the exam. Topic and subtopic results are grouped into three broad categories, and the exam is graded only as “pass” or “fail.” Although a candidate may have achieved a topical score of “above 70%,” she or he cannot factually state that she or he received the highest possible score because that information is not reported. Thus, answer C is incorrect. Answer A is incorrect as long as the member or candidate actually completed the exams consecutively. Standard VII(B) does not prohibit the communication of factual information about completing the CFA Program in three consecutive years.
- 30 Answer C is correct. According to Standard III(A)–Loyalty, Prudence, and Care, the CFA Program would be considered a personal or firm expense and should not be paid for with the fund’s brokerage commissions. Soft dollar accounts should be used only to purchase research services that directly assist the investment manager in the investment decision-making process, not to assist the management of the firm or to further education. Thus, answer A is incorrect. Answer B is incorrect because the reasonableness of how the money is used is not an issue; the issue is that educational expense is not research.
- 31 Answer A is correct. Standard I(B)–Independence and Objectivity emphasizes the need for members and candidates to maintain their independence and objectivity. Best practices dictate that firms adopt a strict policy not to accept compensation for travel arrangements. At times, however, accepting paid

travel would not compromise one's independence and objectivity. Answers B and C are incorrect because the added benefits—free conference admission for additional staff members and an exclusive golf retreat for the speaker—could be viewed as inducements related to the firm's working arrangements and not solely related to the speaking engagement. Should Long wish to bring other team members or participate in the golf outing, he or his firm should be responsible for the associated fees.

- 32** Answer C is correct. The guidance to Standard II(A)—Material Nonpublic Information recommends adding securities to the firm's restricted list when the firm has or may have material nonpublic information. By adding these securities to this list, Andrews would uphold this standard. Because waiting until the next day will not ensure that news of the merger is made public, answer A is incorrect. Negotiations may take much longer between the two companies, and the merger may never happen. Andrews must wait until the information is disseminated to the market before he trades on that information. Answer B is incorrect because Andrews should not disclose the information to other managers; no trading is allowed on material nonpublic information.
- 33** Answer B is correct. Through placing a personal purchase order that is significantly greater than the average volume, Pietro is violating Standard IIB—Market Manipulation. He is attempting to manipulate an increase in the share price and thus bring a buyer to the negotiating table. The news of a possible merger and confirmation of the firm's earnings guidance may also have positive effects on the price of Local Bank, but Pietro's actions in instructing the release of the information does not represent a violation through market manipulation. Announcements of this nature are common and practical to keep investors informed. Thus, answers A and C are incorrect.
- 34** Answer C is correct. Cupp violated Standard III(D)—Performance Presentations when he deviated from the firm's stated policies solely to capture the gain from the holding being acquired. Answer A is incorrect because the firm does not claim GIPS compliance and the GIPS standards require external cash flows to be treated in a consistent manner with the firm's documented policies. Answer B is incorrect because the firm does not state that it is updating its composite policies. If such a change were to occur, all cash flows for the month would have to be reviewed to ensure their consistent treatment under the new policy.
- 35** Answer A is correct. According to Standard V(C)—Record Retention, Cannan needed the permission of her employer to maintain the files at home after her employment ended. Without that permission, she should have deleted the files. All files created as part of a member's or candidate's professional activity are the property of the firm, even those created outside normal work hours. Thus, answer B is incorrect. Answer C is incorrect because the Code and Standards do not prohibit using one's personal computer to complete work for one's employer.
- 36** Answer B is correct. According to Standard VII(B)—Reference to CFA Institute, the CFA Designation, and the CFA Program, Quinn cannot claim to have finished the CFA Program or be eligible for the CFA charter until he officially learns that he has passed the Level III exam. Until the results for the most recent exam are released, those who sat for the exam should continue to refer to themselves as "candidates." Thus, answer C is incorrect. Answer A is incorrect because members and candidates may discuss areas of practice in which they believe the CFA Program improved their personal skills.

- 37** Answer A is correct. Hart's decision to invest in the retail fund appears directly correlated with Rodriguez's statement about the successful quarter of Mega Retail and thus violates Standard II(A)–Material Nonpublic Information. Rodriguez's information would be considered material because it would influence the share price of Mega Retail and probably influence the price of the entire exchange-traded retail fund. Thus, answer B is incorrect. Answer C is also incorrect because Rodriguez shared information that was both material and nonpublic. Company officers regularly have such knowledge about their firms, which is not a violation. The sharing of such information, however, even in a conversation between friends, does violate Standard II(A).
- 38** Answer C is correct. Standard VII(A)–Conduct as Members and Candidates in the CFA Program prohibits providing information to candidates or the public that is considered confidential to the CFA Program. In revealing that questions related to the analysis of inventories and analysis of taxes were on the exam, Park has violated this standard. Answer B is incorrect because the guidance for the standard explicitly acknowledges that members and candidates are allowed to offer their opinions about the CFA Program. Answer A is incorrect because candidates are not prohibited from using outside resources.
- 39** Answer B is correct. Paper has violated Standard III(D)–Performance Presentation by not disclosing that he was part of a team of managers that achieved the results shown. If he had also included the return of the portion he directly managed, he would not have violated the standard. Thus, answer A is incorrect. Answer C is incorrect because Paper received written permission from his prior employer to include the results.
- 40** Answer A is correct. Townsend has not provided any information about her clients to the leaders or managers of the golf program; thus, she has not violated Standard III(E)–Preservation of Confidentiality. Providing contact information about her clients for a direct-mail solicitation would have been a violation. Answer B is incorrect because the notice in the newsletter does not violate Standard III(E). Answer C is incorrect because the golf program's fund-raising campaign had already begun, so discussing the opportunity to donate was appropriate.

## READING

# 4

## Introduction to the Global Investment Performance Standards (GIPS)

### LEARNING OUTCOMES

<i>Mastery</i>	<i>The candidate should be able to:</i>
<input type="checkbox"/>	a. explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards;
<input type="checkbox"/>	b. explain the construction and purpose of composites in performance reporting;
<input type="checkbox"/>	c. explain the requirements for verification.

The objective of this reading is to orient the Level I candidate approaching the assigned sections of the GIPS standards. It explains why the GIPS standards were created, who can claim compliance, and who benefits from compliance. It also introduces the key notion of composites, states the purpose of verification, and previews the structure of the Standards.

### WHY WERE THE GIPS STANDARDS CREATED?

I.

Institutions and individuals are constantly scrutinizing past investment performance returns in search of the best manager to achieve their investment objectives.

In the past, the investment community had great difficulty making meaningful comparisons on the basis of accurate investment performance data. Several performance measurement practices hindered the comparability of performance returns from one firm to another, while others called into question the accuracy and credibility of performance reporting overall. Misleading practices included:

- **Representative Accounts:** Selecting a top-performing portfolio to represent the firm's overall investment results for a specific mandate.

- **Survivorship Bias:** Presenting an “average” performance history that *excludes* portfolios whose poor performance was weak enough to result in termination of the firm.
- **Varying Time Periods:** Presenting performance for a selected time period during which the mandate produced excellent returns or out-performed its benchmark—making comparison with other firms’ results difficult or impossible.

Making a valid comparison of investment performance among even the most ethical investment management firms was problematic. For example, a pension fund seeking to hire an investment management firm might receive proposals from several firms, all using different methodologies for calculating their results.

The GIPS standards are a practitioner-driven set of ethical principles that establish a standardized, industry-wide approach for investment firms to follow in calculating and presenting their historical investment results to prospective clients. The GIPS standards ensure fair representation and full disclosure of investment performance. In other words, the GIPS standards lead investment management firms to avoid misrepresentations of performance and to communicate all relevant information that prospective clients should know in order to evaluate past results.



## WHO CAN CLAIM COMPLIANCE?

First, any investment management firm may choose to comply with the GIPS standards. Complying with the GIPS standards is voluntary. Compliance with the GIPS standards is not typically required by legal or regulatory authorities.

Second, only investment management firms that *actually manage* assets can claim compliance with the Standards. Plan sponsors and consultants cannot make a claim of compliance unless they actually manage assets for which they are making a claim of compliance. They can claim to endorse the Standards and/or require that their investment managers comply with the Standards. Similarly, software (and the vendors who supply software) cannot be “compliant.” Software can assist firms in achieving compliance with the GIPS standards (e.g., by calculating performance in a manner consistent with the calculation requirements of the Standards) but only an investment management firm can claim compliance once the firm has satisfied all requirements of the Standards.

Third, compliance is a firm-wide process that cannot be achieved on a single product or composite. A firm has only two options with regard to compliance with the GIPS standards: fully comply with *all* requirements of the GIPS standards and claim compliance through the use of the GIPS Compliance Statement; or not comply with all requirements of the GIPS standards and not claim compliance with, or make any reference to, the GIPS standards.



## WHO BENEFITS FROM COMPLIANCE?

The GIPS standards benefit two main groups: investment management firms and prospective clients.

- By choosing to comply with the GIPS standards, investment management firms assure prospective clients that the historical “track record” they report is both complete and fairly presented. Compliance enables the GIPS-compliant firm to

participate in competitive bids against other compliant firms throughout the world. Achieving and maintaining compliance may also strengthen the firm's internal controls over performance-related processes and procedures.

- Investors have a greater level of confidence in the integrity of performance presentations of a GIPS-compliant firm and can more easily compare performance presentations from different investment management firms. While the GIPS standards certainly do not eliminate the need for in-depth due diligence on the part of the investor, compliance with the Standards enhances the credibility of investment management firms that have chosen to undertake this responsibility.

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## COMPOSITES

## IV.

One of the key concepts of the Standards is the required use of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. A composite must include all actual, fee-paying, discretionary portfolios managed in accordance with the same investment mandate, objective, or strategy. For example, if a GIPS-compliant firm presents its track record for a Global Equity Composite (the Composite), the Composite must include all portfolios that are managed, or have historically been managed, in the firm's Global Equity strategy. The firm may not subjectively select which Global Equity portfolios will be included in or excluded from the calculation and presentation of the Global Equity Composite. The determination of which portfolios to include in the Composite should be done according to pre-established criteria (i.e., on an ex-ante basis), not after the fact. This prevents a firm from including only their best-performing portfolios in the Composite.

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## VERIFICATION

## V.

Firms that claim compliance with the GIPS standards are responsible for their claim of compliance and for maintaining that compliance. That is, firms self-regulate their claim of compliance. Once a firm claims compliance with the Standards, they may voluntarily hire an independent third party to perform a verification in order to increase confidence in the firm's claim of compliance. Verification may also increase the knowledge of the firm's performance measurement team and improve the consistency and quality of the firm's compliant presentations.

Verification is performed with respect to an entire firm, not on specific composites. Verification does not ensure the accuracy of any specific composite presentation. Verification tests:

- whether the investment firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis, and
- whether the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

Verification must be performed by an independent third party. A firm cannot perform its own verification.

Third-party verification brings additional credibility to a firm's claim of compliance. A verified firm may provide existing and prospective clients with greater assurance about its claim of compliance with the GIPS standards. Verification may also provide improved internal processes and procedures as well as marketing advantages to the firm.

## VI.

### THE STRUCTURE OF THE GIPS STANDARDS

The provisions within the 2010 edition of the GIPS standards are divided into nine sections: Fundamentals of Compliance, Input Data, Calculation Methodology, Composite Construction, Disclosure, Presentation and Reporting, Real Estate, Private Equity, and Wrap Fee/Separately Managed Account (SMA) Portfolios. The provisions are further categorized into requirements and recommendations.

## READING

# 5

## Global Investment Performance Standards (GIPS)

### LEARNING OUTCOMES

<i>Mastery</i>	<i>The candidate should be able to:</i>
<input type="checkbox"/>	a. describe the key features of the GIPS standards and the fundamentals of compliance;
<input type="checkbox"/>	b. describe the scope of the GIPS standards with respect to an investment firm's definition and historical performance record;
<input type="checkbox"/>	c. explain how the GIPS standards are implemented in countries with existing standards for performance reporting and describe the appropriate response when the GIPS standards and local regulations conflict;
<input type="checkbox"/>	d. describe the nine major sections of the GIPS standards.

### PREFACE

CFA Institute is a global not-for-profit association of investment professionals with the mission of leading the investment profession globally by setting the highest standards of ethics, education, and professional excellence. CFA Institute has a long-standing history of and commitment to establishing a broadly accepted ethical standard for calculating and presenting investment performance based on the principles of fair representation and full disclosure. The goals in developing and evolving the Global Investment Performance Standards (GIPS®) are to establish them as the recognized standard for calculating and presenting investment performance around the world and for the GIPS standards to become a firm's "passport" to market investment management services globally. As of January 2010, CFA Institute has partnered with organizations in 32 countries that contribute to the development and promotion of the GIPS standards.

OPTIONAL  
SEGMENT

## History

In 1995, CFA Institute, formerly known as the Association for Investment Management and Research (AIMR), sponsored and funded the Global Investment Performance Standards Committee to develop global standards for calculating and presenting investment performance, based on the existing AIMR Performance Presentation Standards (AIMR-PPS®).

In 1998, the proposed GIPS standards were posted on the CFA Institute website and circulated for comment to more than 4,000 individuals who had expressed interest. The result was the first Global Investment Performance Standards, published in April 1999.

The initial edition of the GIPS standards was designed to create a minimum global investment performance standard that would:

- Permit and facilitate acceptance and adoption in developing markets;
- Give the global investment management industry one commonly accepted approach for calculating and presenting performance; and
- Address liquid asset classes (equity, fixed income, and cash).

In 1999, the Global Investment Performance Standards Committee was replaced by the Investment Performance Council (IPC) to further develop and promote the GIPS standards. The development of the GIPS standards was a global industry initiative with participation from individuals and organizations from more than 15 countries.

The IPC was charged with developing provisions for other asset classes (e.g., real estate, private equity) and addressing other performance-related issues (e.g., fees, advertising) to broaden the scope and applicability of the GIPS standards. This was accomplished when the second edition of the GIPS standards was published in February 2005.

With the release of the 2005 edition of the GIPS standards and growing adoption and expansion of the GIPS standards, the IPC decided to move to a single global investment performance standard and eliminate the need for local variations of the GIPS standards. All country-specific performance standards converged with the GIPS standards, resulting in 25 countries adopting a single, global standard for the calculation and presentation of investment performance.

In 2005, with the convergence of country-specific versions to the GIPS standards and the need to reorganize the governance structure to facilitate involvement from GIPS sponsors, CFA Institute dissolved the IPC and created the GIPS Executive Committee and the GIPS Council. The GIPS Executive Committee serves as the decision-making authority for the GIPS standards, and the GIPS Council facilitates the involvement of all sponsors in the ongoing development and promotion of the GIPS standards.

To maintain global relevance, and in recognition of the dynamic nature of the investment industry, the GIPS standards must be continually updated through interpretations, guidance, and new provisions. In 2008, the GIPS Executive Committee began its review of the GIPS standards in an effort to further refine the provisions as well as eliminate provisions that are no longer necessary and add new requirements and recommendations that promote best practice. The GIPS Executive Committee worked in close collaboration with its technical subcommittees, specially formed working groups, and GIPS sponsors. These groups reviewed the existing provisions and guidance and conducted surveys and other research as part of the efforts to produce the 2010 edition of the GIPS standards.

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## INTRODUCTION

### Preamble—Why Is a Global Investment Performance Standard Needed?

#### *Standardized Investment Performance*

Financial markets and the investment management industry have become increasingly global in nature. The growth in the types and number of financial entities, the globalization of the investment process, and the increased competition among investment management firms demonstrate the need to standardize the calculation and presentation of investment performance.

#### *Global Passport*

Asset managers and both existing and prospective clients benefit from an established global standard for calculating and presenting investment performance. Investment practices, regulation, performance measurement, and reporting of performance vary considerably from country to country. By adhering to a global standard, firms in countries with minimal or no investment performance standards will be able to compete for business on an equal footing with firms from countries with more developed standards. Firms from countries with established practices will have more confidence in being fairly compared with local firms when competing for business in countries that have not previously adopted performance standards. Performance standards that are accepted globally enable investment firms to measure and present their investment performance so that investors can readily compare investment performance among firms.

#### *Investor Confidence*

Investment managers that adhere to investment performance standards help assure investors that the firm's investment performance is complete and fairly presented. Both prospective and existing clients of investment firms benefit from a global investment performance standard by having a greater degree of confidence in the performance information presented to them.

### Objectives

The establishment of a voluntary global investment performance standard leads to an accepted set of best practices for calculating and presenting investment performance that is readily comparable among investment firms, regardless of geographic location. These standards also facilitate a dialogue between investment firms and their existing and prospective clients regarding investment performance.

The goals of the GIPS Executive Committee are:

- To establish investment industry best practices for calculating and presenting investment performance that promote investor interests and instill investor confidence;
- To obtain worldwide acceptance of a single standard for the calculation and presentation of investment performance based on the principles of fair representation and full disclosure;
- To promote the use of accurate and consistent investment performance data;
- To encourage fair, global competition among investment firms without creating barriers to entry; and
- To foster the notion of industry “self-regulation” on a global basis.

## Overview

Key features of the GIPS standards include the following:

- The GIPS standards are ethical standards for investment performance presentation to ensure fair representation and full disclosure of investment performance. In order to claim compliance, firms must adhere to the requirements included in the GIPS standards.
- Meeting the objectives of fair representation and full disclosure is likely to require more than simply adhering to the minimum requirements of the GIPS standards. Firms should also adhere to the recommendations to achieve best practice in the calculation and presentation of performance.
- The GIPS standards require firms to include all actual, discretionary, fee-paying portfolios in at least one composite defined by investment mandate, objective, or strategy in order to prevent firms from cherry-picking their best performance.
- The GIPS standards rely on the integrity of input data. The accuracy of input data is critical to the accuracy of the performance presentation. The underlying valuations of portfolio holdings drive the portfolio's performance. It is essential for these and other inputs to be accurate. The GIPS standards require firms to adhere to certain calculation methodologies and to make specific disclosures along with the firm's performance.
- Firms must comply with all requirements of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS website ([www.gipsstandards.org](http://www.gipsstandards.org)) as well as in the *GIPS Handbook*.

The GIPS standards do not address every aspect of performance measurement or cover unique characteristics of each asset class. The GIPS standards will continue to evolve over time to address additional areas of investment performance. Understanding and interpreting investment performance requires consideration of both risk and return. Historically, the GIPS standards focused primarily on returns. In the spirit of fair representation and full disclosure, and in order to provide investors with a more comprehensive view of a firm's performance, the 2010 edition of the GIPS standards includes new provisions related to risk.

## Historical Performance Record

- A firm is required to initially present, at a minimum, five years of annual investment performance that is compliant with the GIPS standards. If the firm or the composite has been in existence less than five years, the firm must present performance since the firm's inception or the composite inception date.
- After a firm presents a minimum of five years of GIPS-compliant performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in existence less than five years), the firm must present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.
- Firms may link non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods after 1 January 2000 and the firm discloses the periods of non-compliance. Firms must not link non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance.

Firms that manage private equity, real estate, and/or wrap fee/separately managed account (SMA) portfolios must also comply with Sections 6, 7, and 8, respectively, of the Provisions of the GIPS standards that became effective as of 1 January 2006.

## Compliance

Firms must take all steps necessary to ensure that they have satisfied all the requirements of the GIPS standards before claiming compliance. Firms are strongly encouraged to perform periodic internal compliance checks. Implementing adequate internal controls during all stages of the investment performance process—from data input to preparing performance presentations—will instill confidence in the validity of performance presented as well as in the claim of compliance.

Firms may choose to have an independent third-party verification that tests the construction of the firm's composites as well as the firm's policies and procedures as they relate to compliance with the GIPS standards. The value of verification is widely recognized, and being verified is considered to be best practice. The GIPS Executive Committee strongly recommends that firms be verified. In addition to verification, firms may also choose to have specifically focused composite testing (performance examination) performed by an independent third-party verifier to provide additional assurance regarding a particular composite.

## Effective Date

The effective date for the 2010 edition of the GIPS standards is 1 January 2011. Compliant presentations that include performance for periods that begin on or after 1 January 2011 must be prepared in accordance with the 2010 edition of the GIPS standards. Prior editions of the GIPS standards may be found on the GIPS website ([www.gipsstandards.org](http://www.gipsstandards.org)).

## Implementing a Global Standard

The presence of a local sponsoring organization for investment performance standards is essential for effective implementation and ongoing support of the GIPS standards within a jurisdiction. Such sponsors also provide an important link between the GIPS Executive Committee, the governing body for the GIPS standards, and the local markets in which investment managers operate.

The sponsor, by actively supporting the GIPS standards and the work of the GIPS Executive Committee, ensures that the jurisdiction's interests are taken into account as the GIPS standards are developed. Compliance with the GIPS standards is voluntary, and support from the local market sponsor helps to drive the adoption of the GIPS standards.

The GIPS Executive Committee strongly encourages countries without an investment performance standard to promote the GIPS standards as the local standard and translate them into the local language when necessary. Although the GIPS standards may be translated into many languages, if a discrepancy arises, the English version of the GIPS standards is the official governing version.

The GIPS Executive Committee will continue to promote the principles of fair representation and full disclosure and develop the GIPS standards so that they maintain their relevance within the changing investment management industry.

The self-regulatory nature of the GIPS standards necessitates a strong commitment to ethical integrity. Self-regulation also assists regulators in exercising their responsibility for ensuring the fair disclosure of information within financial markets. The GIPS Executive Committee encourages regulators to:

- Recognize the benefit of voluntary compliance with standards that represent global best practices;
- Give consideration to taking enforcement actions against firms that falsely claim compliance with the GIPS standards; and
- Recognize and encourage independent third-party verification.

