ETHICS

A. STUFF TO MEMORIZE

Code of Ethics

1. Act with Integrity
2. Be a Credit to the Profession
3. Be Competent
4. Use Independent Professional Judgment

Concepts

1. Know & Comply with All the Rules
2. Do not KNOWINGLY Aid & Abet others to Break the Rules
3. Use the CFA Designation Correctly
4. Be honest, even in personal life
5. Do not plagiarize
6. Inform your employer about the Code & Standards
7. Do not do outside work without your employer's approval
8. Disclose conflicts of interest to employers, clients, & prospects
9. Disclose all income from an outside job
10. Supervisors must supervise their subordinates
11. Back up Recommendations with good reasons
12. Do not make misrepresentations
13. Keep Good Records
14. Put all relevant facts in research reports
15. Distinguish facts from opinions
16. Indicate the basic characteristics of investments
17. Maintain independence and objectivity
18. Know and carry out your fiduciary duties
19. Know what is suitable for your clients
20. Tell the Client your basic Methodology
21. Treat Clients Fairly
22. Transaction priority belongs to the client and employer
23. Keep Client and Employer information confidential
24. Do not give guarantees
25. Disclose referral fees
26. Do not use material non-public information
27. Present your investment performance fairly & accurately

B. AMPLIFICATION OF RULES

STANDARD I: FUNDAMENTAL RESPONSIBILITIES

I(A): Know & Comply with Laws, Regulations, Ethical Codes & Professional Standards

- Know & comply with the laws of any government, regulatory organization, or professional association. International members must comply with the law of their home country when residing and working in foreign countries or trading in foreign securities. Also, must comply with the local laws & regulations. When in conflict, must comply with the most strict laws & regulations to which he is subject.
- *Compliance Procedures*
  - Maintain current files of applicable laws & regs. and distribute it to employees
  - Establish procedures by which employees are regularly informed about changes in laws & regs.
  - Regularly review written compliance procedures of the firm to make sure they reflect current law and provide adequate guidance to employees

I(B): Do not Knowingly Participate or Assist Others in any Violation of Applicable Regulations or Ethical Codes

- Members are responsible for violations which they knowingly participate or assist in. Assumed to know the law, but there may be situations in which the member is not aware. When see questionable behavior, consult with counsel and disassociate with the wrongdoers. If required by law, report to appropriate authorities. Inaction + continued association with wrongdoers may be construed as participation.
- If question a situation, consult first with supervisor and then with counsel.
- If consult with counsel and still held to be illegal, may be a valid defense.

STANDARD II: RELATIONSHIPS WITH AND RESPONSIBILTIES TO THE PROFESSION

II(A): Use of Professional Designation

- May reference membership in a dignified & judicious manner. Holders of the CFA designation may use "CFA or Chartered Financial Analyst" in a dignified & judicious manner. Candidates may reference their participation in the CFA program as long as it is made clear that they are mere candidates. Only awarded CFA charter holders may use the initials CFA after their name.
- *Compliance Procedures*
  - Only the mark CFA should appear after the name. Designation cannot appear in larger type than the holders name. Any description should be limited to a concise description of the requirements needed to obtain it. No claim of superior performance or ability by virtue of CFA designation should be implied. Candidates may state that they are Level I, II, or III candidates, but should not give a time for completion. To be a requirement, must be enrolled to take next exam. Should notify firm's compliance, PR & marketing departments. Should never use CFA as a noun or in a plural form. People are not CFAs they are holders of a CFA Designation.

II(B): Do Not Engage in any act which adversely reflects upon your Honesty, Trustworthiness, or Professional Competence

- This goes beyond acts which are committed in a professional capacity. Includes violation for criminal convictions for felonies even if not related to the profession. Repeated convictions for misdemeanors show a disrespect for the law. This includes intoxication at work and padding one's expense account. Thus, even non-criminal behavior is covered.
- *Compliance Procedures*
  - Generally, own character ensures compliance. Members should encourage employers to adopt a clear policy indicating that personal behavior which reflects poorly on the

profession shall not be tolerated. Supervisors should conduct background checks on potential employees to ensure that they are not ineligible to work in the investment industry due to past law infractions.

