CHARTA LEARNING · LESSON NOTES

Ethics: the Conduct Program and Professionalism

Ethical and Professional Standards

1 A story: the form that arrives each year

- Each year: the Professional Conduct Statement
- It asks: has anything happened we should know?
- A manager may have to answer yes
- So learn what follows a yes before you need it

IN THE LESSON

- Every year a form lands on Ines Calloway's desk.
- It is the Professional Conduct Statement, and it asks one plain question: has anything happened in the last year that C F A Institute ought to know about, such as a client complaint, a lawsuit or a regulator's inquiry?
- Many members tick no without a second thought.
- But a portfolio manager is exactly the person who might have to tick yes.
- So before we study the rules themselves, we should know what happens after a yes.
- Who reads it?
- What can they do about it?
- And how bad can it get?
- Once you can answer those, the honest answer is much easier to give.

2 Who runs the Professional Conduct Program

Three groups, three jobs

Staff investigate → Board of Governors oversees → Volunteers form hearing panels

IN THE LESSON

- Three groups share the work.
- On the left, the Professional Conduct staff.
- They are C F A Institute employees who receive the information, investigate it and decide what to recommend.
- In the middle, the Board of Governors, which oversees the whole program.
- On the right, the Disciplinary Review Committee.
- Its members are volunteers, and they supply the people who sit on a hearing panel when a case is contested.
- The rules promise a fair and confidential process.
- The one exception comes at the end: if a sanction is public censure, that decision is published.
- Keep these three roles apart, because exam questions love to mix up who investigates and who decides.

3 How an inquiry starts

Four ways an inquiry can begin

Way a case starts	Who reports
Self-disclosure	The member
Written complaint	Anyone
Press or regulator report	Public record
Exam monitoring	Program staff

IN THE LESSON

- An inquiry does not need a formal accusation.
- There are four usual starting points.
- The first is self-disclosure, where the member reports something on the annual statement.
- The second is a written complaint, which can come from a client, a colleague or any member of the public.
- The third is a report in the press or from a regulator, because staff read those too.
- The fourth is exam monitoring, which applies to candidates sitting the exams, for example someone seen breaking the exam rules.
- Notice what they share.
- In every case, the information can reach C F A Institute without the member lifting a finger, so staying silent is never a safe plan.

4 After the investigation

Staff decide, after investigating

Close the matter → Cautionary letter → Propose charges

If charges are proposed

Member weighs them → If rejected: a panel → Panel decides

IN THE LESSON

- Now follow a case through.
- The staff investigate.
- They may ask the member for a written explanation, request documents, and speak to others.
- Then they choose one of three routes, shown on the top row.
- They may close the matter, because nothing needs doing.
- They may send a cautionary letter, which warns the member without a sanction.
- Or they may propose charges and a sanction.
- The bottom row shows what happens when charges are proposed.
- The member can accept, and the case is settled.
- If she rejects them, a hearing panel decides, using volunteers from the Disciplinary Review Committee.
- So most cases never reach a hearing.
- Only a contested charge does.

5 How severe can a sanction be

- Cautionary letter
- Public censure
- Suspension
- Revocation

IN THE LESSON

- Here is the ladder of outcomes, from milder on the left to harsher on the right.
- The cautionary letter sits at the far left, and strictly it is a warning, not a sanction.
- Next comes public censure, a published statement that the member breached the rules.
- Then suspension, where membership is taken away for a period.
- At the far right is revocation, where the right to use the charter is ended.
- Candidates face parallel penalties.
- A candidate can be suspended from the C F A Program or barred from it.
- The further right a case lands, the more serious the breach, and the more likely it is to be remembered by clients and employers.

6 Case: Ines and the client lawsuit

A lawsuit is filed; Ines discloses and cooperates

Client sues the firm	claims a poor fit	**Day 0**
Ines tells compliance	the same week	**Day 2**
Ines tells the staff	in writing, with papers	**Day 6**
She answers every request	full cooperation	**Day 40**
Staff decide	cautionary letter	**Day 120**

IN THE LESSON

- Let us see the practical lesson.
- A client of Brindle Quay sues the firm, claiming the mix was a poor fit.
- That is day zero.
- Ines tells the compliance officer, Mira Tolland, two days later.
- On day six she reports it to the Professional Conduct staff in writing, with the papers.
- When they ask questions, she answers every request, which takes until day forty.
- On day one hundred and twenty the staff decide, and in this story they close with a cautionary letter.
- Now imagine she had said nothing and the press reported it.
- The silence would be a fresh problem of its own, touching Standard seven, conduct as a participant in C F A Institute programs.