Where existing laws, regulations, or industry standards already impose requirements related to the calculation and presentation of investment performance, firms are strongly encouraged to comply with the GIPS standards in addition to applicable regulatory requirements. Compliance with applicable law and/or regulation does not necessarily lead to compliance with the GIPS standards. In cases in which laws and/or regulations conflict with the GIPS standards, firms are required to comply with the laws and regulations and make full disclosure of the conflict in the compliant presentation.

#### OPTIONAL SEGMENT

### Sponsors

The presence of a local sponsoring organization for investment performance standards, known as a “sponsor,” is essential for effective implementation of the GIPS standards and ongoing support within a local market. Sponsors collectively form the GIPS Council, which provides a formal role in the ongoing development and oversight of the GIPS standards. Sponsors:

- Promote the GIPS standards locally;
- Provide local market support and input for the GIPS standards;
- Present local market–specific issues to the GIPS Executive Committee; and
- Participate in the governance of the GIPS standards via membership in the GIPS Council and Regional Investment Performance Subcommittees.

Each organization undergoes a formal review before being endorsed as a sponsor. Additional information and a current list of sponsors can be found on the GIPS website ([www.gipsstandards.org](http://www.gipsstandards.org)).

#### *Endorsed GIPS Sponsors (as of 1 January 2010)*

<b>Australia</b>	Investment and Financial Services Association Limited— Performance Analyst Group
<b>Austria</b>	1) Österreichische Vereinigung für Finanzanalyse und Asset Management and 2) Vereinigung Österreichischer Investmentgesellschaften
<b>Belgium</b>	Belgian Asset Managers Association
<b>Canada</b>	Canadian Investment Performance Committee
<b>Denmark</b>	The Danish Society of Financial Analysts and CFA Denmark
<b>France</b>	1) Société Française des Analystes Financiers and 2) Association Française de la Gestion Financière

<b>Germany</b>	German Asset Management Standards Committee: 1) Bundesverband Investment und Asset Management e.V., 2) Deutsche Vereinigung für Finanzanalyse und Asset Management, and 3) German CFA Society
<b>Greece</b>	Hellenic CFA Society
<b>Hong Kong</b>	Local Sponsor: The Hong Kong Society of Financial Analysts
<b>Hungary</b>	1) CFA Society of Hungary and 2) the Association of Hungarian Investment Fund and Asset Management Companies
<b>Ireland</b>	Irish Association of Investment Managers
<b>Italy</b>	Italian Investment Performance Committee: 1) L'Associazione Bancaria Italiana, 2) L'Associazione Italiana degli Analisti Finanziari, 3) Assogestioni, 4) Sviluppo Mercato Fondi Pensione, 5) Assirevi, and 6) Italian CFA Society
<b>Japan</b>	The Security Analysts Association of Japan
<b>Kazakhstan</b>	Kazakhstan Association of Financial and Investment Analysts
<b>Liechtenstein</b>	Liechtenstein Bankers' Association
<b>Micronesia</b>	Asia Pacific Association for Fiduciary Studies
<b>The Netherlands</b>	The Netherlands Beroepsvereniging van Beleggingsprofessionals
<b>New Zealand</b>	CFA Society of New Zealand
<b>Norway</b>	The Norwegian Society of Financial Analysts
<b>Pakistan</b>	CFA Association of Pakistan
<b>Portugal</b>	Associação Portuguesa de Analista Financeiros
<b>Russia</b>	National League of Management Companies
<b>Singapore</b>	Investment Management Association of Singapore
<b>South Africa</b>	Association for Savings and Investment, South Africa
<b>South Korea</b>	Korea GIPS Committee
<b>Spain</b>	Asociación Española de Presentación de Resultados de Gestión
<b>Sri Lanka</b>	CFA Sri Lanka
<b>Sweden</b>	Swedish Society of Financial Analysts
<b>Switzerland</b>	Swiss Bankers Association
<b>Ukraine</b>	The Ukrainian Association of Investment Business
<b>United Kingdom</b>	UK Investment Performance Committee: 1) Association of British Insurers, 2) Investment Management Association, and 3) National Association of Pension Funds
<b>United States</b>	CFA Institute—US Investment Performance Committee

END OPTIONAL  
SEGMENT

## PROVISIONS OF THE GLOBAL INVESTMENT PERFORMANCE STANDARDS

I.

The provisions within the GIPS standards are divided into the following nine sections: Fundamentals of Compliance, Input Data, Calculation Methodology, Composite Construction, Disclosure, Presentation and Reporting, Real Estate, Private Equity, and Wrap Fee/Separately Managed Account (SMA) Portfolios.

The provisions for each section are categorized into requirements and recommendations. Firms must meet all the requirements to claim compliance with the GIPS standards. Firms are encouraged to implement as many of the recommendations as possible. These recommended provisions are considered to be industry best practice and assist firms in fully adhering to the spirit and intent of the GIPS standards.

- 0 Fundamentals of Compliance:** Several core principles create the foundation for the GIPS standards, including properly defining the firm, providing compliant presentations to all prospective clients, adhering to applicable laws and regulations, and ensuring that information presented is not false or misleading. Two important issues that a firm must consider when becoming compliant with the GIPS standards are the definition of the firm and the firm's definition of discretion. The definition of the firm is the foundation for firm-wide compliance and creates defined boundaries whereby total firm assets can be determined. The firm's definition of discretion establishes criteria to judge which portfolios must be included in a composite and is based on the firm's ability to implement its investment strategy.
- 1 Input Data:** Consistency of input data used to calculate performance is critical to effective compliance with the GIPS standards and establishes the foundation for full, fair, and comparable investment performance presentations. For periods beginning on or after 1 January 2011, all portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles.
- 2 Calculation Methodology:** Achieving comparability among investment management firms' performance presentations requires uniformity in methods used to calculate returns. The GIPS standards mandate the use of certain calculation methodologies to facilitate comparability.
- 3 Composite Construction:** A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. The composite return is the asset-weighted average of the performance of all portfolios in the composite. Creating meaningful composites is essential to the fair presentation, consistency, and comparability of performance over time and among firms.
- 4 Disclosure:** Disclosures allow firms to elaborate on the data provided in the presentation and give the reader the proper context in which to understand the performance. To comply with the GIPS standards, firms must disclose certain information in all compliant presentations regarding their performance and the policies adopted by the firm. Although some disclosures are required for all firms, others are specific to certain circumstances and may not be applicable in all situations. One of the essential disclosures for every firm is the claim of compliance. Once a firm meets all the requirements of the GIPS standards, it must appropriately use the claim of compliance to indicate compliance with the GIPS standards. The 2010 edition of the GIPS standards includes a revised compliance statement that indicates if the firm has or has not been verified.
- 5 Presentation and Reporting:** After constructing the composites, gathering the input data, calculating returns, and determining the necessary disclosures, the firm must incorporate this information in presentations based on the requirements in the GIPS standards for presenting investment performance. No finite set of requirements 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 in GIPS-compliant presentations information not addressed by the GIPS standards.

- 6 Real Estate:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Real estate provisions were first included in the 2005 edition of the GIPS standards and became effective 1 January 2006. The 2010 edition of the GIPS standards includes new provisions for closed-end real estate funds. Firms should note that certain provisions of Sections 0–5 do not apply to real estate investments or are superseded by provisions within Section 6. The provisions that do not apply have been noted within Section 6.
- 7 Private Equity:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Private equity provisions were first included in the 2005 edition of the GIPS standards and became effective 1 January 2006. Firms should note that certain provisions in Sections 0–5 do not apply to private equity investments or are superseded by provisions within Section 7. The provisions that do not apply have been noted within Section 7.
- 8 Wrap Fee/Separately Managed Account (SMA) Portfolios:** Unless otherwise noted, this section supplements all of the required and recommended provisions in Sections 0–5. Firms should note that certain provisions in Sections 0–5 of the GIPS standards do not apply to wrap fee/SMA portfolios or are superseded by provisions within Section 8. The provisions that do not apply have been noted within Section 8.

**Defined Terms:** Words appearing in small capital letters in the GIPS standards are defined in the **GIPS Glossary**, which is located at the end of this reading.

## 0 Fundamentals of Compliance

### Fundamentals of Compliance—Requirements

- 0.A.1** FIRMS MUST comply with all the REQUIREMENTS of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)) as well as in the *GIPS Handbook*.
- 0.A.2** FIRMS MUST comply with all applicable laws and regulations regarding the calculation and presentation of performance.
- 0.A.3** FIRMS MUST NOT present performance or performance-related information that is false or misleading.
- 0.A.4** The GIPS standards MUST be applied on a FIRM-wide basis.
- 0.A.5** FIRMS MUST document their policies and procedures used in establishing and maintaining compliance with the GIPS standards, including ensuring the existence and ownership of client assets, and MUST apply them consistently.
- 0.A.6** If the FIRM does not meet all the REQUIREMENTS of the GIPS standards, the FIRM MUST NOT represent or state that it is “in compliance with the Global Investment Performance Standards except for . . .” or make any other statements that may indicate partial compliance with the GIPS standards.
- 0.A.7** Statements referring to the calculation methodology as being “in accordance,” “in compliance,” or “consistent” with the Global Investment Performance Standards, or similar statements, are prohibited.

- 0.A.8** Statements referring to the performance of a single, existing client PORTFOLIO as being “calculated in accordance with the Global Investment Performance Standards” are prohibited, except when a GIPS-compliant FIRM reports the performance of an individual client’s PORTFOLIO to that client.
- 0.A.9** FIRMS MUST make every reasonable effort to provide a COMPLIANT PRESENTATION to all PROSPECTIVE CLIENTS. FIRMS MUST NOT choose to whom they present a COMPLIANT PRESENTATION. As long as a PROSPECTIVE CLIENT has received a COMPLIANT PRESENTATION within the previous 12 months, the FIRM has met this REQUIREMENT.
- 0.A.10** FIRMS MUST provide a complete list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request. FIRMS MUST include terminated COMPOSITES on the FIRM’S list of COMPOSITE DESCRIPTIONS for at least five years after the COMPOSITE TERMINATION DATE.
- 0.A.11** FIRMS MUST provide a COMPLIANT PRESENTATION for any COMPOSITE listed on the FIRM’S list of COMPOSITE DESCRIPTIONS to any PROSPECTIVE CLIENT that makes such a request.
- 0.A.12** FIRMS MUST be defined as an investment firm, subsidiary, or division held out to clients or PROSPECTIVE CLIENTS as a DISTINCT BUSINESS ENTITY.
- 0.A.13** For periods beginning on or after 1 January 2011, TOTAL FIRM ASSETS MUST be the aggregate FAIR VALUE of all discretionary and non-discretionary assets managed by the FIRM. This includes both fee-paying and non-fee-paying PORTFOLIOS.<sup>1</sup>
- 0.A.14** TOTAL FIRM ASSETS MUST include assets assigned to a SUB-ADVISOR provided the FIRM has discretion over the selection of the SUB-ADVISOR.
- 0.A.15** Changes in a FIRM’S organization MUST NOT lead to alteration of historical COMPOSITE performance.
- 0.A.16** When the FIRM jointly markets with other firms, the FIRM claiming compliance with the GIPS standards MUST be sure that it is clearly defined and separate relative to other firms being marketed, and that it is clear which FIRM is claiming compliance.

#### Fundamentals of Compliance—Recommendations

- 0.B.1** FIRMS SHOULD comply with the RECOMMENDATIONS of the GIPS standards, including RECOMMENDATIONS in any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which will be made available on the GIPS website ([www.gipsstandards.org](http://www.gipsstandards.org)) as well as in the *GIPS Handbook*.
- 0.B.2** FIRMS SHOULD be verified.
- 0.B.3** FIRMS SHOULD adopt the broadest, most meaningful definition of the FIRM. The scope of this definition SHOULD include all geographical (country, regional, etc.) offices operating under the same brand name regardless of the actual name of the individual investment management company.
- 0.B.4** FIRMS SHOULD provide to each existing client, on an annual basis, a COMPLIANT PRESENTATION of the COMPOSITE in which the client’s PORTFOLIO is included.

<sup>1</sup> For periods prior to 1 January 2011, TOTAL FIRM ASSETS MUST be the aggregate of the MARKET VALUE of all discretionary and non-discretionary assets under management within the defined FIRM.

## 1 Input Data

### Input Data—Requirements

- 1.A.1** All data and information necessary to support all items included in a COMPLIANT PRESENTATION MUST be captured and maintained.
- 1.A.2** For periods beginning on or after 1 January 2011, PORTFOLIOS MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles.<sup>2</sup>
- 1.A.3** FIRMS MUST value PORTFOLIOS in accordance with the COMPOSITE-specific valuation policy. PORTFOLIOS MUST be valued:
  - a** For periods beginning on or after 1 January 2001, at least monthly.<sup>3</sup>
  - b** For periods beginning on or after 1 January 2010, on the date of all LARGE CASH FLOWS. FIRMS MUST define LARGE CASH FLOW for each COMPOSITE to determine when PORTFOLIOS in that COMPOSITE MUST be valued.
  - c** No more frequently than required by the valuation policy.
- 1.A.4** For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of the calendar month end or the last business day of the month.
- 1.A.5** For periods beginning on or after 1 January 2005, FIRMS MUST use TRADE DATE ACCOUNTING.
- 1.A.6** ACCRUAL ACCOUNTING MUST be used for fixed-income securities and all other investments that earn interest income. The value of fixed-income securities MUST include accrued income.
- 1.A.7** For periods beginning on or after 1 January 2006, COMPOSITES MUST have consistent beginning and ending annual valuation dates. Unless the COMPOSITE is reported on a non-calendar fiscal year, the beginning and ending valuation dates MUST be at calendar year end or on the last business day of the year.

### Input Data—Recommendations

- 1.B.1** FIRMS SHOULD value PORTFOLIOS on the date of all EXTERNAL CASH FLOWS.
- 1.B.2** Valuations SHOULD be obtained from a qualified independent third party.
- 1.B.3** ACCRUAL ACCOUNTING SHOULD be used for dividends (as of the ex-dividend date).
- 1.B.4** FIRMS SHOULD accrue INVESTMENT MANAGEMENT FEES.

## 2 Calculation Methodology

### Calculation Methodology—Requirements

- 2.A.1** TOTAL RETURNS MUST be used.
- 2.A.2** FIRMS MUST calculate TIME-WEIGHTED RATES OF RETURN that adjust for EXTERNAL CASH FLOWS. Both periodic and sub-period returns MUST be geometrically LINKED. EXTERNAL CASH FLOWS MUST be treated according to the FIRM'S COMPOSITE-specific policy. At a minimum:

<sup>2</sup> For periods prior to 1 January 2011, PORTFOLIO valuations MUST be based on MARKET VALUES (not cost basis or book values).

<sup>3</sup> For periods prior to 1 January 2001, PORTFOLIOS MUST be valued at least quarterly.

- a For periods beginning on or after 1 January 2001, FIRMS MUST calculate PORTFOLIO returns at least monthly.
  - b For periods beginning on or after 1 January 2005, FIRMS MUST calculate PORTFOLIO returns that adjust for daily-weighted EXTERNAL CASH FLOWS.
- 2.A.3** Returns from cash and cash equivalents held in PORTFOLIOS MUST be included in all return calculations.
- 2.A.4** All returns MUST be calculated after the deduction of the actual TRADING EXPENSES incurred during the period. FIRMS MUST NOT use estimated TRADING EXPENSES.
- 2.A.5** If the actual TRADING EXPENSES cannot be identified and segregated from a BUNDLED FEE:
- a When calculating GROSS-OF-FEES returns, returns MUST be reduced by the entire BUNDLED FEE or the portion of the BUNDLED FEE that includes the TRADING EXPENSES. FIRMS MUST NOT use estimated TRADING EXPENSES.
  - b When calculating NET-OF-FEES returns, returns MUST be reduced by the entire BUNDLED FEE or the portion of the BUNDLED FEE that includes the TRADING EXPENSES and the INVESTMENT MANAGEMENT FEE. FIRMS MUST NOT use estimated TRADING EXPENSES.
- 2.A.6** COMPOSITE returns MUST be calculated by asset-weighting the individual PORTFOLIO returns using beginning-of-period values or a method that reflects both beginning-of-period values and EXTERNAL CASH FLOWS.
- 2.A.7** COMPOSITE returns MUST be calculated:
- a For periods beginning on or after 1 January 2006, by asset-weighting the individual PORTFOLIO returns at least quarterly.
  - b For periods beginning on or after 1 January 2010, by asset-weighting the individual PORTFOLIO returns at least monthly.

### Calculation Methodology—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** For periods prior to 1 January 2010, FIRMS SHOULD calculate COMPOSITE returns by asset-weighting the individual PORTFOLIO returns at least monthly.

## 3 Composite Construction

### Composite Construction—Requirements

- 3.A.1** All actual, fee-paying, discretionary PORTFOLIOS MUST be included in at least one COMPOSITE. Although non-fee-paying discretionary PORTFOLIOS may be included in a COMPOSITE (with appropriate disclosure), non-discretionary PORTFOLIOS MUST NOT be included in a FIRM'S COMPOSITES.
- 3.A.2** COMPOSITES MUST include only actual assets managed by the FIRM.
- 3.A.3** FIRMS MUST NOT LINK performance of simulated or model PORTFOLIOS with actual performance.

- 3.A.4** COMPOSITES MUST be defined according to investment mandate, objective, or strategy. COMPOSITES MUST include all PORTFOLIOS that meet the COMPOSITE DEFINITION. Any change to a COMPOSITE DEFINITION MUST NOT be applied retroactively. The COMPOSITE DEFINITION MUST be made available upon request.
- 3.A.5** COMPOSITES MUST include new PORTFOLIOS on a timely and consistent basis after each PORTFOLIO comes under management.
- 3.A.6** Terminated PORTFOLIOS MUST be included in the historical performance of the COMPOSITE up to the last full measurement period that each PORTFOLIO was under management.
- 3.A.7** PORTFOLIOS MUST NOT be switched from one COMPOSITE to another unless documented changes to a PORTFOLIO'S investment mandate, objective, or strategy or the redefinition of the COMPOSITE makes it appropriate. The historical performance of the PORTFOLIO MUST remain with the original COMPOSITE.
- 3.A.8** For periods beginning on or after 1 January 2010, a CARVE-OUT MUST NOT be included in a COMPOSITE unless the CARVE-OUT is managed separately with its own cash balance.<sup>4</sup>
- 3.A.9** If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM MUST NOT include PORTFOLIOS below the minimum asset level in that COMPOSITE. Any changes to a COMPOSITE-specific minimum asset level MUST NOT be applied retroactively.
- 3.A.10** FIRMS that wish to remove PORTFOLIOS from COMPOSITES in cases of SIGNIFICANT CASH FLOWS MUST define "significant" on an EX-ANTE, COMPOSITE-specific basis and MUST consistently follow the COMPOSITE-specific policy.

#### Composite Construction—Recommendations

- 3.B.1** If the FIRM sets a minimum asset level for PORTFOLIOS to be included in a COMPOSITE, the FIRM SHOULD NOT present a COMPLIANT PRESENTATION of the COMPOSITE to a PROSPECTIVE CLIENT known not to meet the COMPOSITE'S minimum asset level.
- 3.B.2** To remove the effect of a SIGNIFICANT CASH FLOW, the FIRM SHOULD use a TEMPORARY NEW ACCOUNT.

## 4 Disclosure

### Disclosure—Requirements

- 4.A.1** Once a FIRM has met all the REQUIREMENTS of the GIPS standards, the FIRM MUST disclose its compliance with the GIPS standards using one of the following compliance statements. The claim of compliance MUST only be used in a COMPLIANT PRESENTATION.

For FIRMS that are verified:

"[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards.

<sup>4</sup> For periods prior to 1 January 2010, if CARVE-OUTS were included in a COMPOSITE, cash MUST have been allocated to the CARVE-OUT in a timely and consistent manner.

[Insert name of FIRM] has been independently verified for the periods [insert dates]. The verification report(s) is/are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation."

For COMPOSITES of a verified FIRM that have also had a PERFORMANCE EXAMINATION:

"[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has been independently verified for the periods [insert dates].

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The [insert name of COMPOSITE] composite has been examined for the periods [insert dates]. The verification and performance examination reports are available upon request."

For FIRMS that have not been verified:

"[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. [Insert name of FIRM] has not been independently verified."

- 4.A.2** FIRMS MUST disclose the definition of the FIRM used to determine TOTAL FIRM ASSETS and FIRM-wide compliance.
- 4.A.3** FIRMS MUST disclose the COMPOSITE DESCRIPTION.
- 4.A.4** FIRMS MUST disclose the BENCHMARK DESCRIPTION.
- 4.A.5** When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRADING EXPENSES.
- 4.A.6** When presenting NET-OF-FEES returns, FIRMS MUST disclose:
  - a** If any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRADING EXPENSES;
  - b** If model or actual INVESTMENT MANAGEMENT FEES are used; and
  - c** If returns are net of any PERFORMANCE-BASED FEES.
- 4.A.7** FIRMS MUST disclose the currency used to express performance.
- 4.A.8** FIRMS MUST disclose which measure of INTERNAL DISPERSION is presented.
- 4.A.9** FIRMS MUST disclose the FEE SCHEDULE appropriate to the COMPLIANT PRESENTATION.
- 4.A.10** FIRMS MUST disclose the COMPOSITE CREATION DATE.
- 4.A.11** FIRMS MUST disclose that the FIRM'S list of COMPOSITE DESCRIPTIONS is available upon request.
- 4.A.12** FIRMS MUST disclose that policies for valuing PORTFOLIOS, calculating performance, and preparing COMPLIANT PRESENTATIONS are available upon request.