II(C): Do Not Plagiarize

- Plagiarism is a violation of the Code. All outside sources used in reports should be acknowledged, identifying the source, its author, and publisher. The ONLY exception is the use of FACTUAL Information published by Recognized Financial & Statistical Reporting Services. This applies to ORAL, WRITTEN, & ELECTRONIC Communications.
- Includes using parts of reports or articles prepared by others either verbatim or with slight alterations without acknowledging the source. Also, citing "leading analysts" without specifically referring to them by name. Also, presenting statistical estimates or forecasts made by others with the source identified, but without any of the caveats appearing in the source
- Using a chart or graph prepared by others without stating the source
- Copying proprietary spreadsheets or algorithms without seeking the cooperation or authorization of their creators.
- *Compliance Procedures*
  - Maintain copies of any materials prepared by others that were relied on in preparing a report. Attribute the source for any direct quotation. Attribute the source when paraphrasing or summarizing material prepared by others.

STANDARD III: RELATIONSHIPS with, and RESPONSIBILITIES to, the EMPLOYER

III(A): Inform Employers of the Code of Ethics and Standards of Professional Conduct

- CFAs must inform their IMMEDIATE Supervisor in Writing that they are required to conform to the Code and deliver a copy of the Code to their Supervisor
- *Compliance Procedures*
  - Need not do this ONLY if the supervisor has stated in writing that the firm policies already include AIMR's Code. Request that the Code & Standard be adopted and disseminated throughout the firm. Maintain a written record of the notification.

III(B): Duty to Employers

- Do not undertake independent practice in competition with your employer that may result in some compensation or other benefit UNLESS you have written consent from BOTH your employer and the outside entity to do so.
- If plan to quit, must act in the best interest of the employer until the employment is terminated

III(C): Disclose Conflicts of Interest to Employer

- Members must disclose to employers any material fact that could reasonably be expected to interfere with their duty to the employer, or their ability to act in an unbiased and objective manner. Includes owning stock, sitting on board, or financial pressures that may influence a decision.
- Policies include restricting personal trading and prohibiting employees from holding outside trustee position or corporate directorships.

III(D): Disclose Additional Compensation Arrangements

- Inform Employers in writing of compensation for services that are in addition to the compensation received from the employer. No Arrangement may be entered into without the employer's approval.

III(E): Responsibility of Supervisors

- Supervisors must establish procedures designed to prevent violations of laws, regulations, compliance procedures, and provisions in the Code & Standards.

- Supervisors must establish responsible behavior among all subordinates, both CFA holders and non-holders of the CFA designation
- Not responsible for all violations of subordinates, but must be reasonable. Should set up a compliance system.
- *Legal Cases for Supervisors*
    - Petrites v JC Bradford & Co.: Since did not meet stock exchange rules, firm is liable
    - Alm, Kane, Rogers & Co. SEC Release: Supervisory procedures were found to be informal and not designed to prevent or uncover the solicitation of business based on inside info.
    - SEC v First Boston: Head Trader & Supervisor were given inside information. They then traded based on this information. Firm had to disgorge its profits, pay a trade, and review its compliance procedures.

STANDARD IV: RELATIONSHIPS with & RESPONSIBILTIES to CLIENTS & PROSPECTS

IV(A): Investment Process

IV(A.1): Reasonable Basis & Representation

- Be Diligent & Thorough in investigations when making recommendations. Have a Reasonable & Adequate Basis, supported by appropriate research, for recommendations. Avoid Material Misrepresentations in research reports. Maintain files & records to support the reasonableness of recommendations.
- Unprofessional to compare financial ratios prepared under different accounting rules without some attempt to make them comparable. Also unprofessional to not inform clients of unusual risks that may exist in certain foreign securities.
- Account Executives & Portfolio Managers are in compliance if they make recommendations based upon firm's research reports or other reports which can be relied upon. Analysis of portfolio needs.

IV(A.2): Research Reports

- Must include all relevant factors in research reports, distinguish between facts & opinions, and indicate the basic characteristic of the investment securities that are the subject of reports written for the general public.
- Research Reports include traditional reports, in-person or telephone communications, media broadcasts and computer transmissions. Capsule recommendations must be supported by background reports or data that are available to interested parties.