7 What the firm should put in place

Procedures that support honest disclosure

Procedure	Purpose
Log of complaints and inquiries	Nothing forgotten
Report to compliance at once	Speed
Help with complete disclosure	Accuracy
Early reminder of the statement	No surprises

IN THE LESSON

- A firm cannot make a lawsuit disappear, but it can make sure the right thing happens quickly.
- Brindle Quay should keep a log of every complaint, lawsuit and regulatory contact, so nothing is forgotten when the annual statement arrives.
- Staff should be told to report any such event to compliance at once.
- Compliance should help each member make a prompt, complete disclosure.
- Finally, it should send a reminder of the annual statement and what it asks well before it is due.
- Each of these turns a personal judgement call into a routine, which is exactly what a good procedure does.

8 A story: six duties and their rules

- Act with integrity and respect
- Put clients and the profession first
- Use reasonable care and independent judgement
- Practise ethically; encourage others to
- Protect markets; keep your competence up

IN THE LESSON

- Think of a doctor's oath.
- It is short and general, and it describes the kind of person the doctor promises to be.
- But a hospital cannot discipline anyone for breaking a vague promise, so it adds detailed rules.
- The C F A Institute Code of Ethics is the oath, and the Standards of Professional Conduct are the rules.
- The Code has six duties.
- Act with integrity and respect.
- Put clients and the profession ahead of your own interest.
- Use reasonable care and independent judgement.
- Practise ethically and encourage others to do so.
- And, on the last line of the board, protect the integrity of global markets and keep your own competence up, which are two duties in one line.

9 Where the twenty three subsections sit

Subsections

I	**5**
II	**2**
III	**5**
IV	**3**
V	**3**
VI	**3**
VII	**2**

Seven Standards, twenty three subsections

IN THE LESSON

- The Standards turn the six duties into seven Standards, which break into twenty three subsections.
- This picture counts them.
- The vertical axis is the number of subsections, and the labels along the bottom are the seven Standards in order.
- Standard one, Professionalism, has five.
- Standard two, Integrity of Capital Markets, has two.
- Standard three, Duties to Clients, has five.
- Standards four, five and six, which are Duties to Employers, Investment Analysis, and Conflicts of Interest, have three each.
- Standard seven, Responsibilities as a Member or Candidate, has two.
- Five and two and five and three and three and three and two add to twenty three.
- The bars are a map, not a ranking of importance.

10 Standard I: Professionalism

Five duties about how you behave

I(A) Knowledge of the Law	**stricter rule**
I(B) Independence and Objectivity	stay objective
I(C) Misrepresentation	no false claims
I(D) Misconduct	no dishonesty
I(E) Competence	stay competent

IN THE LESSON

- Standard one has five subsections.
- A, Knowledge of the Law: follow the law and the Code, and where they differ, the stricter rule wins.
- B, Independence and Objectivity: do not let gifts or pressure bend your judgement.
- C, Misrepresentation: never knowingly make false statements about your analysis, your recommendations or your work, which includes passing off someone else's work as your own.
- D, Misconduct: no dishonesty, fraud or deceit, and no act that damages your professional reputation.
- E, Competence: keep your skills up, and do not act beyond them.
- We will spend most of this lesson in this Standard, so hold these five in your head.

11 Standards II and V: markets and analysis

Two market duties and three analysis duties

II(A) Material Nonpublic Information	**no insider use**
II(B) Market Manipulation	no distortion
V(A) Diligence and Reasonable Basis	research first
V(B) Communication with Clients	be clear
V(C) Record Retention	keep records

IN THE LESSON

- Now Standards two and five.
- Standard two protects the market.
- Two A, Material Nonpublic Information: do not act on information that is both important and not yet public, and do not pass it on to someone who will.
- Two B, Market Manipulation: do not distort prices or inflate trading volume to mislead others.
- Standard five protects the quality of advice.
- Five A, Diligence and Reasonable Basis: research before you recommend, and keep a sound basis.
- Five B, Communication with Clients: explain your process, separate fact from opinion, and mention the key risks.
- Five C, Record Retention: keep the records that support your work.
- In short: market integrity, then sound and clear advice, with proof.

12 Standard III: duties to clients

Five duties owed to clients

III(A) Loyalty, Prudence, and Care	**clients first**
III(B) Fair Dealing	treat all fairly
III(C) Suitability	fits the client
III(D) Performance Presentation	fair, complete
III(E) Preservation of Confidentiality	keep private

IN THE LESSON

- Standard three is the heart of a manager's daily work.
- Three A, Loyalty, Prudence, and Care: put the client first, ahead of the employer and yourself.
- Three B, Fair Dealing: no client is treated unfairly when you issue recommendations or trade.
- Three C, Suitability: gather the client's circumstances and objectives, and make sure investments fit.
- Three D, Performance Presentation: results shown to clients must be fair, accurate and complete.
- Three E, Preservation of Confidentiality: keep client information private, with narrow exceptions such as illegal activity, a legal requirement, or the client's permission.
- Most Level Three cases are decided under this Standard, together with Standards four and five, which cover the manager's duties to the employer and the quality of analysis.