- 4.A.13** FIRMS MUST disclose the presence, use, and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.
- 4.A.14** FIRMS MUST disclose all significant events that would help a PROSPECTIVE CLIENT interpret the COMPLIANT PRESENTATION.
- 4.A.15** For any performance presented for periods prior to 1 January 2000 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
- 4.A.16** If the FIRM is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.
- 4.A.17** If a COMPOSITE is redefined, the FIRM MUST disclose the date of, description of, and reason for the redefinition.
- 4.A.18** FIRMS MUST disclose changes to the name of a COMPOSITE.
- 4.A.19** FIRMS MUST disclose the minimum asset level, if any, below which PORTFOLIOS are not included in a COMPOSITE. FIRMS MUST also disclose any changes to the minimum asset level.
- 4.A.20** FIRMS MUST disclose relevant details of the treatment of withholding taxes on dividends, interest income, and capital gains, if material. FIRMS MUST also disclose if BENCHMARK returns are net of withholding taxes if this information is available.
- 4.A.21** For periods beginning on or after 1 January 2011, FIRMS MUST disclose and describe any known material differences in exchange rates or valuation sources used among the PORTFOLIOS within a COMPOSITE, and between the COMPOSITE and the BENCHMARK.<sup>5</sup>
- 4.A.22** If the COMPLIANT PRESENTATION conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards.
- 4.A.23** For periods prior to 1 January 2010, if CARVE-OUTS are included in a COMPOSITE, FIRMS MUST disclose the policy used to allocate cash to CARVE-OUTS.
- 4.A.24** If a COMPOSITE contains PORTFOLIOS with BUNDLED FEES, FIRMS MUST disclose the types of fees that are included in the BUNDLED FEE.
- 4.A.25** For periods beginning on or after 1 January 2006, FIRMS MUST disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.
- 4.A.26** For periods prior to 1 January 2010, FIRMS MUST disclose if any PORTFOLIOS were not valued at calendar month end or on the last business day of the month.
- 4.A.27** For periods beginning on or after 1 January 2011, FIRMS MUST disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.
- 4.A.28** For periods beginning on or after 1 January 2011, FIRMS MUST disclose if the COMPOSITE's valuation hierarchy materially differs from the RECOMMENDED hierarchy in the GIPS Valuation Principles.
- 4.A.29** If the FIRM determines no appropriate BENCHMARK for the COMPOSITE exists, the FIRM MUST disclose why no BENCHMARK is presented.

<sup>5</sup> For periods prior to 1 January 2011, FIRMS MUST disclose and describe any known inconsistencies in the exchange rates used among the PORTFOLIOS within a COMPOSITE and between the COMPOSITE and the BENCHMARK.

- 4.A.30 If the FIRM changes the BENCHMARK, the FIRM MUST disclose the date of, description of, and reason for the change.
- 4.A.31 If a custom BENCHMARK or combination of multiple BENCHMARKS is used, the FIRM MUST disclose the BENCHMARK components, weights, and rebalancing process.
- 4.A.32 If the FIRM has adopted a SIGNIFICANT CASH FLOW policy for a specific COMPOSITE, the FIRM MUST disclose how the FIRM defines a SIGNIFICANT CASH FLOW for that COMPOSITE and for which periods.
- 4.A.33 FIRMS MUST disclose if the three-year annualized EX-POST STANDARD DEVIATION of the COMPOSITE and/or BENCHMARK is not presented because 36 monthly returns are not available.
- 4.A.34 If the FIRM determines that the three-year annualized EX-POST STANDARD DEVIATION is not relevant or appropriate, the FIRM MUST:
  - a Describe why EX-POST STANDARD DEVIATION is not relevant or appropriate; and
  - b Describe the additional risk measure presented and why it was selected.
- 4.A.35 FIRMS MUST disclose if the performance from a past firm or affiliation is LINKED to the performance of the FIRM.

#### Disclosure—Recommendations

- 4.B.1 FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.
- 4.B.2 FIRMS SHOULD disclose material changes to calculation policies and/or methodologies.
- 4.B.3 FIRMS SHOULD disclose material differences between the BENCHMARK and the COMPOSITE'S investment mandate, objective, or strategy.
- 4.B.4 FIRMS SHOULD disclose the key assumptions used to value PORTFOLIO investments.
- 4.B.5 If a parent company contains multiple firms, each FIRM within the parent company SHOULD disclose a list of the other firms contained within the parent company.
- 4.B.6 For periods prior to 1 January 2011, FIRMS SHOULD disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE.
- 4.B.7 For periods prior to 1 January 2006, FIRMS SHOULD disclose the use of a SUB-ADVISOR and the periods a SUB-ADVISOR was used.
- 4.B.8 FIRMS SHOULD disclose if a COMPOSITE contains PROPRIETARY ASSETS.

## 5 Presentation and Reporting

### Presentation and Reporting—Requirements

- 5.A.1 The following items MUST be presented in each COMPLIANT PRESENTATION:
  - a At least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. After a FIRM presents a minimum of five years of GIPS-compliant performance (or for the period since the FIRM'S inception

or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years), the FIRM MUST present an additional year of performance each year, building up to a minimum of 10 years of GIPS-compliant performance.

- b** COMPOSITE returns for each annual period. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.
  - c** For COMPOSITES with a COMPOSITE INCEPTION DATE of 1 January 2011 or later, when the initial period is less than a full year, returns from the COMPOSITE INCEPTION DATE through the initial annual period end.
  - d** For COMPOSITES with a COMPOSITE TERMINATION DATE of 1 January 2011 or later, returns from the last annual period end through the COMPOSITE TERMINATION DATE.
  - e** The TOTAL RETURN for the BENCHMARK for each annual period. The BENCHMARK MUST reflect the investment mandate, objective, or strategy of the COMPOSITE.
  - f** The number of PORTFOLIOS in the COMPOSITE as of each annual period end. If the COMPOSITE contains five or fewer PORTFOLIOS at period end, the number of PORTFOLIOS is NOT REQUIRED.
  - g** COMPOSITE assets as of each annual period end.
  - h** Either TOTAL FIRM ASSETS or COMPOSITE assets as a percentage of TOTAL FIRM ASSETS, as of each annual period end.
  - i** A measure of INTERNAL DISPERSION of individual PORTFOLIO returns for each annual period. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is NOT REQUIRED.
- 5.A.2** For periods ending on or after 1 January 2011, FIRMS MUST present, as of each annual period end:
- a** The three-year annualized EX-POST STANDARD DEVIATION (using monthly returns) of both the COMPOSITE and the BENCHMARK; and
  - b** An additional three-year EX-POST risk measure for the BENCHMARK (if available and appropriate) and the COMPOSITE, if the FIRM determines that the three-year annualized EX-POST STANDARD DEVIATION is not relevant or appropriate. The PERIODICITY of the COMPOSITE and the BENCHMARK MUST be identical when calculating the EX-POST risk measure.
- 5.A.3** FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2000 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2000.
- 5.A.4** Returns for periods of less than one year MUST NOT be annualized.
- 5.A.5** For periods beginning on or after 1 January 2006 and ending prior to 1 January 2011, if a COMPOSITE includes CARVE-OUTS, the FIRM MUST present the percentage of COMPOSITE assets represented by CARVE-OUTS as of each annual period end.
- 5.A.6** If a COMPOSITE includes non-fee-paying PORTFOLIOS, the FIRM MUST present the percentage of COMPOSITE assets represented by non-fee-paying PORTFOLIOS as of each annual period end.
- 5.A.7** If a COMPOSITE includes PORTFOLIOS with BUNDLED FEES, the FIRM MUST present the percentage of COMPOSITE assets represented by PORTFOLIOS with BUNDLED FEES as of each annual period end.

- 5.A.8**
- a** Performance of a past firm or affiliation **MUST** be **LINKED** to or used to represent the historical performance of a new or acquiring **FIRM** if, on a **COMPOSITE**-specific basis:
    - i.** Substantially all of the investment decision makers are employed by the new or acquiring **FIRM** (e.g., research department staff, portfolio managers, and other relevant staff);
    - ii.** The decision-making process remains substantially intact and independent within the new or acquiring **FIRM**; and
    - iii.** The new or acquiring **FIRM** has records that document and support the performance.
  - b** If a **FIRM** acquires another firm or affiliation, the **FIRM** has one year to bring any non-compliant assets into compliance.

### Presentation and Reporting—Recommendations

- 5.B.1** **FIRMS SHOULD** present **GROSS-OF-FEES** returns.
- 5.B.2** **FIRMS SHOULD** present the following items:
- a** Cumulative returns of the **COMPOSITE** and the **BENCHMARK** for all periods;
  - b** Equal-weighted mean and median **COMPOSITE** returns;
  - c** Quarterly and/or monthly returns; and
  - d** Annualized **COMPOSITE** and **BENCHMARK** returns for periods longer than 12 months.
- 5.B.3** For periods prior to 1 January 2011, **FIRMS SHOULD** present the three-year annualized **EX-POST STANDARD DEVIATION** (using monthly returns) of the **COMPOSITE** and the **BENCHMARK** as of each annual period end.
- 5.B.4** For each period for which an annualized **EX-POST STANDARD DEVIATION** of the **COMPOSITE** and the **BENCHMARK** are presented, the corresponding annualized return of the **COMPOSITE** and the **BENCHMARK SHOULD** also be presented.
- 5.B.5** For each period for which an annualized return of the **COMPOSITE** and the **BENCHMARK** are presented, the corresponding annualized **EX-POST STANDARD DEVIATION** (using monthly returns) of the **COMPOSITE** and the **BENCHMARK SHOULD** also be presented.
- 5.B.6** **FIRMS SHOULD** present additional relevant **COMPOSITE**-level **EX-POST** risk measures.
- 5.B.7** **FIRMS SHOULD** present more than 10 years of annual performance in the **COMPLIANT PRESENTATION**.
- 5.B.8** **FIRMS SHOULD** comply with the GIPS standards for all historical periods.
- 5.B.9** **FIRMS SHOULD** update **COMPLIANT PRESENTATIONS** quarterly.

## 6 Real Estate

Unless otherwise noted, the following **REAL ESTATE** provisions supplement the **REQUIRED** and **RECOMMENDED** provisions of the GIPS standards in Sections 0–5.

**REAL ESTATE** provisions were first included in the GIPS standards in 2005 and became effective 1 January 2006. All **COMPLIANT PRESENTATIONS** that included **REAL ESTATE** performance for periods beginning on or after 1 January 2006 were **REQUIRED** to meet all the **REQUIREMENTS** of the **REAL ESTATE** provisions of the 2005 edition of the GIPS standards. The following **REAL ESTATE** provisions are effective 1

January 2011. All REAL ESTATE COMPOSITES that include performance for periods beginning on or after 1 January 2011 MUST comply with all the REQUIREMENTS and SHOULD adhere to the RECOMMENDATIONS of the following REAL ESTATE provisions.

The following investment types are not considered REAL ESTATE and, therefore, MUST follow Sections 0–5 of the Global Investment Performance Standards:

- Publicly traded REAL ESTATE securities;
- Commercial mortgage-backed securities (CMBS); and
- Private debt investments, including commercial and residential loans where the expected return is solely related to contractual interest rates without any participation in the economic performance of the underlying REAL ESTATE.

### *Real Estate—Requirements*

**Input Data—Requirements (the following provisions do not apply: 1.A.3.a, 1.A.3.b, and 1.A.4)**

- 6.A.1** For periods beginning on or after 1 January 2011, REAL ESTATE investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.<sup>6</sup>
- 6.A.2** For periods beginning on or after 1 January 2008, REAL ESTATE investments MUST be valued at least quarterly.<sup>7</sup>
- 6.A.3** For periods beginning on or after 1 January 2010, FIRMS MUST value PORTFOLIOS as of each quarter end or the last business day of each quarter.
- 6.A.4** REAL ESTATE investments MUST have an EXTERNAL VALUATION:
  - a** For periods prior to 1 January 2012, at least once every 36 months.
  - b** For periods beginning on or after 1 January 2012, at least once every 12 months unless client agreements stipulate otherwise, in which case REAL ESTATE investments MUST have an EXTERNAL VALUATION at least once every 36 months or per the client agreement if the client agreement requires EXTERNAL VALUATIONS more frequently than every 36 months.
- 6.A.5** EXTERNAL VALUATIONS must be performed by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser. In markets where these professionals are not available, the FIRM MUST take the necessary steps to ensure that only well-qualified independent property valuers or appraisers are used.

**Calculation Methodology—Requirements (the following provisions do not apply: 2.A.2.a, 2.A.4, and 2.A.7)**

- 6.A.6** FIRMS MUST calculate PORTFOLIO returns at least quarterly.
- 6.A.7** All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.

<sup>6</sup> For periods prior to 1 January 2011, REAL ESTATE investments MUST be valued at MARKET VALUE (as previously defined for REAL ESTATE in the 2005 edition of the GIPS standards).

<sup>7</sup> For periods prior to 1 January 2008, REAL ESTATE investments MUST be valued at least once every 12 months.

- 6.A.8** For periods beginning on or after 1 January 2011, INCOME RETURNS and CAPITAL RETURNS (component returns) MUST be calculated separately using geometrically LINKED TIME-WEIGHTED RATES OF RETURN.
- 6.A.9** COMPOSITE TIME-WEIGHTED RATES OF RETURN, including component returns, MUST be calculated by asset-weighting the individual PORTFOLIO returns at least quarterly.

**Disclosure—Requirements (the following provisions do not apply: 4.A.5, 4.A.6.a, 4.A.15, 4.A.26, 4.A.33, and 4.A.34)**

- 6.A.10** The following items MUST be disclosed in each COMPLIANT PRESENTATION:
  - a** The FIRM'S description of discretion;
  - b** The INTERNAL VALUATION methodologies used to value REAL ESTATE investments for the most recent period;
  - c** For periods beginning on or after 1 January 2011, material changes to valuation policies and/or methodologies;
  - d** For periods beginning on or after 1 January 2011, material differences between an EXTERNAL VALUATION and the valuation used in performance reporting and the reason for the differences;
  - e** The frequency REAL ESTATE investments are valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser;
  - f** When component returns are calculated separately using geometrically LINKED TIME-WEIGHTED RATES OF RETURN; and
  - g** For periods prior to 1 January 2011, if component returns are adjusted such that the sum of the INCOME RETURN and the CAPITAL RETURN equals the TOTAL RETURN.
- 6.A.11** For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
- 6.A.12** When presenting GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.
- 6.A.13** When presenting NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.

**Presentation and Reporting—Requirements (the following provisions do not apply: 5.A.1.i, 5.A.2, and 5.A.3)**

- 6.A.14** FIRMS MUST present component returns in addition to TOTAL RETURNS. COMPOSITE component returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.
- 6.A.15** FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.
- 6.A.16** The following items MUST be presented in each COMPLIANT PRESENTATION:

- a As a measure of INTERNAL DISPERSION, high and low annual TIME-WEIGHTED RATES OF RETURN for the individual PORTFOLIOS in the COMPOSITE. If the COMPOSITE contains five or fewer PORTFOLIOS for the full year, a measure of INTERNAL DISPERSION is not REQUIRED.
- b As of each annual period end, the percentage of COMPOSITE assets valued using an EXTERNAL VALUATION during the annual period.

The following provisions are additional REQUIREMENTS for REAL ESTATE CLOSED-END FUND COMPOSITES:

#### Calculation Methodology—Requirements

- 6.A.17 FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).
- 6.A.18 The SI-IRR MUST be calculated using quarterly cash flows at a minimum.

#### Composite Construction—Requirements

- 6.A.19 COMPOSITES MUST be defined by VINTAGE YEAR and investment mandate, objective, or strategy. The COMPOSITE DEFINITION MUST remain consistent throughout the life of the COMPOSITE.

#### Disclosure—Requirements

- 6.A.20 FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.
- 6.A.21 FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation.
- 6.A.22 FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.

#### Presentation and Reporting—Requirements

- 6.A.23 The following items MUST be presented in each COMPLIANT PRESENTATION:
  - a FIRMS MUST present the NET-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance.
  - b For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES SI-IRR through the initial annual period end.
  - c For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.
- 6.A.24 If the GROSS-OF-FEES SI-IRR of the COMPOSITE is presented in the COMPLIANT PRESENTATION, FIRMS MUST present the GROSS-OF-FEES SI-IRR of the COMPOSITE for the same periods as the NET-OF-FEES SI-IRR is presented.
- 6.A.25 FIRMS MUST present, as of each annual period end:
  - a COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;
  - b COMPOSITE SINCE INCEPTION DISTRIBUTIONS;
  - c COMPOSITE cumulative COMMITTED CAPITAL;
  - d TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI);

- e SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI);
  - f SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and
  - g RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).
- 6.A.26** FIRMS MUST present the SI-IRR of the BENCHMARK through each annual period end. The BENCHMARK MUST:
- a Reflect the investment mandate, objective, or strategy of the COMPOSITE;
  - b Be presented for the same time period as presented for the COMPOSITE; and
  - c Be the same VINTAGE YEAR as the COMPOSITE.

#### *Real Estate—Recommendations*

##### **Input Data—Recommendations (the following provision does not apply: 1.B.1)**

- 6.B.1** For periods prior to 1 January 2012, REAL ESTATE investments SHOULD be valued by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser at least once every 12 months.
- 6.B.2** REAL ESTATE investments SHOULD be valued as of the annual period end by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser.

##### **Disclosure—Recommendations**

- 6.B.3** FIRMS SHOULD disclose the basis of accounting for the PORTFOLIOS in the COMPOSITE (e.g., US GAAP, IFRS).
- 6.B.4** FIRMS SHOULD explain and disclose material differences between the valuation used in performance reporting and the valuation used in financial reporting as of each annual period end.
- 6.B.5** For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

##### **Presentation and Reporting—Recommendations (the following provisions do not apply: 5.B.3, 5.B.4, and 5.B.5)**

- 6.B.6** FIRMS SHOULD present both GROSS-OF-FEES and NET-OF-FEES returns.
- 6.B.7** FIRMS SHOULD present the percentage of the total value of COMPOSITE assets that are not REAL ESTATE as of each annual period end.
- 6.B.8** FIRMS SHOULD present the component returns of the BENCHMARK, if available.

The following provision is an additional RECOMMENDATION for REAL ESTATE CLOSED-END FUND COMPOSITES:

##### **Calculation Methodology—Recommendations**

- 6.B.9** The SI-IRR SHOULD be calculated using daily cash flows.

## 7 Private Equity

Unless otherwise noted, the following PRIVATE EQUITY provisions supplement the REQUIRED and RECOMMENDED provisions of the GIPS standards in Sections 0–5.

PRIVATE EQUITY provisions were first included in the GIPS standards in 2005 and became effective 1 January 2006. All COMPLIANT PRESENTATIONS that included PRIVATE EQUITY performance for periods ending on or after 1 January 2006 were REQUIRED to meet all the REQUIREMENTS of the PRIVATE EQUITY provisions of the 2005 edition of the GIPS standards. The following PRIVATE EQUITY provisions are effective 1 January 2011. All PRIVATE EQUITY COMPOSITES that include performance for periods ending on or after 1 January 2011 MUST comply with all the REQUIREMENTS and SHOULD comply with the RECOMMENDATIONS of the following PRIVATE EQUITY provisions.

The following are provisions that apply to the calculation and presentation of PRIVATE EQUITY investments made by fixed life, fixed commitment PRIVATE EQUITY investment vehicles including PRIMARY FUNDS and FUNDS OF FUNDS. These provisions also apply to fixed life, fixed commitment SECONDARY FUNDS, which MUST apply either the provisions applicable to PRIMARY FUNDS or the provisions applicable to FUNDS OF FUNDS, depending on which form the SECONDARY FUND uses to make investments. PRIVATE EQUITY OPEN-END and EVERGREEN FUNDS MUST follow Sections 0–5 in the Provisions of the Global Investment Performance Standards. REAL ESTATE CLOSED-END FUNDS MUST follow Section 6 in the Provisions of the Global Investment Performance Standards.

### *Private Equity—Requirements*

#### **Input Data—Requirements (the following provisions do not apply: 1.A.3.a, 1.A.3.b, and 1.A.4)**

- 7.A.1** For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.<sup>8</sup>
- 7.A.2** PRIVATE EQUITY investments MUST be valued at least annually.

#### **Calculation Methodology—Requirements (the following provisions do not apply: 2.A.2, 2.A.4, 2.A.6, and 2.A.7)**

- 7.A.3** FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).
- 7.A.4** For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.<sup>9</sup>
- 7.A.5** All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.
- 7.A.6** NET-OF-FEES returns MUST be net of actual INVESTMENT MANAGEMENT FEES (including CARRIED INTEREST).
- 7.A.7** For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.

<sup>8</sup> For periods ending prior to 1 January 2011, PRIVATE EQUITY investments MUST be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in the 2010 edition of the GIPS standards.

<sup>9</sup> For periods ending prior to 1 January 2011, the SI-IRR MUST be calculated using either daily or monthly cash flows.

**Composite Construction—Requirements (the following provision does not apply: 3.A.10)**

- 7.A.8** COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.
- 7.A.9** PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.
- 7.A.10** FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.