IV(A.3): Maintaining Independence & Objectivity

- Try to avoid situations that might cause, or be perceived to cause, a loss of independence and objectivity in making recommendations.
- Violate if take an allocation of shares in an oversubscribed IPO for personal account, accept expensive gifts or entertainment from corporations, allow the firm's business relationship with a company to affect a research review, allow compensation schedule to cloud judgment
- *Compliance*
    - Structure Compensation properly, disclose any potential conflict, create a restricted list, when attending a corporate meeting, should pay own way, should not accept gifts above a token amount, restrict IPOs or Private placement. Gifts above $100 should be disclosed to employer and employer gives permission to accept.

IV(B): Interaction with Clients & Prospects

IV(B.1): Fiduciary Duties

- Especially for managing Trust & Pension Funds.
- Fiduciary: LOYALTY, CARE, PRUDENCE, IMPARIALITY & DISCRETION
- Avoid Conflicts of Interest and Self-Dealing (LOYALTY)
- Carefully Analyze Investments (CARE)
- Make preservation of assets the prime objective with earning a reasonable return a close second (PRUDENCE)
- Treat all Clients Fairly (IMPARTIALITY)
- Keep information about clients confidential (DISCRETION)
- **Trust Management**: Prudent Man Rule or Prudent Investor Rule → manage assets entrusted to them with the same care and prudence as the prudent person. Primary interest is asset preservation and secondary is an adequate & safe return on the capital invested.
  - Prudent Investor has replaced Prudent Man: there is no illegal investment per se. Prudence applies to the entire portfolio, not just individual assets. Explicit requirement of diversification. Professional Standard of prudence, rather than ordinary person
  - Must treat all beneficiaries of a trust equally. Best efforts at maximizing after-tax return. Must fulfill legal requirements.
- **Qualified Private Retirement Plans (ERISA)** → does not apply to churches, government, worker's comp., disability, etc)
  - LOYALTY, CARE, PRUDENCE, Compliance with the Law
  - Prohibit Self-dealing, conflicts of interest, kickbacks
- **Public Pension Plans**
  - Not governed by ERISA, but by local law of trusts. But same type of ERISA duties. Beware of requirement for local investment. Still must be prudent
- **Money Management**
  - Look to the INDEPENDENT ADVISERS ACT of 1940. Prohibits fraud and acting as a principal in a client's account without the client's permission. Should be honest & loyal to the client, always in his best interest. Use care & independent professional judgment. Avoid Conflicts of Interest.
- **Brokers & Dealers**
  - Still held to a professional standard. Should not Churn, should not accept funds when insolvent, should not engage in fraud, should not exploit client's trust or ignorance, should deal fairly with their clients.
- **Security Analysts**
  - Do their best, use independent judgment, have adequate basis for recommendation, deal fairly with clients & professionals.
- **Charitable Organizations & Endowments**
  - UMIFA. Has origin in Corporate Law. Ordinary Business Care & Prudence. Not as high a standard (want to encourage people to do these things pro bono)
- **Social & Relationship Investing**
  - Permitted only if Return & Risk factors are not compromised, diversification is still sufficient to avoid the risk of sustaining unusually large losses, and excessive costs are not incurred.
- **Proxy Voting**
  - Right to a proxy vote has economic value.
- **Soft Dollars**

IV(B.2): Portfolio Investment Recommendations & Actions

- Should find out what the Clients want, and update this at least once per year.
- Before making a recommendation, make sure it is suitable
- Create an INVESTMENT POLICY STATEMENT: which shows the Objectives & Constraints of the Investor

IV(B.3): Fair Treatment of Clients

- Deal fairly with dissemination of recommendation, dissemination of prior opinion, taking investment action
- Impossible to reach all simultaneously, but should communicate ideas to clients as simultaneously as possible within the reasonable limits of communication technology

IV(B.4): Priority of Transactions

IV(B.5): Confidentiality

- Preserve Confidentiality unless it concerns illegal activity.