**Disclosure—Requirements (the following provisions do not apply: 4.A.5, 4.A.6.a, 4.A.6.b, 4.A.8, 4.A.15, 4.A.26, 4.A.32, 4.A.33, and 4.A.34)**

- 7.A.11** FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.
- 7.A.12** FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.
- 7.A.13** FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.
- 7.A.14** For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.
- 7.A.15** If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.
- 7.A.16** FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.
- 7.A.17** FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.
- 7.A.18** For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.
- 7.A.19** For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.
- 7.A.20** For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

**Presentation and Reporting—Requirements (the following provisions do not apply: 5.A.1.a, 5.A.1.b, 5.A.1.c, 5.A.1.d, 5.A.1.e, 5.A.1.i, 5.A.2, and 5.A.3)**

- 7.A.21** The following items MUST be presented in each COMPLIANT PRESENTATION:
  - a** FIRMS MUST present both the NET-OF-FEES and GROSS-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM's inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.

- b** For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES and GROSS-OF-FEES SI-IRR through the initial annual period end.
  - c** For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES and GROSS-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.
- 7.A.22** For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy, FIRMS MUST also present the SI-IRR of the underlying investments aggregated by VINTAGE YEAR as well as other measures as REQUIRED in 7.A.23. These measures MUST be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES and MUST be presented as of the most recent annual period end.
- 7.A.23** FIRMS MUST present as of each annual period end:
  - a** COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;
  - b** COMPOSITE SINCE INCEPTION DISTRIBUTIONS;
  - c** COMPOSITE cumulative COMMITTED CAPITAL;
  - d** TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI);
  - e** SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI);
  - f** SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and
  - g** RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).
- 7.A.24** FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:
  - a** Reflect the investment mandate, objective, or strategy of the COMPOSITE;
  - b** Be presented for the same time periods as presented for the COMPOSITE; and
  - c** Be the same VINTAGE YEAR as the COMPOSITE.
- 7.A.25** For FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.
- 7.A.26** For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.
- 7.A.27** For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.
- 7.A.28** FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.

*Private Equity—Recommendations***Input Data—Recommendations (the following provision does not apply: 1.B.1)**

**7.B.1** PRIVATE EQUITY investments SHOULD be valued at least quarterly.

**Calculation Methodology—Recommendations (the following provision does not apply: 2.B.2)**

**7.B.2** For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.

**Composite Construction—Recommendations (the following provision does not apply: 3.B.2)****Disclosure—Recommendations**

**7.B.3** FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.

**7.B.4** For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.

**Presentation and Reporting—Recommendations (the following provisions do not apply: 5.B.2, 5.B.3, 5.B.4, and 5.B.5)**

**7.B.5** For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.

**7.B.6** For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.

**7.B.7** For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.

**8 Wrap Fee/Separately Managed Account (SMA) Portfolios**

The following provisions apply to the calculation and presentation of performance when presenting a COMPLIANT PRESENTATION to a WRAP FEE/SMA PROSPECTIVE CLIENT (which includes prospective WRAP FEE/SMA sponsors, prospective WRAP FEE/SMA clients, and existing WRAP FEE/SMA sponsors). Unless otherwise noted, the following WRAP FEE/SMA provisions supplement all the REQUIRED and RECOMMENDED provisions of the GIPS standards in Sections 0–5.

Although there are different types of WRAP FEE/SMA structures, these provisions apply to all WRAP FEE/SMA PORTFOLIOS where there are BUNDLED FEES and the WRAP FEE/SMA sponsor serves as an intermediary between the FIRM and the end user of the investment services. These provisions are not applicable to PORTFOLIOS defined as other types of BUNDLED FEE PORTFOLIOS. These provisions are also not applicable to model PORTFOLIOS that are provided by a FIRM to a WRAP FEE/SMA sponsor if

the FIRM does not have discretionary PORTFOLIO management responsibility for the individual WRAP FEE/SMA PORTFOLIOS. Similarly, a FIRM or overlay manager in a Multiple Strategy Portfolio (MSP) or similar program is also excluded from applying these provisions to such PORTFOLIOS if they do not have discretion.

All WRAP FEE/SMA COMPLIANT PRESENTATIONS that include performance results for periods beginning on or after 1 January 2006 MUST meet all the REQUIREMENTS of the following WRAP FEE/SMA provisions.

### *Wrap Fee/SMA Requirements*

#### **Composite Construction—Requirements**

**8.A.1** FIRMS MUST include the performance record of actual WRAP FEE/SMA PORTFOLIOS in appropriate COMPOSITES in accordance with the FIRM'S established PORTFOLIO inclusion policies. Once established, these COMPOSITES (containing actual WRAP FEE/SMA PORTFOLIOS) MUST be used in the FIRM'S COMPLIANT PRESENTATIONS presented to WRAP FEE/SMA PROSPECTIVE CLIENTS.

#### **Disclosure—Requirements (the following provision does not apply: 4.A.15)**

**8.A.2** For all WRAP FEE/SMA COMPLIANT PRESENTATIONS that include periods prior to the inclusion of an actual WRAP FEE/SMA PORTFOLIO in the COMPOSITE, the FIRM MUST disclose, for each period presented, that the COMPOSITE does not contain actual WRAP FEE/SMA PORTFOLIOS.

**8.A.3** For any performance presented for periods prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.

**8.A.4** When FIRMS present COMPOSITE performance to an existing WRAP FEE/SMA sponsor that includes only that sponsor'S WRAP FEE/SMA PORTFOLIOS (resulting in a "sponsor-specific COMPOSITE"):

- a** FIRMS MUST disclose the name of the WRAP FEE/SMA sponsor represented by the sponsor-specific COMPOSITE; and
- b** If the sponsor-specific COMPOSITE COMPLIANT PRESENTATION is intended for the purpose of generating WRAP FEE/SMA business and does not include performance net of the entire WRAP FEE, the COMPLIANT PRESENTATION MUST disclose that the named sponsor-specific COMPLIANT PRESENTATION is only for the use of the named WRAP FEE/SMA sponsor.

**Presentation and Reporting—Requirements (the following provision does not apply: 5.A.3)**

- 8.A.5** When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, the COMPOSITE presented MUST include the performance of all actual WRAP FEE/SMA PORTFOLIOS, if any, managed according to the COMPOSITE investment mandate, objective, or strategy, regardless of the WRAP FEE/SMA sponsor (resulting in a “style-defined COMPOSITE”).
- 8.A.6** When FIRMS present performance to a WRAP FEE/SMA PROSPECTIVE CLIENT, performance MUST be presented net of the entire WRAP FEE.
- 8.A.7** FIRMS MUST NOT LINK non-GIPS-compliant performance for periods beginning on or after 1 January 2006 to their GIPS-compliant performance. FIRMS may LINK non-GIPS-compliant performance to their GIPS-compliant performance provided that only GIPS-compliant performance is presented for periods beginning on or after 1 January 2006.

## II.

### GIPS VALUATION PRINCIPLES

The GIPS standards are based on the ethical principles of fair representation and full disclosure. In order for the performance calculations to be meaningful, the valuations of PORTFOLIO investments must have integrity and fairly reflect their value. Effective 1 January 2011, the GIPS standards REQUIRE FIRMS to apply a FAIR VALUE methodology following the definition and REQUIREMENTS listed below. The GIPS Valuation Principles, including the definition of FAIR VALUE, were developed with consideration of the work done by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) as well as other organizations.

The shift to a broader FAIR VALUE REQUIREMENT has implications for all FIRMS claiming compliance with the GIPS standards. For liquid securities in active markets, the change to FAIR VALUE from MARKET VALUE will typically not result in a change to valuations. FIRMS MUST use the objective, observable, unadjusted quoted market prices for identical investments on the measurement date, if available.

Markets are not always liquid and investment prices are not always objective and/or observable. For illiquid or hard to value investments, or for investments where no observable MARKET VALUE or market price is available, additional steps are necessary. A FIRM’S valuation policies and procedures MUST address situations where the market prices may be available for similar but not identical investments, inputs to valuations are subjective rather than objective, and/or markets are inactive instead of active. There is a RECOMMENDED valuation hierarchy in Section C below. FIRMS MUST disclose if the COMPOSITE’S valuation hierarchy materially differs from the RECOMMENDED valuation hierarchy.

Although a FIRM may use external third parties to value investments, the FIRM still retains responsibility for compliance with the GIPS standards, including the GIPS Valuation Principles.

FIRMS claiming compliance with the GIPS standards MUST adhere to all the REQUIREMENTS and SHOULD comply with the RECOMMENDATIONS below.

#### Fair Value Definition

FAIR VALUE is defined as the amount at which an investment could be exchanged in a current arm’s length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation MUST be determined using the objective,

observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation **MUST** represent the **FIRM'S** best estimate of the **MARKET VALUE**. **FAIR VALUE MUST** include accrued income.

## Valuation Requirements

**FIRMS MUST** comply with the following valuation **REQUIREMENTS**:

- 1 For periods beginning on or after 1 January 2011, **PORTFOLIOS MUST** be valued in accordance with the definition of **FAIR VALUE** and the GIPS Valuation Principles (Provision 1.A.2) Chapter II.
- 2 **FIRMS MUST** value investments using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available.
- 3 **FIRMS MUST** comply with all applicable laws and regulations regarding the calculation and presentation of performance (Provision 0.A.2). Accordingly, **FIRMS MUST** comply with applicable laws and regulations relating to valuation.
- 4 If the **COMPLIANT PRESENTATION** conforms with laws and/or regulations that conflict with the **REQUIREMENTS** of the GIPS standards, **FIRMS MUST** disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards (Provision 4.A.22). This includes any conflicts between laws and/or regulations and the GIPS Valuation Principles.
- 5 **FIRMS MUST** document their policies and procedures used in establishing and maintaining compliance with the GIPS standards, including ensuring the existence and ownership of client assets, and **MUST** apply them consistently (Provision 0.A.5). Accordingly, **FIRMS MUST** document their valuation policies, procedures, methodologies, and hierarchy, including any changes, and **MUST** apply them consistently.
- 6 **FIRMS MUST** disclose that policies for valuing **PORTFOLIOS**, calculating performance, and preparing **COMPLIANT PRESENTATIONS** are available upon request (Provision 4.A.12).
- 7 For periods beginning on or after 1 January 2011, **FIRMS MUST** disclose the use of subjective unobservable inputs for valuing **PORTFOLIO** investments (as described in the GIPS Valuation Principles) if the **PORTFOLIO** investments valued using subjective unobservable inputs are material to the **COMPOSITE** (Provision 4.A.27).
- 8 For periods beginning on or after 1 January 2011, **FIRMS MUST** disclose if the **COMPOSITE'S** valuation hierarchy materially differs from the **RECOMMENDED** hierarchy in the GIPS Valuation Principles (Provision 4.A.28).

### *Additional Real Estate Valuation Requirements*

- 9 **REAL ESTATE** investments **MUST** have an **EXTERNAL VALUATION** (Provision 6.A.4).
- 10 The **EXTERNAL VALUATION** process **MUST** adhere to practices of the relevant valuation governing and standard setting body.
- 11 The **FIRM MUST NOT** use **EXTERNAL VALUATIONS** where the valuer's or appraiser's fee is contingent upon the investment's appraised value.

- 12 EXTERNAL VALUATIONS must be performed by an independent external PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser. In markets where these professionals are not available, the FIRM MUST take necessary steps to ensure that only well-qualified independent property valuers or appraisers are used (Provision 6.A.5).
- 13 FIRMS MUST disclose the INTERNAL VALUATION methodologies used to value REAL ESTATE investments for the most recent period (Provision 6.A.10.b).
- 14 For periods beginning on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies (Provision 6.A.10.c).
- 15 For periods beginning on or after 1 January 2011, FIRMS MUST disclose material differences between an EXTERNAL VALUATION and the valuation used in performance reporting and the reason for the differences (Provision 6.A.10.d).
- 16 FIRMS MUST present, as of each annual period end, the percentage of COMPOSITE assets valued using an EXTERNAL VALUATION during the annual period (Provision 6.A.16.b).

#### *Additional Private Equity Valuation Requirements*

- 17 The valuation methodology selected MUST be the most appropriate for a particular investment based on the nature, facts, and circumstances of the investment.
- 18 FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period (Provision 7.A.13).
- 19 For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies (Provision 7.A.14).
- 20 If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied (Provision 7.A.15).

### Valuation Recommendations

FIRMS SHOULD comply with the following valuation RECOMMENDATIONS:

- 1 **Valuation Hierarchy:** FIRMS SHOULD incorporate the following hierarchy into the policies and procedures for determining FAIR VALUE for PORTFOLIO investments on a COMPOSITE-specific basis.
  - a Investments MUST be valued using objective, observable, unadjusted quoted market prices for identical investments in active markets on the measurement date, if available. If not available, then investments SHOULD be valued using;
  - b Objective, observable quoted market prices for similar investments in active markets. If not available or appropriate, then investments SHOULD be valued using;
  - c Quoted prices for identical or similar investments in markets that are not active (markets in which there are few transactions for the investment, the prices are not current, or price quotations vary substantially over time and/or between market makers). If not available or appropriate, then investments SHOULD be valued based on;
  - d Market-based inputs, other than quoted prices, that are observable for the investment. If not available or appropriate, then investments SHOULD be valued based on;

- e Subjective unobservable inputs for the investment where markets are not active at the measurement date. Unobservable inputs SHOULD only be used to measure FAIR VALUE to the extent that observable inputs and prices are not available or appropriate. Unobservable inputs reflect the FIRM'S own assumptions about the assumptions that market participants would use in pricing the investment and SHOULD be developed based on the best information available under the circumstances.
- 2 FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 4.B.1).
  - 3 FIRMS SHOULD disclose the key assumptions used to value PORTFOLIO investments (Provision 4.B.4).
  - 4 For periods prior to 1 January 2011, FIRMS SHOULD disclose the use of subjective unobservable inputs for valuing PORTFOLIO investments (as described in the GIPS Valuation Principles in Chapter II) if the PORTFOLIO investments valued using subjective unobservable inputs are material to the COMPOSITE (Provision 4.B.6).
  - 5 Valuations SHOULD be obtained from a qualified independent third party (Provision 1.B.2).

#### ***Additional Real Estate Valuation Recommendations***

- 6 Although appraisal standards may allow for a range of estimated values, it is RECOMMENDED that a single value be obtained from external valuers or appraisers because only one value is used in performance reporting.
- 7 It is RECOMMENDED that the external appraisal firm be rotated every three to five years.
- 8 FIRMS SHOULD explain and disclose material differences between the valuation used in performance reporting and the valuation used in financial reporting as of each annual period end (Provision 6.B.4).
- 9 For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 6.B.5).

#### ***Additional Private Equity Valuation Recommendations***

- 10 FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end (Provision 7.B.3).
- 11 For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies (Provision 7.B.4).
- 12 The following considerations SHOULD be incorporated into the valuation process:
  - a The quality and reliability of the data used in each methodology;
  - b The comparability of enterprise or transaction data;
  - c The stage of development of the enterprise; and
  - d Any additional considerations unique to the enterprise.



## GIPS ADVERTISING GUIDELINES

### Purpose of the GIPS Advertising Guidelines

The GIPS Advertising Guidelines provide FIRMS with options for advertising performance when mentioning the FIRM's claim of compliance. The GIPS Advertising Guidelines do not replace the GIPS standards, nor do they absolve FIRMS from presenting a COMPLIANT PRESENTATION as REQUIRED by the GIPS standards. These guidelines only apply to FIRMS that already satisfy all the REQUIREMENTS of the GIPS standards on a FIRM-wide basis and claim compliance with the GIPS standards in an advertisement. FIRMS that choose to claim compliance in an advertisement MUST follow the GIPS Advertising Guidelines or include a COMPLIANT PRESENTATION in the advertisement.

#### *Definition of Advertisement*

For the purposes of these guidelines, an advertisement includes any materials that are distributed to or designed for use in newspapers, magazines, FIRM brochures, letters, media, websites, or any other written or electronic material addressed to more than one PROSPECTIVE CLIENT. Any written material, other than one-on-one presentations and individual client reporting, distributed to maintain existing clients or solicit new clients for a FIRM is considered an advertisement.

#### *Relationship of GIPS Advertising Guidelines to Regulatory Requirements*

FIRMS advertising performance MUST adhere to all applicable laws and regulations governing advertisements. FIRMS are encouraged to seek legal or regulatory counsel because additional disclosures may be REQUIRED. In cases where applicable laws and/or regulations conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines, FIRMS are REQUIRED to comply with the law or regulation.

The calculation and advertisement of pooled unitized investment vehicles, such as mutual funds and open-ended investment companies, are regulated in most markets. The GIPS Advertising Guidelines are not intended to replace applicable laws and/or regulations when a FIRM is advertising performance solely for a pooled unitized investment vehicle.

#### *Other Information*

The advertisement may include other information beyond what is REQUIRED under the GIPS Advertising Guidelines provided the information is shown with equal or lesser prominence relative to the information REQUIRED by the GIPS Advertising Guidelines and the information does not conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines. FIRMS MUST adhere to the principles of fair representation and full disclosure when advertising and MUST NOT present performance or performance-related information that is false or misleading.

### Requirements of the GIPS Advertising Guidelines

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines MUST disclose the following:

- 1 The definition of the FIRM.
- 2 How a PROSPECTIVE CLIENT can obtain a COMPLIANT PRESENTATION and/or the FIRM's list of COMPOSITE DESCRIPTIONS.
- 3 The GIPS compliance statement for advertisements:

“[Insert name of FIRM] claims compliance with the Global Investment Performance Standards (GIPS®).”

All advertisements that include a claim of compliance with the GIPS standards by following the GIPS Advertising Guidelines and that present performance MUST also disclose the following information, which MUST be taken or derived from a COMPLIANT PRESENTATION:

- 4 The COMPOSITE DESCRIPTION.
- 5 COMPOSITE TOTAL RETURNS according to one of the following:
  - a One-, three-, and five-year annualized COMPOSITE returns through the most recent period with the period-end date clearly identified. If the COMPOSITE has been in existence for less than five years, FIRMS MUST also present the annualized returns since the COMPOSITE INCEPTION DATE. (For example, if a COMPOSITE has been in existence for four years, FIRMS MUST present one-, three-, and four-year annualized returns through the most recent period.) Returns for periods of less than one year MUST NOT be annualized.
  - b Period-to-date COMPOSITE returns in addition to one-, three-, and five-year annualized COMPOSITE returns through the same period of time as presented in the corresponding COMPLIANT PRESENTATION with the period end date clearly identified. If the COMPOSITE has been in existence for less than five years, FIRMS MUST also present the annualized returns since the COMPOSITE INCEPTION DATE (For example, if a COMPOSITE has been in existence for four years, FIRMS MUST present one-, three-, and four-year annualized returns in addition to the period-to-date COMPOSITE return.) Returns for periods of less than one year MUST NOT be annualized.
  - c Period-to-date COMPOSITE returns in addition to five years of annual COMPOSITE returns (or for each annual period since the COMPOSITE INCEPTION DATE if the COMPOSITE has been in existence for less than five years) with the period end date clearly identified. The annual returns MUST be calculated through the same period of time as presented in the corresponding COMPLIANT PRESENTATION.
- 6 Whether returns are presented GROSS-OF-FEES and/or NET-OF-FEES.
- 7 The TOTAL RETURN for the BENCHMARK for the same periods for which the COMPOSITE return is presented. FIRMS MUST present TOTAL RETURNS for the same BENCHMARK as presented in the corresponding COMPLIANT PRESENTATION.
- 8 The BENCHMARK DESCRIPTION.
- 9 If the FIRM determines no appropriate BENCHMARK for the COMPOSITE exists, the FIRM MUST disclose why no BENCHMARK is presented.
- 10 The currency used to express performance.
- 11 The presence, use, and extent of leverage, derivatives, and short positions, if material, including a description of the frequency of use and characteristics of the instruments sufficient to identify risks.
- 12 For any performance presented in an advertisement for periods prior to 1 January 2000 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.
- 13 If the advertisement conforms with laws and/or regulations that conflict with the REQUIREMENTS of the GIPS standards and/or the GIPS Advertising Guidelines, FIRMS MUST disclose this fact and disclose the manner in which the laws and/or regulations conflict with the GIPS standards and/or the GIPS Advertising Guidelines.

## IV.

### VERIFICATION

VERIFICATION is intended to provide a FIRM and its existing clients and PROSPECTIVE CLIENTS additional confidence in the FIRM's claim of compliance with the GIPS standards. VERIFICATION may increase the knowledge of the FIRM's performance measurement team and improve the consistency and quality of the FIRM's COMPLIANT PRESENTATIONS. VERIFICATION may also provide improved internal processes and procedures as well as marketing advantages to the FIRM. Verification does not ensure the accuracy of any specific COMPOSITE presentation.

The GIPS standards RECOMMEND that FIRMS be verified. VERIFICATION brings additional credibility to the claim of compliance and supports the overall guiding principles of fair representation and full disclosure of a FIRM's investment performance.

The VERIFICATION procedures attempt to strike a balance between ensuring the quality, accuracy, and relevance of performance presentations and minimizing the cost to FIRMS.

#### Scope and Purpose of Verification

- 1 VERIFICATION MUST be performed by a qualified independent third party.
- 2 VERIFICATION assesses whether:
  - a The FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and
  - b The FIRM's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
- 3 A single VERIFICATION REPORT is issued with respect to the whole FIRM. VERIFICATION cannot be carried out on a COMPOSITE and, accordingly, does not provide assurance about the performance of any specific COMPOSITE. FIRMS MUST NOT state that a particular COMPOSITE has been "verified" or make any claim to that effect.
- 4 The initial minimum period for which VERIFICATION can be performed is one year (or from FIRM inception date through period end if less than one year) of a FIRM's presented performance. The RECOMMENDED period over which VERIFICATION is performed is that part of the FIRM's performance for which compliance with the GIPS standards is claimed.
- 5 A VERIFICATION REPORT MUST opine that:
  - a The FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis, and
  - b The FIRM's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The FIRM MUST NOT state that it has been verified unless a VERIFICATION REPORT has been issued.
- 6 A principal verifier may accept the work of another verifier as part of the basis for the principal verifier's opinion. A principal verifier may also choose to rely on the audit and/or internal control work of a qualified and reputable independent third party. In addition, a principal verifier may choose to rely on the other audit and/or internal control work performed by the VERIFICATION firm. If reliance on another party's work is planned, the scope of work, including time period covered, results of procedures performed, qualifications, competency, objectivity, and reputation of the other party, MUST be assessed by the principal verifier when making the determination as to whether to place any reliance on

such work. Reliance considerations and conclusions **MUST** be documented by the principal verifier. The principal verifier **MUST** use professional skepticism when deciding whether to place reliance on work performed by another independent third party.

- 7 Sample PORTFOLIO Selection: Verifiers **MUST** subject the entire FIRM to testing when performing VERIFICATION procedures unless reliance is placed on work performed by a qualified and reputable independent third party or appropriate alternative control procedures have been performed by the verifier. Verifiers may use a sampling methodology when performing such procedures. Verifiers **MUST** consider the following criteria when selecting samples:
  - a Number of COMPOSITES at the FIRM;
  - b Number of PORTFOLIOS in each COMPOSITE;
  - c Type of COMPOSITE;
  - d TOTAL FIRM ASSETS;
  - e Internal control structure at the FIRM (system of checks and balances in place);
  - f Number of years being verified; and
  - g Computer applications, software used in the construction and maintenance of COMPOSITES, the use of external performance measurers, and the method of calculating performance.

This list is not all-inclusive and contains only the minimum criteria that **MUST** be considered in the selection and evaluation of a sample. For example, one potentially useful approach would be to include in the sample a PORTFOLIO that has the largest impact on COMPOSITE performance because of its size or because of extremely good or bad performance. Missing or incomplete documents, or the presence of errors, would normally be expected to warrant selecting a larger sample or applying additional VERIFICATION procedures.

- 8 After performing the VERIFICATION, the verifier may conclude that the FIRM is not in compliance with the GIPS standards or that the records of the FIRM cannot support a VERIFICATION. In such situations, the verifier **MUST** issue a statement to the FIRM clarifying why a VERIFICATION REPORT could not be issued. A VERIFICATION REPORT **MUST NOT** be issued when the verifier knows that the FIRM is not in compliance with the GIPS standards or the records of the FIRM cannot support a VERIFICATION.
- 9 The minimum VERIFICATION procedures are described below in Section B. The VERIFICATION REPORT **MUST** state that the VERIFICATION has been conducted in accordance with these VERIFICATION procedures.

## Required Verification Procedures

The following are the minimum procedures that verifiers **MUST** follow when conducting a VERIFICATION. Verifiers **MUST** complete the VERIFICATION in accordance with these procedures prior to issuing a VERIFICATION REPORT to the FIRM:

- 1 Pre-VERIFICATION Procedures:
  - a Knowledge of the GIPS Standards: Verifiers **MUST** understand all the REQUIREMENTS and RECOMMENDATIONS of the GIPS standards, including any updates, Guidance Statements, interpretations, Questions & Answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)) as well as in the *GIPS Handbook*.

- b Knowledge of Regulations: Verifiers **MUST** be knowledgeable of applicable laws and regulations regarding the calculation and presentation of performance and **MUST** consider any differences between these laws and regulations and the GIPS standards.
  - c Knowledge of the FIRM: Verifiers **MUST** gain an understanding of the FIRM, including the corporate structure of the FIRM and how it operates.
  - d Knowledge of the FIRM's Policies and Procedures: Verifiers **MUST** understand the FIRM's policies and procedures for establishing and maintaining compliance with all the applicable REQUIREMENTS and adopted RECOMMENDATIONS of the GIPS standards. The verifier **MUST** obtain a copy of the FIRM's policies and procedures used in establishing and maintaining compliance with the GIPS standards and ensure that all applicable policies and procedures are properly included and adequately documented.
  - e Knowledge of Valuation Basis and Performance Calculations: Verifiers **MUST** understand the policies, procedures, and methodologies used to value PORTFOLIOS and compute investment performance.
- 2 VERIFICATION Procedures:
- a Fundamentals of Compliance: Verifiers **MUST** perform sufficient procedures to determine that:
    - i. The FIRM is, and has been, appropriately defined;
    - ii. The FIRM has defined and maintained COMPOSITES in compliance with the GIPS standards;
    - iii. All the FIRM's actual, fee-paying, discretionary PORTFOLIOS are included in at least one COMPOSITE;
    - iv. The FIRM's definition of discretion has been consistently applied over time;
    - v. At all times, all PORTFOLIOS are included in their respective COMPOSITES and no PORTFOLIOS that belong in a particular COMPOSITE have been excluded;
    - vi. The FIRM's policies and procedures for ensuring the existence and ownership of client assets are appropriate and have been consistently applied;
    - vii. The COMPOSITE BENCHMARK reflects the investment mandate, objective, or strategy of the COMPOSITE;
    - viii. The FIRM's policies and procedures for creating and maintaining COMPOSITES have been consistently applied;
    - ix. The FIRM's list of COMPOSITE DESCRIPTIONS is complete; and
    - x. TOTAL FIRM ASSETS are appropriately calculated and disclosed.
  - b Determination of Discretionary Status of PORTFOLIOS: Verifiers **MUST** obtain a list of all PORTFOLIOS. Verifiers **MUST** select PORTFOLIOS from this list and perform sufficient procedures to determine that the FIRM's classification of the PORTFOLIOS as discretionary or non-discretionary is appropriate by referring to the PORTFOLIO's investment management agreement and/or investment guidelines and the FIRM's policies and procedures for determining investment discretion.
  - c Allocation of PORTFOLIOS to COMPOSITES: Verifiers **MUST** obtain lists of all open (both new and existing) and closed PORTFOLIOS for all COMPOSITES for the periods being verified. Verifiers **MUST** select PORTFOLIOS from these lists and perform sufficient procedures to determine that:

- i. The timing of inclusion in the COMPOSITE is in accordance with policies and procedures of the FIRM.
  - ii. The timing of exclusion from the COMPOSITE is in accordance with policies and procedures of the FIRM.
  - iii. The PORTFOLIO'S investment mandate, objective, or strategy, as indicated by the PORTFOLIO'S investment management agreement, investment guidelines, PORTFOLIO summary, and/or other appropriate documentation, is consistent with the COMPOSITE DEFINITION.
  - iv. PORTFOLIOS are completely and accurately included in COMPOSITES by tracing selected PORTFOLIOS from:
    - a. The PORTFOLIO'S investment management agreement and/or investment management guidelines to the COMPOSITE(s); and
    - b. The COMPOSITE(s) to the PORTFOLIO'S investment management agreement and/or investment guidelines.
  - v. PORTFOLIOS sharing the same investment mandate, objective, or strategy are included in the same COMPOSITE.
  - vi. Movements from one COMPOSITE to another are appropriate and consistent with documented changes to a PORTFOLIO'S investment mandate, objective, or strategy or the redefinition of the COMPOSITE.
- d** Data Review: For selected PORTFOLIOS, verifiers MUST perform sufficient procedures to determine that the treatment of the following items is consistent with the FIRM'S policy:
- i. Classification of PORTFOLIO flows (e.g., receipts, disbursements, dividends, interest, fees, and taxes);
  - ii. Accounting treatment of income, interest, and dividend accruals and receipts;
  - iii. Accounting treatment of taxes, tax reclaims, and tax accruals;
  - iv. Accounting treatment of purchases, sales, and the opening and closing of other positions; and
  - v. Accounting treatment and valuation methodologies for investments, including derivatives.
- e** Performance Measurement Calculation: Recognizing that VERIFICATION does not provide assurance that specific COMPOSITE returns are correctly calculated and presented, verifiers MUST determine that the FIRM has calculated and presented performance in accordance with the FIRM'S policies and procedures. Verifiers MUST perform the following procedures:
- i. Recalculate rates of return for a sample of PORTFOLIOS, determine that an acceptable return formula as REQUIRED by the GIPS standards is used, and determine that the FIRM'S calculations are in accordance with the FIRM'S policies and procedures. The verifier MUST also determine that any fees and expenses are treated in accordance with the GIPS standards and the FIRM'S policies and procedures.
  - ii. Take a sample of COMPOSITE and BENCHMARK calculations to determine the accuracy of all required numerical data (e.g., risk measures, INTERNAL DISPERSION).
  - iii. If a custom BENCHMARK or combination of multiple BENCHMARKS is used, take a sample of the BENCHMARK data used by the FIRM to determine that the calculation methodology has been correctly applied and the data used are consistent with the BENCHMARK disclosure in the COMPLIANT PRESENTATION.

- f **COMPLIANT PRESENTATIONS:** Verifiers **MUST** perform sufficient procedures on a sample of **COMPLIANT PRESENTATIONS** to determine that the presentations include all the information and disclosures **REQUIRED** by the GIPS standards. The information and disclosures **MUST** be consistent with the **FIRM'S** records, the **FIRM'S** documented policies and procedures, and the results of the verifier's procedures.
- g **Maintenance of Records:** The verifier **MUST** maintain sufficient documentation to support all procedures performed supporting the issuance of the **VERIFICATION REPORT**, including all significant judgments and conclusions made by the verifier.
- h **Representation Letter:** The verifier **MUST** obtain a representation letter from the **FIRM** confirming that policies and procedures used in establishing and maintaining compliance with the GIPS standards are as described in the **FIRM'S** policies and procedures documents and have been consistently applied throughout the periods being verified. The representation letter **MUST** confirm that the **FIRM** complies with the GIPS standards for the period being verified. The representation letter **MUST** also contain any other specific representations made to the verifier during the **VERIFICATION**.

## Performance Examinations

In addition to a **VERIFICATION**, a **FIRM** may choose to have a specifically focused **PERFORMANCE EXAMINATION** of a particular **COMPOSITE COMPLIANT PRESENTATION**. However, a **PERFORMANCE EXAMINATION REPORT** **MUST NOT** be issued unless a **VERIFICATION REPORT** has also been issued. The **PERFORMANCE EXAMINATION** may be performed concurrently with the **VERIFICATION**.

A **PERFORMANCE EXAMINATION** is not **REQUIRED** for a **FIRM** to be verified. The **FIRM** **MUST NOT** state that a **COMPOSITE** has been examined unless the **PERFORMANCE EXAMINATION REPORT** has been issued for the specific **COMPOSITE**.

Please see the Guidance Statement on **PERFORMANCE EXAMINATIONS** for additional guidance.

END OPTIONAL  
SEGMENT

## V.

## GIPS GLOSSARY

<b>ACCRUAL ACCOUNTING</b>	The recording of financial transactions as they come into existence rather than when they are paid or settled.
<b>ADDITIONAL INFORMATION</b>	Information that is <b>REQUIRED</b> or <b>RECOMMENDED</b> under the GIPS standards and is not considered <b>SUPPLEMENTAL INFORMATION</b> .
<b>ADMINISTRATIVE FEE</b>	All fees other than <b>TRADING EXPENSES</b> and the <b>INVESTMENT MANAGEMENT FEE</b> . <b>ADMINISTRATIVE FEES</b> include <b>CUSTODY FEES</b> , accounting fees, auditing fees, consulting fees, legal fees, performance measurement fees, and other related fees. (See " <b>BUNDLED FEE</b> ")

<b>ALL-IN FEE</b>	A type of <b>BUNDLED FEE</b> that can include any combination of <b>INVESTMENT MANAGEMENT FEES</b> , <b>TRADING EXPENSES</b> , <b>CUSTODY FEES</b> , and <b>ADMINISTRATIVE FEES</b> . <b>ALL-IN-FEES</b> are client specific and typically offered in certain jurisdictions where asset management, brokerage, and custody services are offered by the same company.
<b>BENCHMARK</b>	A point of reference against which the <b>COMPOSITE</b> 's performance and/or risk is compared.
<b>BENCHMARK DESCRIPTION</b>	General information regarding the investments, structure, and/or characteristics of the <b>BENCHMARK</b> . The description <b>MUST</b> include the key features of the <b>BENCHMARK</b> or the name of the <b>BENCHMARK</b> for a readily recognized index or other point of reference.
<b>BUNDLED FEE</b>	A fee that combines multiple fees into one total or "bundled" fee. <b>BUNDLED FEES</b> can include any combination of <b>INVESTMENT MANAGEMENT FEES</b> , <b>TRADING EXPENSES</b> , <b>CUSTODY FEES</b> , and/or <b>ADMINISTRATIVE FEES</b> . Two examples of <b>BUNDLED FEES</b> are <b>WRAP FEES</b> and <b>ALL-IN-FEES</b> .
<b>CAPITAL EMPLOYED</b> (real estate)	The denominator of the return calculations and is defined as the "weighted-average equity" (weighted-average capital) during the measurement period. <b>CAPITAL EMPLOYED</b> does not include any <b>INCOME RETURN</b> or <b>CAPITAL RETURN</b> earned during the measurement period. Beginning capital is adjusted by weighting the <b>EXTERNAL CASH FLOWS</b> that occurred during the period.
<b>CAPITAL RETURN</b> (real estate)	The change in value of the <b>REAL ESTATE</b> investments and cash and/or cash equivalent assets held throughout the measurement period, adjusted for all capital expenditures (subtracted) and net proceeds from sales (added). The <b>CAPITAL RETURN</b> is computed as a percentage of the <b>CAPITAL EMPLOYED</b> . Also known as "capital appreciation return" or "appreciation return."
<b>CARRIED INTEREST</b> (real estate and private equity)	The profits that <b>GENERAL PARTNERS</b> are allocated from the profits on the investments made by the investment vehicle. Also known as "carry" or "promote."
<b>CARVE-OUT</b>	A portion of a <b>PORTFOLIO</b> that is by itself representative of a distinct investment strategy. It is used to create a track record for a narrower mandate from a multiple-strategy <b>PORTFOLIO</b> managed to a broader mandate. For periods beginning on or after 1 January 2010, a <b>CARVE-OUT</b> <b>MUST</b> be managed separately with its own cash balance.
<b>CLOSED-END FUND</b> (real estate and private equity)	A type of investment vehicle where the number of investors, total <b>COMMITTED CAPITAL</b> , and life are fixed and not open for subscriptions and/or redemptions. <b>CLOSED-END FUNDS</b> have a capital call (drawdown) process in place that is controlled by the <b>GENERAL PARTNER</b> .

*(continued)*

<b>COMMITTED CAPITAL</b> (real estate and private equity)	Pledges of capital to an investment vehicle by investors (LIMITED PARTNERS and the GENERAL PARTNER) or by the FIRM. COMMITTED CAPITAL is typically not drawn down at once but drawn down over a period of time. Also known as “commitments.”
<b>COMPLIANT PRESENTATION</b>	A presentation for a COMPOSITE that contains all the information REQUIRED by the GIPS standards and may also include ADDITIONAL INFORMATION or SUPPLEMENTAL INFORMATION. (See Sample COMPLIANT PRESENTATIONS in Appendix A)
<b>COMPOSITE</b>	An aggregation of one or more PORTFOLIOS managed according to a similar investment mandate, objective, or strategy.
<b>COMPOSITE CREATION DATE</b>	The date when the FIRM first groups one or more PORTFOLIOS to create a COMPOSITE. The COMPOSITE CREATION DATE is not necessarily the same as the COMPOSITE INCEPTION DATE.
<b>COMPOSITE DEFINITION</b>	Detailed criteria that determine the assignment of PORTFOLIOS to COMPOSITES. Criteria may include investment mandate, style or strategy, asset class, the use of derivatives, leverage and/or hedging, targeted risk metrics, investment constraints or restrictions, and/or PORTFOLIO type (e.g., segregated or pooled, taxable versus tax exempt.)
<b>COMPOSITE DESCRIPTION</b>	General information regarding the investment mandate, objective, or strategy of the COMPOSITE. The COMPOSITE DESCRIPTION may be more abbreviated than the COMPOSITE DEFINITION but MUST include all key features of the COMPOSITE and MUST include enough information to allow a PROSPECTIVE CLIENT to understand the key characteristics of the COMPOSITE’s investment mandate, objective, or strategy. (See the Sample List of Composite Descriptions in Appendix C)
<b>COMPOSITE INCEPTION DATE</b>	The initial date of the COMPOSITE’s performance record. The COMPOSITE INCEPTION DATE is not necessarily the same as the COMPOSITE CREATION DATE.
<b>COMPOSITE TERMINATION DATE</b>	The date that the last PORTFOLIO exits a COMPOSITE.
<b>CUSTODY FEE</b>	The fees payable to the custodian for the safekeeping of PORTFOLIO assets. CUSTODY FEES are considered to be ADMINISTRATIVE FEES and typically contain an asset-based portion and a transaction-based portion. The CUSTODY FEE may also include charges for additional services, including accounting, securities lending, and/or performance measurement. Custodial fees that are charged per transaction SHOULD be included in the CUSTODY FEE and not included as part of TRADING EXPENSES.
<b>DIRECT INVESTMENTS</b> (private equity)	Investments made directly in PRIVATE EQUITY investments rather than investments made in fund investment vehicles or cash and/or cash equivalents.

<b>DISTINCT BUSINESS ENTITY</b>	A unit, division, department, or office that is organizationally and functionally segregated from other units, divisions, departments, or offices and that retains discretion over the assets it manages and that should have autonomy over the investment decision-making process. Possible criteria that can be used to determine this include: <ul style="list-style-type: none"> <li>■ being a legal entity,</li> <li>■ having a distinct market or client type (e.g., institutional, retail, private client, etc.), and</li> <li>■ using a separate and distinct investment process.</li> </ul>
<b>DISTRIBUTION</b> (real estate and private equity)	Cash or stock distributed to LIMITED PARTNERS (or investors) from an investment vehicle. DISTRIBUTIONS are typically at the discretion of the GENERAL PARTNER (or the FIRM). DISTRIBUTIONS include both recallable and non-recallable DISTRIBUTIONS.
<b>DPI</b> (real estate and private equity)	SINCE INCEPTION DISTRIBUTIONS divided by SINCE INCEPTION PAID-IN CAPITAL. (See “REALIZATION MULTIPLE”)
<b>EVERGREEN FUND</b> (private equity)	An OPEN-END FUND that allows for on-going subscriptions and/or redemptions by investors.
<b>EX-ANTE</b>	Before the fact.
<b>EX-POST</b>	After the fact.
<b>EXTERNAL CASH FLOW</b>	Capital (cash or investments) that enters or exits a PORTFOLIO.
<b>EXTERNAL VALUATION</b> (real estate)	An assessment of value performed by an independent external third party who is a qualified, PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/ APPRAISER.
<b>FAIR VALUE</b>	The amount at which an investment could be exchanged in a current arm's length transaction between willing parties in which the parties each act knowledgeably and prudently. The valuation MUST be determined using the objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, if available. In the absence of an objective, observable, unadjusted quoted market price for an identical investment in an active market on the measurement date, the valuation MUST represent the FIRM's best estimate of the MARKET VALUE. FAIR VALUE MUST include accrued income.
<b>FEE SCHEDULE</b>	The FIRM's current schedule of INVESTMENT MANAGEMENT FEES OR BUNDLED FEES relevant to the particular COMPLIANT PRESENTATION.
<b>FINAL LIQUIDATION DATE</b> (real estate and private equity)	The date when the last PORTFOLIO in a COMPOSITE is fully distributed.
<b>FIRM</b>	The entity defined for compliance with the GIPS standards. (See “DISTINCT BUSINESS ENTITY”)

*(continued)*

<b>FUND OF FUNDS</b> (private equity)	An investment vehicle that invests in underlying investment vehicles. PRIVATE EQUITY FUNDS OF FUNDS predominately invest in CLOSED-END FUNDS and may make opportunistic DIRECT INVESTMENTS.
<b>GENERAL PARTNER</b> (real estate and private equity)	A class of partner in a LIMITED PARTNERSHIP. The GENERAL PARTNER (GP) retains liability for the actions of the LIMITED PARTNERSHIP. The GENERAL PARTNER is typically the fund manager, and the LIMITED PARTNERS (LPs) are the other investors in the LIMITED PARTNERSHIP. The GENERAL PARTNER earns an INVESTMENT MANAGEMENT FEE that typically includes a percentage of the LIMITED PARTNERSHIP's profits. (See "CARRIED INTEREST")
<b>GROSS-OF-FEES</b>	The return on investments reduced by any TRADING EXPENSES incurred during the period.
<b>GROSS-OF-FEES</b> (real estate and private equity)	The return on investments reduced by any TRANSACTION EXPENSES incurred during the period.
<b>INCOME RETURN</b> (real estate)	The investment income earned on all investments (including cash and cash equivalents) during the measurement period net of all non-recoverable expenditures, interest expense on debt, and property taxes. The INCOME RETURN is computed as a percentage of the CAPITAL EMPLOYED.
<b>INTERNAL DISPERSION</b>	A measure of the spread of the annual returns of individual PORTFOLIOS within a COMPOSITE. Measures may include, but are not limited to, high/low, range, or STANDARD DEVIATION (asset weighted or equal weighted) of PORTFOLIO returns.
<b>INTERNAL VALUATION</b> (real estate)	A FIRM's best estimate of value based on the most current and accurate information available under the circumstances. INTERNAL VALUATION methodologies include applying a discounted cash flow model, using a sales comparison or replacement cost approach, or conducting a review of all significant events (both general market and asset specific) that could have a material impact on the investment.
<b>INVESTMENT MANAGEMENT FEE</b>	A fee payable to the FIRM for the management of a PORTFOLIO. INVESTMENT MANAGEMENT FEES are typically asset based (percentage of assets), performance based (see "PERFORMANCE-BASED FEE"), or a combination of the two but may take different forms as well. INVESTMENT MANAGEMENT FEES also include CARRIED INTEREST.
<b>INVESTMENT MULTIPLE (TVPI)</b> (real estate and private equity)	TOTAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL.
<b>LARGE CASH FLOW</b>	The level at which the FIRM determines that an EXTERNAL CASH FLOW may distort performance if the PORTFOLIO is not valued. FIRMS MUST define the amount in terms of the value of cash/asset flow or in terms of a percentage of the PORTFOLIO assets or the COMPOSITE assets.