IV(B.6): Prohibition Against Misrepresentation

- May not Misrepresent Performance, qualifications, academic or professional credentials

IV(B.7): Disclose Conflicts of Interest to Clients & Prospects

- Must Disclose relations if close to issuer, underwriting relation, or material benefit of ownership

IV(B.8): Disclose Referral Fees

- Existence of Referral Fees must be disclosed

STANDARD V: RELATIONSHIPS with & RESPONSIBILITIES to the INVESTING PUBLIC

V(A): Do Not Use Material Non-Public Information

- **Traditional Theory**: trading on inside information is an act of securities fraud only when the person taking the investment action has a fiduciary duty to the company whose securities are acted upon and breaches that duty
  1. Information Must be MATERIAL – significantly changes the mix of information about the company or it pertains to a tender offer or if it is a specific fact rather than an opinion
  2. Information must be NON-PUBLIC – Information becomes public as soon as it is disclosed by a firm in a way calculated to make it available to the general investing public. Selective Disclosure does not constitute a public disclosure.
  3. Source must be an INSIDER – Insider is someone who knows the information because he is in a position to receive confidential information and who has a Fiduciary Duty NOT to disclose it. Fiduciary exists as a matter of LAW, not fact specific.
- **Misappropriation Theory**: An individual can trade while possession material non-public information if the person owes NO Fiduciary Duty to the issue of the Security Under the Traditional Theory. But, under Misappropriation, it is fraud to obtain material nonpublic information from another to whom they owe a duty of trust and then communicate it even if they owe no fiduciary duty to the issuer.
- **IMPORTANT LAWS re: INSIDE INFO.**
  - **Rule 10b-5**: Scheme to defraud, deliberate false disclosure or omission of a material fact, or any act that would operate to defraud. Violation can result in civil suit, SEC administrative action, suit by SEC for injunction, criminal action
  - **Insider Trading Sanctions Act (1984)**: Inside Traders can also have civil monetary damages up to 3X the profit obtained or loss avoided, and fines up to $100,000. Employers are not subject to this law, just Employees. Statute of Limitations is 5 years.

    - **Insider Trading & Securities Enforcement Act (1988)**: must establish, maintain, and enforce written policies to prevent illegal insider trading. Exclude banks, but not insurance companies.
    - **Securities Enforcement Remedies & Penny Stock Reform Act (1990)**: Additional punishment
    - **§ 20(A) of SEA** makes tippers jointly & severally liable for the profits gained.
    - **CEA**: several anti-fraud provisions
    - **CFTC Rule 1.59**. Illegal to communicate material non-public information obtained as a result of employment in a regulatory body.
- **CASES**
    - **Cady Roberts (1961)**: Director told a partner about firm's dividend cut before disclosed publicly. Partner sold.
    - **Texas Gulf Sulphur (1968)**: Insiders know of a major mineral discovery, but did not immediately disclose it to the public. Considered to be insiders were those who bought the stock AFTER the public Disclosure, but Before the public could assimilate the information.
    - **Investors Management Company (1968)**: While underwriting, discovered probable low cash flows, and passed info. on to traders. This was Insider Trading
    - **Chiarella v US (1980)**: Concept of Constructive Insiders (employee of printing firm). In a footnote, though trading on inside info may be legal, can still be unethical. So AIMR can come in to play. Used Mosaic Concept. OK
    - **US v Chestman**: Upheld Misappropriation Theory. But require a substantial amount of proof. Must prove Fiduciary Duty to Abstain from Trading, Breach of that duty, and knowledge of that duty. (Stockbroker of nephew of president of company.) Can transfer, if trade on inside info. from Tipper who you knew had a fiduciary duty.

V(B): Performance Presentation Standards

- Must not Misrepresent Investment performance.
- Voluntarily Adopt Performance Presentation Standards

Professionalism & Service to the Investing Public

- Should act well

Possible Sanctions

1. Private Censure
2. Public Censure
3. Suspension of Membership
4. Suspension of Right to use CFA Designation
5. Revocation of Membership
6. Revocation of Right to use CFA Designation

C. ARTICLES & CASES

Look over past Exams instead.