<b>LIMITED PARTNER</b> (real estate and private equity)	An investor in a <b>LIMITED PARTNERSHIP</b> . The <b>GENERAL PARTNER</b> is liable for the actions of the <b>LIMITED PARTNERSHIP</b> , and the <b>LIMITED PARTNERS</b> are generally protected from legal actions and any losses beyond their <b>COMMITTED CAPITAL</b> .
<b>LIMITED PARTNERSHIP</b> (real estate and private equity)	The legal structure used by most <b>PRIVATE EQUITY</b> and <b>REAL ESTATE CLOSED-END FUNDS</b> . <b>LIMITED PARTNERSHIPS</b> are usually fixed life investment vehicles. The <b>GENERAL PARTNER</b> manages the <b>LIMITED PARTNERSHIP</b> pursuant to the partnership agreement.
<b>LINK</b>	<p><b>1</b> <i>Mathematical Linking</i>: The method by which sub-period returns are geometrically combined to calculate the period return using the following formula:</p> $\text{Period return} = [(1 + R_1) \times (1 + R_2) \dots (1 + R_n)] - 1,$ <p>where <math>R_1, R_2 \dots R_n</math> are the sub-period returns for sub-period 1 through <math>n</math>, respectively.</p> <p><b>2</b> <i>Presentation Linking</i>: To be visually connected or otherwise associated within a <b>COMPLIANT PRESENTATION</b> (e.g., two pieces of information are <b>LINKED</b> by placing them next to each other).</p>
<b>MARKET VALUE</b>	The price at which investors can buy or sell an investment at a given time multiplied by the quantity held plus any accrued income.
<b>MUST</b>	A provision, task, or action that is mandatory or <b>REQUIRED</b> to be followed or performed. (See “ <b>REQUIRE/REQUIREMENT</b> ”)
<b>MUST NOT</b>	A task or action that is forbidden or prohibited.
<b>NET-OF-FEES</b>	The <b>GROSS-OF-FEES</b> return reduced by <b>INVESTMENT MANAGEMENT FEES</b> (including <b>PERFORMANCE-BASED FEES</b> and <b>CARRIED INTEREST</b> ).
<b>OPEN-END FUND</b> (real estate and private equity)	A type of investment vehicle where the number of investors and the total <b>COMMITTED CAPITAL</b> is not fixed and is open for subscriptions and/or redemptions. (See “ <b>EVERGREEN FUND</b> ”)
<b>PAID-IN CAPITAL</b> (real estate and private equity)	Capital inflows to an investment vehicle. <b>COMMITTED CAPITAL</b> is typically drawn down from <b>LIMITED PARTNERS</b> (or investors) over a period of time through a series of capital calls, which are at the discretion of the <b>GENERAL PARTNER</b> or <b>FIRM</b> . <b>PAID-IN CAPITAL</b> is equal to the amount of <b>COMMITTED CAPITAL</b> that has been drawn down <b>SINCE INCEPTION</b> . <b>PAID-IN CAPITAL</b> includes <b>DISTRIBUTIONS</b> that are subsequently recalled by the <b>GENERAL PARTNER</b> or <b>FIRM</b> and reinvested into the investment vehicle. <i>(continued)</i>
<b>PERFORMANCE-BASED FEE</b>	A type of <b>INVESTMENT MANAGEMENT FEE</b> that is typically based on the performance of the <b>PORTFOLIO</b> on an absolute basis or relative to a <b>BENCHMARK</b> .

<b>PERFORMANCE EXAMINATION</b>	A detailed examination of a specific COMPOSITE'S COMPLIANT PRESENTATION by an independent verifier.
<b>PERFORMANCE EXAMINATION REPORT</b>	A PERFORMANCE EXAMINATION REPORT is issued after a PERFORMANCE EXAMINATION has been performed and opines that a particular COMPOSITE'S COMPLIANT PRESENTATION has been prepared and presented in compliance with the GIPS standards.
<b>PERIODICITY</b>	The length of the time period over which a variable is measured (e.g., a variable that is measured at a monthly PERIODICITY consists of observations for each month).
<b>PIC MULTIPLE</b> (real estate and private equity)	SINCE INCEPTION PAID-IN CAPITAL divided by cumulative COMMITTED CAPITAL.
<b>PORTFOLIO</b>	An individually managed group of investments. A PORTFOLIO may be an account or pooled investment vehicle.
<b>PRIMARY FUND</b> (private equity)	An investment vehicle that makes DIRECT INVESTMENTS rather than investing in other investment vehicles.
<b>PRIVATE EQUITY</b>	Investment strategies include, but are not limited to, venture capital, leveraged buyouts, consolidations, mezzanine and distressed debt investments, and a variety of hybrids, such as venture leasing and venture factoring.
<b>PROFESSIONALLY DESIGNATED, CERTIFIED, OR LICENSED COMMERCIAL PROPERTY VALUER/APPRaiser</b> (real estate)	In Europe, Canada, and parts of Southeast Asia, the predominant professional designation is that of the Royal Institution of Chartered Surveyors (RICS). In the United States, the professional designation is Member [of the] Appraisal Institute (MAI). In addition, each state regulates REAL ESTATE appraisers and registers, licenses, or certifies them based on their experience and test results.
<b>PROPRIETARY ASSETS</b>	Investments owned by the FIRM, the FIRM'S management, and/or the FIRM'S parent company that are managed by the FIRM.
<b>PROSPECTIVE CLIENT</b>	Any person or entity that has expressed interest in one of the FIRM'S COMPOSITE strategies and qualifies to invest in the COMPOSITE. Existing clients may also qualify as PROSPECTIVE CLIENTS for any strategy that is different from their current investment strategy. Investment consultants and other third parties are included as PROSPECTIVE CLIENTS if they represent investors that qualify as PROSPECTIVE CLIENTS.
<b>PUBLIC MARKET EQUIVALENT (PME)</b> (private equity)	The performance of a public market index expressed in terms of an internal rate of return (IRR), using the same cash flows and timing as those of the COMPOSITE over the same time period. A PME can be used as a BENCHMARK by comparing the IRR of a PRIVATE EQUITY COMPOSITE with the PME of a public market index.

<b>REAL ESTATE</b>	Investments in: <ul style="list-style-type: none"> <li>■ wholly owned or partially owned properties;</li> <li>■ commingled funds, property unit trusts, and insurance company separate accounts;</li> <li>■ unlisted, private placement securities issued by private REAL ESTATE investment trusts (REITs) and REAL ESTATE operating companies (REOCs); and</li> <li>■ equity-oriented debt (e.g., participating mortgage loans) or any private interest in a property where some portion of return to the investor at the time of investment is related to the performance of the underlying REAL ESTATE.</li> </ul>
<b>REALIZATION MULTIPLE (DPI)</b> (real estate and private equity)	SINCE INCEPTION DISTRIBUTIONS divided by SINCE INCEPTION PAID-IN CAPITAL.
<b>RECOMMEND/RECOMMENDATION</b>	A suggested provision, task, or action that SHOULD be followed or performed. A RECOMMENDATION is considered to be best practice but is not a REQUIREMENT. (See “SHOULD”)
<b>REQUIRE/REQUIREMENT</b>	A provision, task, or action that MUST be followed or performed. (See “MUST”)
<b>RESIDUAL VALUE</b> (private equity and real estate)	The remaining equity that LIMITED PARTNERS (or investors) have in an investment vehicle at the end of the performance reporting period.
<b>RVPI</b> (real estate and private equity)	RESIDUAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL. (See “UNREALIZED MULTIPLE”)
<b>SECONDARY FUND</b> (private equity)	An investment vehicle that buys interests in existing investment vehicles.
<b>SETTLEMENT DATE ACCOUNTING</b>	Recognizing the asset or liability on the date when the exchange of cash and investments is completed.
<b>SHOULD</b>	A provision, task, or action that is RECOMMENDED to be followed or performed and is considered to be best practice but is not REQUIRED. (See “RECOMMEND/RECOMMENDATION”)
<b>SIGNIFICANT CASH FLOW</b>	The level at which the FIRM determines that a client-directed EXTERNAL CASH FLOW may temporarily prevent the FIRM from implementing the COMPOSITE strategy. The measure of significance MUST be determined as either a specific monetary amount (e.g., €50,000,000) or a percentage of PORTFOLIO assets (based on the most recent valuation).
<b>SINCE INCEPTION</b> (real estate and private equity)	From the initial cash flow of a COMPOSITE.
<b>SINCE INCEPTION INTERNAL RATE OF RETURN (SI-IRR)</b> (real estate and private equity)	The internal rate of return (IRR) is the implied discount rate or effective compounded rate of return that equates the present value of cash outflows with the present value of cash inflows. The SI-IRR is a special case of the IRR that equates the present value of all cash flows (capital calls and DISTRIBUTIONS) with the period end value. The SI-IRR is always annualized except when the reporting period is less than one year, in which case the SI-IRR is not annualized.

*(continued)*

<b>STANDARD DEVIATION</b>	A measure of the variability of returns. As a measure of INTERNAL DISPERSION, STANDARD DEVIATION quantifies the distribution of the returns of the individual PORTFOLIOS within the COMPOSITE. As a measure of historical risk, STANDARD DEVIATION quantifies the variability of the COMPOSITE and/or BENCHMARK returns over time. Also referred to as “external STANDARD DEVIATION.”
<b>SUB-ADVISOR</b>	A third-party investment manager hired by the FIRM to manage some or all of the assets for which a FIRM has investment management responsibility.
<b>SUPPLEMENTAL INFORMATION</b>	Any performance-related information included as part of a COMPLIANT PRESENTATION that supplements or enhances the REQUIRED and/or RECOMMENDED provisions of the GIPS standards.
<b>TEMPORARY NEW ACCOUNT</b>	An account for temporarily holding client-directed EXTERNAL CASH FLOWS until they are invested according to the COMPOSITE strategy or disbursed. FIRMS can use a TEMPORARY NEW ACCOUNT to remove the effect of a SIGNIFICANT CASH FLOW on a PORTFOLIO. When a SIGNIFICANT CASH FLOW occurs in a PORTFOLIO, the FIRM may direct the EXTERNAL CASH FLOW to a TEMPORARY NEW ACCOUNT according to the COMPOSITE’S SIGNIFICANT CASH FLOW policy.
<b>TIME-WEIGHTED RATE OF RETURN</b>	A method of calculating period-by-period returns that negates the effects of EXTERNAL CASH FLOWS.
<b>TOTAL FIRM ASSETS</b>	All discretionary and non-discretionary assets for which a FIRM has investment management responsibility. TOTAL FIRM ASSETS includes assets assigned to a SUB-ADVISOR provided the FIRM has discretion over the selection of the SUB-ADVISOR.
<b>TOTAL RETURN</b>	The rate of return that includes the realized and unrealized gains and losses plus income for the measurement period.
<b>TOTAL RETURN (real estate)</b>	The rate of return, including all CAPITAL RETURN and INCOME RETURN components, expressed as a percentage of the CAPITAL EMPLOYED over the measurement period.
<b>TOTAL VALUE (real estate and private equity)</b>	RESIDUAL VALUE plus DISTRIBUTIONS.
<b>TRADE DATE ACCOUNTING</b>	Recognizing the asset or liability on the date of the purchase or sale and not on the settlement date. Recognizing the asset or liability within three days of the date the transaction is entered into (trade date, T+1, T+2, or T+3) satisfies the TRADE DATE ACCOUNTING REQUIREMENT for purposes of the GIPS standards. (See “SETTLEMENT DATE ACCOUNTING”)
<b>TRADING EXPENSES</b>	The actual costs of buying or selling investments. These costs typically take the form of brokerage commissions, exchange fees and/or taxes, and/or bid–offer spreads from either internal or external brokers. Custodial fees charged per transaction SHOULD be considered CUSTODY FEES and not TRADING EXPENSES.

<b>TRANSACTION EXPENSES</b> (real estate and private equity)	All actual legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing PORTFOLIO investments as well as TRADING EXPENSES, if any.
<b>TVPI</b> (real estate and private equity)	TOTAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL. (See “INVESTMENT MULTIPLE”)
<b>UNREALIZED MULTIPLE (RVPI)</b> (real estate and private equity)	RESIDUAL VALUE divided by SINCE INCEPTION PAID-IN CAPITAL.
<b>VERIFICATION</b>	A process by which an independent verifier assesses whether <ol style="list-style-type: none"> <li>1 the FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and</li> <li>2 the FIRM’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.</li> </ol>
<b>VERIFICATION REPORT</b>	A VERIFICATION REPORT is issued after a VERIFICATION has been performed and opines that the FIRM has complied with all the COMPOSITE construction REQUIREMENTS of the GIPS standards on a FIRM-wide basis and that the FIRM’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.
<b>VINTAGE YEAR</b> (real estate and private equity)	Two methods used to determine VINTAGE YEAR are: <ol style="list-style-type: none"> <li>1 the year of the investment vehicle’s first draw-down or capital call from its investors; or</li> <li>2 the year when the first COMMITTED CAPITAL from outside investors is closed and legally binding.</li> </ol>
<b>WRAP FEE</b>	WRAP FEES are a type of BUNDLED FEE and are specific to a particular investment product. The WRAP FEE is charged by a WRAP FEE sponsor for investment management services and typically includes associated TRADING EXPENSES that cannot be separately identified. WRAP FEES can be all-inclusive, asset-based fees and may include a combination of INVESTMENT MANAGEMENT FEES, TRADING EXPENSES, CUSTODY FEES, and/or ADMINISTRATIVE FEES. A WRAP FEE PORTFOLIO is sometimes referred to as a “separately managed account” (SMA) or “managed account.”

## APPENDIX A: SAMPLE COMPLIANT PRESENTATIONS

### SAMPLE 1 INVESTMENT FIRM BALANCED GROWTH COMPOSITE

1 January 2002 through 31 December 2011

Year	Composite Gross Return (%)	Composite Net Return (%)	Custom		Number of Portfolios	Internal Dispersion (%)	Composite Assets (\$ M)	Firm Assets (\$ M)	
			Benchmark Return (%)	Composite 3-Yr St Dev (%)					Benchmark 3-Yr St Dev (%)
2002	-10.5	-11.4	-11.8		31	4.5	165	236	
2003	16.3	15.1	13.2		34	2.0	235	346	
2004	7.5	6.4	8.9		38	5.7	344	529	
2005	1.8	0.8	0.3		45	2.8	445	695	
2006	11.2	10.1	12.2		48	3.1	520	839	
2007	6.1	5.0	7.1		49	2.8	505	1,014	
2008	-21.3	-22.1	-24.9		44	2.9	475	964	
2009	16.5	15.3	14.7		47	3.1	493	983	
2010	10.6	9.5	13.0		51	3.5	549	1,114	
2011	2.7	1.7	0.4	7.1	7.4	54	2.5	575	1,236

Sample 1 Investment Firm claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 1 Investment Firm has been independently verified for the periods 1 January 2000 through 31 December 2010. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

*Notes:*

- 1 Sample 1 Investment Firm is a balanced portfolio investment manager that invests solely in US-based securities. Sample 1 Investment Firm is defined as an independent investment management firm that is not affiliated with any parent organization. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- 2 The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap US equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50–70%, the typical allocation is between 55–65%. The account minimum for the composite is \$5 million.

- 3 The custom benchmark is 60% YYY US Equity Index and 40% ZZZ US Aggregate Bond Index. The benchmark is rebalanced monthly.
- 4 Valuations are computed and performance is reported in US dollars.
- 5 Gross-of-fees returns are presented before management and custodial fees but after all trading expenses. Composite and benchmark returns are presented net of non-reclaimable withholding taxes. Net-of-fees returns are calculated by deducting the highest fee of 0.83% from the monthly gross composite return. The management fee schedule is as follows: 1.00% on the first \$25 million; 0.60% thereafter.
- 6 This composite was created in February 2000. A complete list of composite descriptions is available upon request.
- 7 Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year.
- 8 The three-year annualized standard deviation measures the variability of the composite and the benchmark returns over the preceding 36-month period. The standard deviation is not presented for 2002 through 2010 because monthly composite and benchmark returns were not available and is not required for periods prior to 2011.

## SAMPLE 2 ASSET MANAGEMENT COMPANY ACTIVE WORLD EQUITY COMPOSITE

**Creation Date: 1 July 2005**

**Reporting Currency: EUR**

Year	Gross Return (%)	XYZ World Index Return (%)	Dispersion (Range) (%)	# of Portfolios	Composite Assets (€ M)	% of Firm Assets (%)
2011	-1.9	-0.5	0.2	6	224.9	2.1
2010	16.3	13.5	0.7	8	256.7	2.0
2009	29.0	25.8	1.5	8	205.6	1.9
2008	-39.8	-36.4	1.3	7	164.1	1.5
2007	-2.8	-2.7	n/a	≤ 5	143.7	1.2
2006	9.3	7.5	n/a	≤ 5	62.8	0.4
2005*	14.2	12.6	n/a	≤ 5	16.1	< 0.1

\*Returns are for the period from 1 July 2005 (inception date) through 31 December 2005.

### Compliance Statement

Sample 2 Asset Management Company claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 2 Asset Management Company has not been independently verified.

### Definition of the Firm

Sample 2 Asset Management Company is an independent investment management firm that was established in 1997. Sample 2 Asset Management Company manages a variety of equity, fixed-income, and balanced assets for primarily European clients.

**Policies**

Sample 2 Asset Management Company's policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

**Composite Description**

The Active World Equity Composite includes accounts whose objective is to exceed the XYZ World Index by 2% over a rolling three-year period. Securities are selected using the firm's proprietary analytics tool, which selects securities expected to be the top performers from within the XYZ World Index universe. Portfolios are more concentrated, typically holding approximately 100–120 securities, versus the benchmark, which reflects the performance of more than 500 holdings. Composite returns may, therefore, have a lower correlation with the benchmark than a more diversified global equity strategy.

**Benchmark**

The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ country-specific developed market indexes. Sources of foreign exchange rates may be different between the composite and the benchmark; however, there have not been material differences to date. Benchmark returns are net of withholding taxes.

**Fees**

Returns are presented gross of management fees, custodial fees, and withholding taxes but net of all trading expenses.

**List of Composites**

A list of all composite descriptions is available upon request.

**Fee Schedule**

The standard fixed management fee for accounts with assets under management of up to €50 million is 0.35% per annum; 0.25% thereafter.

**Minimum Account Size**

The minimum portfolio size for inclusion in the composite is €1 million.

**Internal Dispersion**

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross-of-fees returns of those portfolios that were included in the composite for the entire year. For those years when less than six portfolios were included in the composite for the full year, no dispersion measure is presented.

**Ex-Post Standard Deviation**

The three-year annualized ex-post standard deviation of the composite and benchmark as of each year end is as follows:

Year	Composite 3-Yr St Dev (%)	Benchmark 3-Yr St Dev (%)
2011	12.9	14.6
2010	13.2	14.1
2009	17.0	16.3
2008	15.6	14.2

## SAMPLE 3 REAL ESTATE: OPEN-END FUNDS/SEPARATE ACCOUNTS

**Real Estate Advisors Value-Added Strategy Composite  
 Schedule of Performance Results 1 January 2002 through 31 December 2011**

Year	Composite Gross-of-Fees Returns					Composite Net-of-Fees Returns	Value-Added Benchmark Returns (Open-End Funds/ Separate Accounts)			Composite Statistics at Year End				
	Income Return (%)	Capital Return (%)	Total Return (%)	Low (%)	High (%)	Total Return (%)	Income Return (%)	Capital Return (%)	Total Return (%)	# of Portfolios	Composite Assets (HKD Million)	External Appraisal % of Composite Assets	Total Firm Assets (HKD Million)	Non-Real Estate % of Composite Assets
	2002	7.9	1.9	9.9	n/a	n/a	8.8	8.4	-1.6	7.1	≤ 5	3,085	25	13,919
2003	8.5	2.9	11.7	5.8	20.4	10.5	8.0	1.0	9.2	6	3,294	25	14,911	0
2004	8.2	2.6	10.9	5.5	19.2	8.3	7.5	6.7	14.4	7	3,348	44	15,144	0
2005	6.6	11.2	18.1	9.0	31.6	16.6	6.8	12.7	19.7	7	3,728	72	19,794	0
2006	6.1	7.9	14.2	7.1	24.9	12.5	6.2	9.9	16.3	8	4,022	46	20,482	0
2007	5.4	8.0	13.7	6.8	23.9	11.8	5.6	9.9	15.6	7	4,348	33	24,219	0
2008	5.2	-11.4	-6.6	-9.8	-1.6	-8.2	5.1	-11.1	-5.9	7	3,836	100	21,447	0
2009	7.5	2.7	10.3	5.2	18.1	7.4	7.3	3.2	10.8	7	3,371	52	16,601	0
2010	7.2	1.7	9.0	4.2	19.5	6.9	7.8	3.1	11.1	7	2,852	38	4,516	0
2011	7.2	2.8	10.2	5.1	17.8	8.1	7.1	3.2	10.6	7	3,457	50	17,414	5
<b>Annualized Returns (%)</b>														
3 Year	7.3	1.9	9.8			7.5	7.4	3.2	10.8					
5 Year	6.5	2.9	7.1			5.0	6.6	1.4	8.2					
7 Year	6.4	2.6	9.6			7.6	6.6	4.2	10.9					
10 Year	7.0	11.2	10.0			8.1	7.0	3.5	10.7					
Since Inception	7.0	7.9	10.0			8.1	7.0	3.5	10.7					

## Disclosures

### Compliance Statement

Sample 3 Real Estate Advisors claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 3 Real Estate Advisors has been independently verified for the periods 1 January 2006 through 31 December 2011. The verification reports are available upon request.

Verification assesses whether 1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and 2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

### The Firm

Sample 3 Real Estate Advisors (the "Firm"), a subsidiary of Sample 3 Capital, Inc., is based in Hong Kong and manages international real estate strategies. A list of the Firm's composite descriptions is available upon request.

### The Composite

The Value-Added Strategy Composite consists of all discretionary open-end funds and separate accounts managed by the Firm using a value-added investment strategy with an equal income and appreciation focus and having a minimum portfolio size of HKD 10 million. Portfolio management will invest in only Asian multi-family, office, industrial, and retail property types that require correction or mitigation of the investments' operating, financial, redevelopment, and/or

management risk(s). A moderate level of leverage ranging between 30% and 40% is used. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources.

The composite was created on 1 January 2006. The returns presented for periods prior to 2006 are not in compliance with the GIPS standards. Annual internal dispersion is presented using the high and low gross total returns for those portfolios that have been in the composite for the entire year.

#### ***Description of Discretion***

The Firm has responsibility for sourcing, valuing, and managing the acquisition and disposition of assets. Although some of the Firm's separate accounts require client approval for the acquisition and disposition of assets, the Firm defines such portfolios as discretionary because its recommendations are consistent with the investment strategy and such client approvals are typically perfunctory.

#### ***Valuation***

Real estate assets are internally valued by the Firm quarterly. For periods prior to 1 January 2011, assets were externally appraised by an independent appraiser at least every 36 months. Beginning 1 January 2011, assets are externally appraised annually unless client agreements stipulate otherwise, in which case such assets are appraised at least every 36 months or per the client agreement if the client agreement requires external valuation more frequently than every 36 months. The percentage of composite assets valued using an external valuation is shown for each annual period. When market circumstances dictate, the Firm may increase the frequency of external appraisals. All valuations are performed as of calendar quarter-ends.

Internal property valuations are determined by applying market discount rates to future projections of gross cash flows and capitalized terminal values over the expected holding period for each asset. To the extent leverage (debt) is used, the debt is valued separately from the real estate. Property mortgages, notes, and loans are marked to market using prevailing interest rates for comparable property loans if the terms of existing loans preclude the immediate repayment of such loans. Due to the nature of real estate investments, valuations are based upon subjective unobservable inputs.

#### ***Basis of Accounting***

All funds in the composite report their assets and liabilities on a fair value basis using International Financial Reporting Standards (IFRS).

#### ***Calculation of Performance Returns***

Returns are presented in Hong Kong dollars and are net of leverage. Net-of-fee returns are net of actual investment management fees including incentive fees, which are recorded on an accrual basis. Returns include cash and cash equivalents and related interest income.

Capital expenditures, tenant improvements, and lease commissions are capitalized, included in the cost of property, and reflected in the capital return component. Income and capital returns may not equal total returns due to the compounding linking of quarterly returns. Composite returns are calculated quarterly on an asset-weighted basis using beginning-of-period values. Annual returns are calculated by linking quarterly composite returns.

Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

**Investment Management Fees**

Some of the funds in the composite pay incentive fees ranging between 10% and 20% of profits in excess of a targeted SI-IRR. The standard annual investment management fee schedule for separately managed institutional accounts is as follows:

Up to HKD 30 million:	1.6%
HKD 30–50 million:	1.3%
Over HKD 50 million:	1.0%

**Benchmark**

The benchmark is the Value-Added Open-End Fund/Separate Account Index (the “Benchmark”). The Benchmark returns have been taken from published sources. The Benchmark is leveraged, includes various real estate property types, and excludes cash, cash equivalents, and other non-property-related assets, liabilities, income, and expenses. The extent of leverage used by the Benchmark may be different from that of the portfolios in the composite. As of 31 December 2011, the Benchmark leverage was 52%.

**SAMPLE 4 REAL ESTATE: CLOSED-END FUND**
**2006 Value-Added Strategy Closed-End Fund Composite  
Schedule of Performance Results 1 April 2006 through 31 December 2011**

Year	Composite Gross TWR			Composite NET TWR	Benchmark			# of Portfolios	Composite at Year-End						
	Income Return (%)	Capital Return (%)	Total Return (%)	Total Return (%)	Income Return (%)	Capital Return (%)	Total Return (%)		Composite Assets (U.S. Million)	Leverage (%)	External Appraisal % of Composite Assets	Total Firm Assets (U.S. Million)	% of Firm Assets	Non-Real Estate % of Composite Assets	
4/06–12/06	-3.2	0.8	-2.5	-4.0	4.9	2.2	7.2	1	70	40	35	2,641	20	0	
2007	2.5	3.4	6.0	4.5	5.8	1.1	7.1	1	164	45	28	3,125	18	0	
2008	6.2	1.9	8.2	6.7	6.9	3.8	10.9	1	215	50	100	2,754	18	0	
2009	7.4	30.7	38.6	36.1	7.0	10.2	17.4	1	256	53	44	2,142	21	0	
2010	6.6	-13.7	-7.3	-8.8	6.1	-8.8	-2.5	1	111	57	28	1,873	19	0	
2011	5.8	-1.5	4.3	2.8	5.4	-2.6	3.0	1	112	60	85	2,247	20	15	

Year	Gross SI-IRR	Net SI-IRR	Total Committed Capital	Paid-In Capital	Cumulative Distributions	TVPI	DPI	RVPI	PIC
			(U.S. Million)	(U.S. Million)	(U.S. Million)	Multiple	Multiple	Multiple	Multiple
4/06–12/06	-2.3	-3.1	250	71	0	0.99	0.00	0.99	0.28
2007	3.7	2.2	250	161	1	1.02	0.01	1.02	0.64
2008	5.8	4.2	250	226	26	1.07	0.12	0.95	0.90
2009	18.5	15.2	250	236	76	1.41	0.32	1.08	0.94
2010	11.5	9.8	250	240	201	1.30	0.84	0.46	0.96
2011	10.8	9.1	250	245	208	1.31	0.85	0.46	0.98

TVPI (investment multiple) = total value to paid-in capital

DPI (realization multiple) = cumulative distributions to paid-in capital

RVPI (unrealized multiple) = residual value to paid-in capital

PIC (PIC multiple) = paid-in capital to committed capital

## **Disclosures**

### ***Compliance Statement***

Sample 4 Real Estate Managers claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 4 Real Estate Managers has been independently verified for the periods 1 January 2006 through 31 December 2011. The verification reports are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

### ***The Firm***

Sample 4 Real Estate Managers (the "Firm") is a registered investment adviser under the Investment Advisers Act of 1940. A list of the Firm's composite descriptions is available upon request.

### ***The Composite***

The 2006 Value-Added Strategy Closed-End Fund Composite includes a single closed-end commingled fund managed by the Firm using a value-added investment strategy with a focus on both income and appreciation. Portfolio management intends to invest in properties located in major markets within the United States with higher operational risk than traditional property types. The target level of leverage is 50% with a maximum allowable level of 60%. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The composite was created on 1 January 2006. The composite vintage year is 2006, which was determined based on the fund's first capital call in April 2006.

### ***Description of Discretion***

The Firm has complete discretion for all investment activities within the fund.

### ***Valuation***

Real estate investments are internally valued by the Firm quarterly. For periods prior to 1 January 2011, investments were externally appraised by an independent appraiser at least every 36 months. Beginning 1 January 2011, assets are externally appraised annually. The percentage of composite assets valued using an external valuation is shown for each annual period. When market circumstances dictate, the Firm may increase the frequency of external appraisals. All valuations are performed as of calendar quarter-ends. Internal investment valuations are determined by applying market discount rates to future projections of net cash flows (gross real estate cash flows less debt service) and capitalized terminal values over the expected holding period for each asset. Due to the nature of real estate investments, valuations are based upon subjective unobservable inputs.

### ***Basis of Accounting***

All assets and liabilities are reported on a fair value basis using US Generally Accepted Accounting Principles for non-operating companies.

**Calculation of Performance Returns and Metrics**

Returns are presented in US dollars and are net of leverage. Net-of-fee returns are net of actual investment management fees, including incentive fees, which are recorded on an accrual basis.

Capital expenditures, tenant improvements, and lease commissions are capitalized, included in the cost of property, and reflected in the capital return component. Income and capital returns may not equal total returns due to the compounding linking of quarterly returns. Composite time-weighted returns are calculated quarterly on an asset-weighted basis using beginning-of-period values. Annual returns are calculated by linking quarterly composite returns.

SI-IRRs are calculated using quarterly cash flows through 2010 and daily cash flows starting in 2011.

Policies for valuing portfolios, calculating performance, and preparing presentations are available upon request.

**Investment Management Fees**

The fund pays an incentive fee of 15% of profits if the SI-IRR exceeds a preferred return to investors of 11%. The incentive fee is calculated annually. The standard annual investment management fee schedule for separately managed institutional accounts is as follows:

Up to \$100 million:	1.50%
Over \$100 million:	1.25%

**Benchmark**

The benchmark is the Value-Added Closed-End Fund Index (the “Benchmark”). The Benchmark is a time-weighted return index and returns have been taken from published sources. The Benchmark is leveraged and includes various real estate investment and property types, cash and other non-property-related assets, liabilities, income, and expenses. The extent of leverage used by the Benchmark may be different from that of the fund in the composite. As of 31 December 2011, the Benchmark leverage was 60%. There is no SI-IRR benchmark available for the 2006 vintage year.

**SAMPLE 5 PRIVATE EQUITY: FUND OF FUNDS BY INVESTMENT STRATEGY**

**ABC Fund of Funds Manager, LLC**  
**2006 Buyout Strategy Fund of Funds Composite**  
**Results Reported as of Calendar Year End**

<b>Year End</b>	<b># of Portfolios</b>	<b>Gross-of-Fees SI-IRR (%)</b>	<b>Net-of-Fees SI-IRR (%)</b>	<b>Benchmark SI-IRR (%)</b>	<b>Composite Assets (\$ Mil)</b>	<b>Composite % of Firm Assets</b>
2006*	8	26.9	26.4	17.2	2,336	80.8
2007	10	18.5	17.8	10.2	2,512	83.6
2008	11	18.7	18.1	11.0	3,227	84.2
2009	13	19.6	18.9	11.5	4,518	84.8
2010	13	20.7	20.1	11.8	6,330	85.2
2011	13	21.9	21.3	11.8	9,269	86.0

*(continued)*

**(Continued)**

Year End	# of Portfolios	Gross-of-Fees SI-IRR (%)	Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)	Composite Assets (\$ Mil)	Composite % of Firm Assets
2012	14	22.2	21.7	12.3	12,286	86.4
2013	14	15.1	14.4	9.6	12,346	87.7

\*Partial year from 15 April 2006 (inception) through 31 December 2006.

Year End	Paid-In Capital (\$ Mil)	Cumulative Committed Capital (\$ Mil)	Since Inception Distributions	Investment Multiple (TVPI)	Realization Multiple (DPI)	Unrealized Multiple (RVPI)	PIC Multiple (PIC)
2006	1,556	3,177	1,205	1.5	0.8	0.7	0.48
2007	1,908	3,675	1,341	1.3	0.7	0.6	0.51
2008	2,371	5,166	1,623	1.4	0.7	0.7	0.45
2009	3,254	6,401	2,186	1.4	0.7	0.7	0.50
2010	4,400	8,370	2,950	1.4	0.7	0.8	0.51
2011	6,303	11,344	4,138	1.5	0.7	0.8	0.54
2012	8,167	13,713	6,513	1.5	0.8	0.7	0.69
2013	9,651	15,290	7,091	1.3	0.7	0.5	0.71

**Aggregate Performance of Underlying Investments by Vintage Year**  
Results Reported as of 31 December 2013

Vintage Year	Gross-of-Fees Annualized SI-IRR (%)	Benchmark SI-IRR (%)
2006	22.3	2.5
2007	13.4	1.9
2008	26.0	7.1
2009	18.1	3.9
2010	0.7	1.0
2011	-16.2	-7.5
2012	-25.6	-19.9
2013	-49.9	-40.3

Vintage Year	Paid-In Capital (\$ Mil)	Cumulative Committed Capital (\$ Mil)	Since Inception Distributions (\$ Mil)	Investment Multiple (TVPI)	Realization Multiple (DPI)	Unrealized Multiple (RVPI)	PIC Multiple (PIC)
2006	731	724	939	3.0	1.3	1.7	1.0
2007	710	234	294	1.8	0.4	1.3	3.0
2008	1,475	1,220	1,442	2.0	1.0	1.0	1.2

Vintage Year	Paid-In Capital (\$ Mil)	Cumulative Committed Capital (\$ Mil)	Since Inception Distributions (\$ Mil)	Investment Multiple (TVPI)	Realization Multiple (DPI)	Unrealized Multiple (RVPI)	PIC Multiple (PIC)
2009	1,640	1,048	1,156	1.9	0.7	1.2	1.6
2010	1,896	3,695	1,124	1.9	0.6	1.4	0.5
2011	1,984	4,518	1,100	2.1	0.6	1.5	0.4
2012	680	1,998	938	2.2	1.4	0.8	0.3
2013	535	1,853	100	1.1	0.2	0.9	0.3

TVPI (investment multiple) = total value to paid-in capital

DPI (realization multiple) = cumulative distributions to paid-in capital

RVPI (unrealized multiple) = residual value to paid-in capital

PIC (PIC multiple) = paid-in capital to committed capital

### **Compliance Statement**

ABC Fund of Funds Manager, LLC, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. ABC Fund of Funds Manager, LLC, has been independently verified for the periods 15 April 2006 through 31 December 2012.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. The verification report is available upon request.

### **The Firm**

ABC Fund of Funds Manager, LLC, is an independent private equity investment firm with offices in New York, London, and Tokyo. The firm's list of composite descriptions, as well as information regarding the firm's policies for valuing investments, calculating performance, and preparing compliant presentations, are available upon request.

### **The Composite**

The 2006 Buyout Strategy Fund of Funds Composite includes primary and secondary partnership investments with strategies focused on leveraged and growth-oriented buyouts primarily in the United States. Managers of partnerships are expected to focus on reducing costs, preparing companies for downturn, and providing operational improvement rather than financial engineering. Investments may be in small, medium, and large buyout partnerships, aiming to make selective commitments diversifying across stages, industries, and vintage years. Secondary deals take advantage of distressed primary partnership sales providing access to an increased mix of assets. The underlying funds are leveraged 100–300%. Private equity investments are illiquid and, therefore, if investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The composite was created on 31 December 2006. The vintage year is 2006 and was determined by the initial subscription date of the fund of funds.

**Valuation**

The firm uses valuations reported by the general partner of the investment partnerships. Given the nature of the investments, all valuations are determined using both subjective observable and subjective unobservable inputs.

**Calculation of Performance Returns**

The fund's SI-IRR calculation uses daily cash flows. All cash flows and values used to calculate returns are in, or have been converted to, US dollars. Gross returns are net of all underlying investment partnership expenses, management fees, and carried interest but gross of ABC Fund of Funds Manager's management fees. Net returns are net of all underlying partnership fees and expenses, including ABC Fund of Funds Manager's management fees.

**Investment Management Fee**

ABC Fund of Funds Manager's management fee varies based on the size of the commitment and structure of the program. The management fee is 100 basis points, based on the total commitment to a fund of funds, plus a 10% carry on total gains. Net returns are calculated using actual management fees of the fund of funds and underlying funds, including performance fees.

**Benchmark**

The benchmark is derived from private equity dollar-weighted IRRs, and the calculation is based on the overall market return for buyout fund of funds as determined by benchmark provider GHI. Individual vintage year benchmarks are the median SI-IRR for the applicable vintage years, at 31 December 2013.

**SAMPLE 6 PRIVATE EQUITY: FUND OF FUNDS BY VINTAGE YEAR**
**Investments 2002 Fund of Funds Composite  
Results Reported as of Calendar Year End**

Calendar Year	Gross-of-Fees SI-IRR (%)	Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)	Composite Assets (\$ Mil)	Total Firm Assets (\$ Mil)	# of Portfolios
2002*	2.5	-5.5	8.5	2.6	250	≤ 5
2003	-4.2	-12.3	-3.8	4.7	300	≤ 5
2004	12.5	6.5	14.4	7.5	350	≤ 5
2005	45.8	40.8	42.7	24.2	400	≤ 5
2006	35.6	31.5	30.2	21.6	450	≤ 5
2007	22.2	19.3	13.5	14.7	500	≤ 5
2008	17.4	15.5	8.1	11.8	550	≤ 5
2009	17.3	15.3	7.5	11.0	600	≤ 5
2010	16.5	14.8	8.0	9.3	650	≤ 5
2011	15.9	13.5	8.5	8.1	700	≤ 5
2012	16.8	14.0	10.3	6.5	750	≤ 5

\*Returns are for the period from 1 May 2002 (inception date) through 31 December 2002.

Calendar Year	Cumulative Committed Capital (\$ Mil)	Paid-In Capital (\$ Mil)	Cumulative Distributions (\$ Mil)	DPI	RVPI	TVPI	PIC
2002	20	3	0	0.00	1.04	1.04	0.15
2003	20	5	0	0.00	0.93	0.93	0.25
2004	20	8	2	0.22	0.94	1.16	0.40
2005	20	15	4	0.23	1.62	1.85	0.75
2006	20	17	12	0.71	1.25	1.96	0.85
2007	20	18	16	0.89	0.82	1.71	0.90
2008	20	19	17	0.89	0.62	1.51	0.95
2009	20	19	19	0.99	0.57	1.56	0.96
2010	20	20	23	1.18	0.47	1.65	0.98
2011	20	20	25	1.25	0.41	1.66	1.00
2012	20	20	29	1.45	0.33	1.78	1.00

#### Underlying Partnership Investments by Strategy Results Reported as of 31 December 2012

Investment Strategy	SI-IRR Gross-of-Fees (%)	Benchmark Return (%)	Committed Capital (\$ Mil)	Paid-In Capital (\$ Mil)	Cumulative Distributions (\$ Mil)	Assets (\$ Mil)	DPI Multiple	RVPI Multiple	TVPI Multiple	PIC Multiple
Venture Capital	65.3	32.6	8.0	8.0	16.0	2.0	2.0	0.3	2.3	1.0
Buyout	11.3	10.2	12.0	12.0	13.0	4.5	1.1	0.4	1.5	1.0

#### Disclosures

Sample 6 Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 6 Investments has not been independently verified.

Sample 6 Investments is an independent private equity manager of fund of funds strategies with offices in Zurich, Menlo Park, New York, and Hong Kong. The composite was created in May 2002 and includes one closed-end fund that invests in buyout and venture capital funds. The fund of funds has an 8–10 year investment time horizon, but it may be longer based on the life of the underlying funds, which may be extended due to changes in investment and/or exit opportunities. As more fully described in the fund's offering memorandum, primary risks include industry and geographic concentration depending on investment opportunities, and liquidity risks due to the nature of the fund's investments.

The composite's vintage year is 2002, which was determined using the date of the initial capital call of the fund of funds. Returns are presented in US dollars.

The 2002 Fund of Funds Composite complies with PQR's valuation guidelines, which are consistent with the GIPS Valuation Principles. Valuations are normally based on valuations provided by the manager of the underlying investments' partnerships. Because fund investments are not publicly traded, all investments are considered to be valued using subjective unobservable inputs.

All returns for the 2002 Fund of Funds Composite reflect the deduction of administrative expenses (legal, auditing, etc.) of the closed-end fund. Gross returns do not reflect the deduction of Sample 6 Investments' management fees. Net returns reflect the deduction of actual management fees and accrued carried interest, if any.

The fund's SI-IRR calculation incorporates daily cash flows. Sample 6 Investments' annual management fee is 1% on the total committed capital.

The Vendor ABC Private Equity Fund of Funds Index (vintage year 2002) is used as the benchmark.

A complete list of the firm's composite descriptions is available upon request, as are policies for valuing portfolios, calculating performance, and preparing compliant presentations.

#### SAMPLE 7 PRIVATE EQUITY: PRIMARY FUND VEHICLE

##### Private Equity Capital Management 2001 Venture Capital Composite Results Reported as of 31 December

Year End	Paid-In Capital (AUD Mil)	Since Inception Distributions (AUD Mil)	Cumulative Committed Capital (AUD Mil)	Composite Assets (AUD Mil)	% of Firm Assets
2001*	40.3	0.0	175.0	38.5	64.2
2002	82.3	1.0	175.0	78.8	52.5
2003	129.5	29.9	175.0	105.0	58.3
2004	143.5	42.3	175.0	120.8	41.6
2005	157.5	97.0	175.0	119.0	37.8
2006	166.2	129.3	175.0	112.0	31.1
2007	171.5	184.7	175.0	98.0	28.0
2008	182.5	184.7	175.0	78.8	21.0
2009	182.5	184.7	175.0	49.0	11.9
2010	182.5	184.7	175.0	31.5	7.5
2011	182.5	205.8	175.0	5.2	1.1

\*Returns are for the period from 3 February 2001 (inception date) through 31 December 2001.

Year End	TVPI	DPI	RVPI	PIC	Composite Gross-of-Fees SI-IRR (%)	Composite Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)
2001	0.96	0.00	0.96	0.23	-7.5	-9.5	-12.5
2002	0.97	0.01	0.96	0.47	0.3	-1.6	-3.5
2003	1.04	0.23	0.81	0.74	4.1	2.3	1.2
2004	1.14	0.29	0.84	0.82	8.2	6.4	7.4
2005	1.37	0.62	0.76	0.90	11.0	9.3	8.2
2006	1.45	0.78	0.67	0.95	13.0	10.1	9.7
2007	1.65	1.08	0.57	0.98	18.1	12.3	11.4
2008	1.44	1.01	0.43	1.04	16.9	10.4	10.1

Year End	TVPI	DPI	RVPI	PIC	Composite Gross-of-Fees SI-IRR (%)	Composite Net-of-Fees SI-IRR (%)	Benchmark SI-IRR (%)
2009	1.28	1.01	0.27	1.04	14.9	8.7	7.2
2010	1.18	1.01	0.17	1.04	14.0	7.7	6.8
2011	1.16	1.13	0.03	1.04	11.2	6.2	5.5

TVPI = Total Value to Since Inception Paid-In Capital

DPI = Since Inception Distributions to Since Inception Paid-In Capital

PIC = Since Inception Paid-In Capital to Cumulative Committed Capital

RVPI = Residual Value to Since Inception Paid-In Capital

## Disclosures

### *Compliance Statement*

Private Equity Capital Management claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Private Equity Capital Management has been independently verified for the periods 3 February 2001 through 31 December 2010.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The 2001 Venture Capital Composite has been examined for the periods 1 January 2005 through 31 December 2010. The verification and performance examination reports are available upon request.

### *Firm & Composite*

Private Equity Capital Management ("PECM") is an independent private equity investment firm with offices in New York, London, and Sydney. The 2001 Venture Capital Composite includes one fund, whose objective is to seek long-term capital appreciation by acquiring minority interests in early-stage technology companies. The fund invests in technology companies in Europe, Asia Pacific, and emerging markets. European venture investments are more concentrated than in the other regions and are focused in a few high-quality companies. Exit opportunities include IPOs, trade sales, and secondary sales. Opportunities in China and India will be targeted for investment, and an allocation to Chinese high-tech will be at least 10% of the invested capital over the life of the fund. International venture capital investments are generally illiquid and are subject to currency risk. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed. The 2001 Venture Capital Composite was created in 2001. The vintage year of the composite is 2001 and was determined by the year of the first drawdown. The firm's list of composite descriptions and the firm's policies for calculating performance and preparing compliant presentation are available upon request.

### *Input Data & Calculation*

The 2001 Venture Capital Composite complies with the LMN Venture Capital Association's valuation guidelines as well as the GIPS Valuation Principles. Valuations are prepared by PECM's valuation committee and reviewed by an independent advisory board. All investments within the composite are valued

using either a most recent transaction or an earnings multiple. Policies for valuing investments are available upon request. Due to the nature of private equity investments, all investments are valued using subjective unobservable inputs.

The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter. Performance is expressed in Australian dollars (AUD).

Gross returns are net of transaction expenses and all administrative expenses. Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest. The standard fee schedule currently in effect is as follows:

The manager will receive an annual management fee equal to 2% of capital commitments. The manager's participation in profits (carried interest) begins after the limited partners have been provided an 8% preferred return. The manager collects 20% of the distributed profits from that point forward. Subsequently, if the amount of cumulative carried interest exceeds 20% of the net cumulative gains, the manager will repay the excess amount to the fund for distribution to the limited partners.

There is only one fund in the composite for all periods; therefore, the internal dispersion of portfolio returns is not applicable.

#### **Benchmark**

The benchmark return is derived from private equity dollar-weighted IRRs, and the calculation is based on the overall market return for international venture capital funds as published by Benchmark Provider GHI. Vintage year benchmarks are median returns for the applicable vintage year, as of each year end.

### **SAMPLE 8 INVESTMENTS LARGE-CAP SMA COMPOSITE**

**1 January 2001 through 31 December 2010**

Year	Net Return (%)	XYZ Index Return (%)	Internal Dispersion (%)	As of 31 December			
				Number of Portfolios	Composite Assets (\$ Millions)	Firm Assets (\$ Millions)	% of SMA Portfolios
2010	8.4	10.2	0.7	1,834	2,125	18,222	100
2009	21.1	21.1	1.1	1,730	2,130	17,635	100
2008	-39.7	-39.8	1.0	1,631	2,141	19,246	100
2007	1.4	6.2	1.2	1,532	2,127	14,819	100
2006	11.4	10.5	0.9	1,428	2,116	12,362	100
2005	1.0	4.3	0.8	68	1,115	12,051	0
2004	6.8	4.9	1.0	52	1,110	13,419	0
2003	23.9	27.0	1.1	46	990	10,612	0
2002	-24.4	-19.1	0.9	38	975	9,422	0
2001	-17.7	-12.8	0.8	41	870	8,632	0

## Notes:

**1** Sample 8 Investments claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Sample 8 Investments has been independently verified for the period from 1 April 1996 through 31 December 2009.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The Large Cap SMA Composite has been examined for the period from 1 January 2006 through 31 December 2009. The verification and performance examination reports are available upon request.

- 2** Sample 8 Investments is an independent investment adviser registered under the Investment Advisers Act of 1940, was founded in March 1996, and manages global large-cap equity, fixed-income, and balanced strategies.
- 3** Beginning 1 January 2006, the composite includes only wrap fee (SMA) portfolios benchmarked to the XYZ Index. Performance results prior to 2006 are based on the Large-Cap Institutional Composite returns.
- 4** The Large-Cap SMA Composite is composed of portfolios invested in US equities which have a market capitalization greater than \$5 billion.
- 5** The composite was created in February 2006. A list of composite descriptions is available upon request.
- 6** All returns are expressed in US dollars. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.
- 7** The XYZ Index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested and includes the reinvestment of income. The returns for the index do not include any trading costs, management fees, or other costs. Index returns have been taken from published sources.
- 8** "Pure" gross returns, presented below as supplemental information, from 2006 through 2010 do not reflect the deduction of any trading costs, fees, or expenses and are presented for comparison purposes only. "Pure" gross returns prior to 2006 reflect the deduction of trading costs. The SMA fee includes all charges for trading costs, portfolio management, custody, and other administrative fees. Net returns are calculated by subtracting the highest applicable SMA fee (2.50% on an annual basis, or 0.21% monthly) on a monthly basis from the "pure" gross composite monthly return. The standard fee schedule in effect is as follows: 2.50% on total assets.
- 9** The dispersion is measured by the equal-weighted standard deviation of annual returns of those portfolios that are included in the composite for the full year.
- 10** At 31 December 2010, the three-year annualized ex-post standard deviation of the composite and the benchmark are 12.3% and 13.2%, respectively.
- 11** Past performance is not an indicator of future results.

**Supplemental Information**

<b>Year</b>	<b>"Pure" Gross Return* (%)</b>	<b>Net Return (%) Assuming 3% SMA Fees</b>	<b>Net Return (%) Assuming 2% SMA Fees</b>
2010	11.1	7.9	9.0
2009	24.0	20.5	21.7
2008	-38.0	-40.1	-39.4
2007	4.0	0.9	2.0
2006	14.1	10.8	11.9
2005	3.5	0.5	1.5
2004	9.5	6.3	7.4
2003	26.9	23.3	24.5
2002	-22.3	-24.8	-23.9
2001	-15.5	-18.1	-17.2

\* "Pure" gross-of-fees returns do not reflect the deduction of any expenses, including trading costs. "Pure" gross-of-fees returns are supplemental to net returns.

## APPENDIX B: SAMPLE ADVERTISEMENTS

### 1. SAMPLE ADVERTISEMENT WITHOUT PERFORMANCE

#### Generic Asset Management

Generic Asset Management is the institutional asset management division of Generic Inc. and is a registered investment advisory firm specializing in qualitative growth-oriented investment management.

Generic Asset Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a list of composite descriptions of Generic Asset Management and/or a presentation that complies with the GIPS standards, contact Jean Paul at (123) 456-7890, or write to Generic Asset Management, 123 Main Street, Returnsville 12345, or [jpaul@genericassetmanagement.com](mailto:jpaul@genericassetmanagement.com).

### 2. SAMPLE ADVERTISEMENT INCLUDING ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS

#### Generic Asset Management: Global Equity Growth Composite

	Ending 31 Mar 2012		
	1-Year	3-Year Annualized	5-Year Annualized
Global Equity Growth Composite	-0.3%	13.7%	0.1%
XYZ World Index	-0.5%	13.8%	-0.6%

*Note:* Returns are shown in US dollars net of fees.

Generic Asset Management is the institutional asset management subsidiary of Generic Inc. and is a registered investment adviser specializing in qualitative growth-oriented investment management. The Global Equity Growth strategy focuses on earnings, growth of earnings, and key valuation metrics. The benchmark is the XYZ World Index, which is designed to measure the equity market performance of developed market countries. The benchmark is market-cap weighted and is composed of all XYZ developed market indexes.

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### 3. SAMPLE ADVERTISEMENT INCLUDING PERIOD-TO-DATE AND ONE-, THREE-, AND FIVE-YEAR ANNUALIZED RETURNS

#### Generic Asset Management: Global Equity Growth Composite

	Ending 31 Mar 2012	Ending 31 Dec 2011		
	Period to Date (3 months)	1-Year	3-Year Annualized	5-Year Annualized
<b>Global Equity Growth Composite</b>	-3.84%	1.3%	15.0%	-1.2%
<b>XYZ World Index</b>	-4.94%	1.5%	14.1%	-0.7%

*Note:* Returns are shown in US dollars net of fees.

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### 4. SAMPLE ADVERTISEMENT INCLUDING FIVE YEARS OF ANNUAL RETURNS

#### Generic Asset Management: Global Equity Growth Composite

	Period to Date (3 months to 31 Mar 2012)	Annual Returns Periods Ended 31 December				
		2011	2010	2009	2008	2007
<b>Global Equity Growth Composite</b>	-3.84%	1.3%	13.0%	33.0%	-40.6%	9.6%
<b>XYZ World Index</b>	-4.94%	1.5%	11.8%	30.8%	-40.3%	9.6%

*Note:* Returns are shown in US dollars net of fees.

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## APPENDIX C: SAMPLE LIST OF COMPOSITE DESCRIPTIONS

### 1 Unconstrained Activist UK Equity Composite

The Unconstrained Activist UK Equity Composite includes all institutional portfolios invested in both listed and unlisted UK equities that pursue an activist investment policy; there is no restriction on the market capitalization of companies held. Portfolios within this composite are highly concentrated, holding approximately 15 securities, so returns may have lower correlation with the benchmark than a fully diversified strategy. In times of increased market volatility, the composite characteristics may change significantly and stock liquidity could be reduced. Due to their more concentrated nature, portfolios will tend to have more stock-specific risk than a more diversified strategy. Portfolios can use both exchange-traded and OTC derivative contracts for efficient portfolio management, which may expose the strategy to counterparty risk. The benchmark is the FTSE All Share® Index.

### 2 Emerging Market High Yield Fixed Income Composite

The Emerging Market High Yield Fixed Income Composite includes all institutional and retail portfolios invested in high yield debt securities issued by countries outside the OECD. The strategy allows for investment in foreign currency denominated assets over which the manager has full discretion on hedging. The strategy aims to deliver a total return primarily through income but with some capital growth. High yield bonds carry increased levels of credit and default risk and are less liquid than government and investment grade bonds. Investment in less regulated markets carries increased political, economic, and issuer risk. The benchmark is the J.P. Morgan Emerging Market Bond Index (EMBI+).

### 3 UK Liquidity Plus Composite

The UK Liquidity Plus Composite includes all institutional portfolios invested in a broad range of short-dated interest-bearing deposits, cash equivalents, short-term commercial paper, and other money market investments issued by major UK clearing banks and lending institutions. The strategy has a targeted modified duration of less than one year. The principal investment objectives are preservation of capital, maintenance of liquidity, and provision of yield greater than that available for the benchmark, the three-month Libor rate. The UK Liquidity Plus strategy differs from more conventional cash strategies in that it additionally holds short-term commercial paper, which has a greater exposure to credit risk.

### 4 Socially Responsible Investment (SRI) Composite

The Socially Responsible Investment Composite includes all segregated institutional and pooled portfolios that invest in global equity securities issued by companies that make a positive contribution to society and the environment through sustainable and socially responsible practices. The strategy aims to provide long-term capital appreciation together with a growing income stream through investment in a portfolio of core equity holdings diversified by economic sector, industry group, and geographic business concentration. All foreign currency exposures are fully hedged back to US dollars.

The SRI process tends to screen out certain companies and sectors, which may result in a more concentrated strategy than a fully diversified strategy. Changes in legislation, scientific thinking, national and supra-national policies, and

behaviors could significantly affect the stocks of companies held within the strategy. The benchmark is the Morningstar Ethical/SRI Global GIF Sector peer group.

#### **5 Leveraged Bond Composite**

The Leveraged Bond Composite includes all institutional segregated portfolios invested in a diversified range of high yield corporate and government bonds with the aim of providing investors with a high level of income while seeking to maximize the total return. The portfolios are invested in domestic and international fixed income securities of varying maturities. The strategy allows investment in exchange-traded and OTC derivative contracts (including, but not limited to, options, futures, swaps, and forward currency contracts) for the purposes of risk, volatility, and currency exposure management. The strategy allows leverage up to but not exceeding twice the value of a portfolio's investments through the use of repurchase financing arrangements with counterparties. Inherent in derivative instrument investments is the risk of counterparty default. Leverage may also magnify losses as well as gains to the extent that leverage is employed. The benchmark is the Bloomberg Barclays Global Aggregate Bond Index.

#### **6 Global Commodity Composite**

The Global Commodity Composite includes institutional portfolios that globally invest in a diversified range of companies that provide exposure to commodities, energy, and materials. Investment is primarily through the common or ordinary stock of these companies. Investment directly in raw materials is allowable to a maximum exposure of 10%. Exchange-traded funds and exchange-traded commodity securities up to a maximum 20% exposure are also allowed. The base currency is US dollars, and any or all of the currency risk associated with investments in currencies other than dollars may be hedged between 0% and 100% at the manager's discretion. The strategy cannot gear or otherwise deploy leverage but may use exchange-traded derivative instruments for efficient portfolio management.

Investments directly or indirectly in commodities may add to portfolio volatility. Global commodity prices can be affected by changes in legislation, national and supra-national policies, and behaviors. In times of commodity price volatility, the liquidity of directly held commodities and the correlation with the broad market can change quickly. The benchmark is the Dow Jones–UBS Commodity Index Total Return<sup>SM</sup>.

#### **7 Large Cap Equity Growth Composite**

The Large Cap Equity Growth Composite includes all institutional portfolios that invest in large capitalization US stocks that are considered to have growth in earnings prospects that is superior to that of the average company within the benchmark, the Russell 3000<sup>®</sup> Growth Index. The targeted tracking error between the composite and the benchmark is less than 3%.

#### **8 Balanced Growth Composite**

The Balanced Growth Composite includes all institutional balanced portfolios that invest in large-cap US equities and investment-grade bonds with the goal of providing long-term capital growth and steady income from a well-diversified strategy. Although the strategy allows for equity exposure ranging between 50% and 70%, the typical allocation is between 55% and 65%.

#### **9 Currency Overlay Composite**

The Currency Overlay Composite includes all institutional and retail portfolios invested in a broad range of foreign-currency-denominated deposits or instruments, such as forward contracts, futures, or foreign exchange derivatives. The principal investment objective is alpha generation through currency appreciation and/or risk mitigation from adverse movements in exchange rates where the original currency exposure stems from a global or international portfolio. Hedging strategies may range from passive to fully active. Currency-related investing carries inherent risks due to changes in macroeconomic policy, which can be amplified in the case of emerging markets, where political regime shifts and changes in the control of capital may be more prevalent. In volatile periods, liquidity and correlations between currencies may change expected returns drastically. Foreign exchange forwards and derivatives traded over the counter have counterparty default risk.

#### **10 Asian Market Neutral Composite**

The Asian Market Neutral Composite includes a single hedge fund with a market neutral strategy that invests in publically traded Asian equities with a market capitalization greater than \$500 million. The strategy uses a risk controlled quantitative screening and optimization process that invests at least 85% of the net asset value in long equity positions and at least 85% of the net asset value in short equity positions. The long portion of the strategy will overweight those securities that have been quantitatively identified as potentially exhibiting superior and sustainable earnings growth compared with the market; conversely, the short portion of the strategy will consist of securities that have been identified as having inferior growth prospects or that may also be adversely affected by either specific events or by momentum considerations. The principal objective of the strategy is to outperform the return on three-month US Treasury Bills through active trading of long and short equity positions.

The Asian Market Neutral strategy seeks to dollar balance exposures between long and short positions so that broad market movements are neutralized. In certain market conditions, the investment process behind the strategy can give rise to unmatched country, sector, industry, market capitalization, and/or style bias exposures in the portfolio. The active trading strategy will involve significantly greater stock turnover when compared with passive strategies.

#### **11 2001 Venture Capital Composite**

The 2001 Venture Capital Composite includes one fund, whose objective is to seek long-term capital appreciation by acquiring minority interests in early-stage technology companies. The fund invests in technology companies in Europe, Asia Pacific, and emerging markets. European venture investments are more concentrated than in the other regions and are focused in a few high-quality companies. Exit opportunities include IPOs, trade sales, and secondary sales. Opportunities in China and India will be targeted for investment, and an allocation to Chinese high-tech will be at least 10% of the invested capital over the life of the fund. International venture capital investments are generally illiquid and are subject to currency risk. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

#### **12 2006 Buyout Strategy Fund of Funds Composite**

The 2006 Buyout Strategy Fund of Funds Composite includes primary and secondary partnership investments with strategies focused on leveraged and growth-oriented buyouts primarily in the United States. Managers of partnerships are expected to focus on reducing costs, preparing companies for downturn, and providing operational improvement rather than financial engineering.

Investments may be in small, medium, and large buyout partnerships, aiming to make selective commitments diversifying across stages, industries, and vintage years. Secondary deals take advantage of distressed primary partnership sales providing access to an increased mix of assets. The underlying funds are leveraged 100–300%. Private equity investments are illiquid and, therefore, if investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

### **13 Value-Added Strategy Non-Closed-End Real Estate Composite**

The Value-Added Strategy Composite consists of all discretionary open-end funds and separate accounts managed by the Firm using a value-added investment strategy with an equal income and appreciation focus and having a minimum portfolio size of \$10 million. Portfolio management will invest in multi-family, office, industrial, and retail property types only within Asia that require correction or mitigation of the investments' operating, financial, redevelopment, and/or management risk(s). A moderate level of leverage ranging between 30% and 40% is used. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources.

### **14 Value-Added Strategy Closed-End Real Estate Composite**

The Value-Added Strategy Composite includes a single closed-end commingled fund managed by the Firm using a value-added investment strategy with a focus on both income and appreciation. Portfolio management intends to invest in properties located in major markets within the United States with higher operational risk than traditional property types. The target level of leverage is 50% with a maximum allowable level of 60%. Real estate investments are generally illiquid, and the investment outlook may change given the availability of credit or other financing sources. If investment opportunities and/or exit strategies become limited, the life of the fund may be extended and capital calls and distributions may be delayed.

### **15 US Core Equity Composite (Terminated Composites)**

The US Core Equity Composite includes all institutional portfolios and pooled funds managed to a GARP (growth at a reasonable price) strategy through investment in a high-quality, focused portfolio of domestic, large-capitalization stocks that are expected to generate returns above the S&P 500® Index over a market cycle. Sample Asset Management Firm uses a quantitative screening process together with fundamental research and then overlays macroeconomic factors and economic sector exposures to construct portfolios. The benchmark is the S&P 500 Index. Quantitative-driven investment screening relies on historical stock correlations, which can be adversely affected during periods of severe market volatility. The composite terminated in March 2009.

*Detailed composite definitions are available upon request.*

## PRACTICE PROBLEMS

- 1 With respect to the Global Investment Performance Standards, which of the following is one of the nine sections containing investment performance provisions?
  - A Real Estate.
  - B Derivatives.
  - C Legal and Ethical Considerations.
- 2 According to the Fundamentals of Compliance section of the Global Investment Performance Standards, issues that a firm must consider when claiming compliance include all of the following *except*:
  - A replicating performance.
  - B properly defining the firm.
  - C documenting firm policies and procedures used in establishing and maintaining compliance with the Standards.
- 3 G&F Advisors claims compliance with the Global Investment Performance Standards (GIPS) in its marketing materials. The compliant presentation includes a footnote which indicates that the firm has been verified by an independent third party. An additional note states that G&F is in compliance with the GIPS standards except for its private equity investments. Is it *likely* that G&F violated the GIPS standards?
  - A No, because the footnotes meet the requirements of the Standards.
  - B No, because the provisions do not apply to the private equity investments.
  - C Yes, because they cannot claim compliance unless all requirements of the Standard are met.

## SOLUTIONS

- 1 A is correct. Real Estate is one of the nine sections in the 2010 edition of the GIPS standards. Derivatives and Legal and Ethical Considerations are not sections of the Standards.
- 2 A is correct. Replication of performance is not included in the Fundamentals of Compliance section within the GIPS standards.
- 3 C is correct. Firms must meet all the requirements set forth in the GIPS standards and cannot claim partial compliance.