13 Standards IV and VII: employer and programs

Three employer duties and two program duties

IV(A) Loyalty	**to the employer**
IV(B) Additional Compensation	get consent
IV(C) Responsibilities of Supervisors	supervise well
VII(A) Conduct in CFA programs	no cheating
VII(B) Citing the designation	no exaggeration

IN THE LESSON

- Standard four is about the employer.
- Four A, Loyalty: do not harm the employer by taking its clients or using its property for yourself.
- Four B, Additional Compensation Arrangements: get written consent before accepting pay or benefits from anyone else for related work.
- Four C, Responsibilities of Supervisors: if you supervise, take reasonable steps to prevent and detect breaches by the people you supervise.
- Standard seven is about your membership.
- Seven A, Conduct as Participants in C F A Institute Programs: do not cheat on exams or compromise the integrity of the program, and answer the statement honestly.
- Seven B, Reference to C F A Institute and the Designation: describe your credentials accurately, without exaggeration.

14 Standard VI: conflicts of interest

Three duties about conflicts

VI(A) Disclosure of Conflicts	**tell all**
VI(B) Priority of Transactions	clients first
VI(C) Referral Fees	disclose them

IN THE LESSON

- Last, Standard six.
- Six A, Disclosure of Conflicts: tell clients, prospects and the employer about anything that could cloud your independence, in plain words, and where it counts.
- Six B, Priority of Transactions: when you trade, client and employer transactions come before your own account.
- Six C, Referral Fees: if you pay or receive anything for recommending a product or service, disclose it, so the client can weigh the recommendation.
- Do not read disclosure as a cure.
- Avoiding a conflict is preferred where that is reasonably possible, and one that remains must be disclosed.
- Even then, disclosure tells people about the conflict, and it does not excuse an act that puts the manager ahead of the client, and that stays true whatever was disclosed.

15 Case: Dev's trade, six subsections

Dev Okoro buys Orlin Freight shares

Buys for himself, then the plan		**VI(B), III(A)**
Calls a blog 'deep research'		**V(A), I(C)**
Keeps no notes of why		**V(C)**
Letter hides the main risk		**V(B)**
Different subsections engaged	counted once each	**6**

IN THE LESSON

- Now the skill the exam really tests: naming the exact subsection for each act, and noticing that one story can breach many.
- A colleague, Dev Okoro, wants shares in a company called Orlin Freight.
- He buys them for himself first, then for the Alder Pension Plan.
- That is six B, putting his own trade ahead of the client's, and three A, loyalty.
- He then tells the trustees the idea came from deep research, when it came from a single blog.
- That is five A and one C.
- He keeps no notes, which is five C.
- His letter hides the main risk, five B.
- Six different subsections come from one chain of events.

16 A way to name the subsection

Name it

What exactly was done? →

Which of the seven Standards? →

Which exact subsection?

Then check

Does a second one apply? →

Is there a duty to act? →

What should the firm change?

IN THE LESSON

- When the exam gives you a case, do not guess the Standard from a keyword.
- Walk down the questions in order.
- First, the top row.
- Ask what exactly was done, in one plain sentence.
- Then ask which of the seven Standards that act belongs to.
- Then pin down the exact subsection.
- The bottom row is the check.
- Does a second subsection also apply, as it did for Dev?
- Is there a duty to act, such as reporting a colleague or telling the employer?
- And what should the firm change so it cannot happen again?
- That last question leads straight to the second half of this lesson.

17 Mistakes to avoid so far

- Sending every case to a hearing panel: most end earlier
- Staying quiet about a lawsuit until the press reports it
- Naming one subsection when the act engages several
- Treating disclosure as a cure for every conflict

IN THE LESSON

- Four mistakes appear again and again.
- First, thinking every case goes to a hearing panel.
- Most end earlier, with the matter closed, a cautionary letter, or a settlement.
- Second, staying quiet about a lawsuit until it reaches the press.
- Third, naming one subsection when the act engages several, as Dev's did.
- And fourth, treating disclosure as a cure for every conflict.
- Disclosure is required under six A, but it does not excuse a conflict that was settled in the manager's favour.
- If you can avoid these four, you are already ahead of most candidates, so pause here and check that each one makes sense to you.

18 A story: pressure and presentation

- Pressure: brokers, sponsors and clients want something
- Presentation: how the strategy is described
- Test: is judgement independent and are words true?
- Place each case under I(A) to I(E)

IN THE LESSON

- At Level Three, Standard one cases rarely involve outright fraud.
- They involve two quieter things.
- The first is pressure: a broker who wants order flow, a plan sponsor who wants its own shares bought, a client who wants a promise.
- The second is presentation: how a strategy is described to the people who buy it.
- In each case, the test is the same.
- Does the manager's judgement stay independent, and are her words true?
- Ines Calloway will meet both kinds at Brindle Quay.
- Our job is to place each situation under the right subsection, one A to one E, and then say what she should do.

19 Judging a Standard I case

Pressure

Something offered or pushed? → Could it bend judgement? → Decline or disclose

Presentation

Is every claim true? → Do I have the skill? → Is the whole picture honest?

IN THE LESSON

- Here is a way to judge any Standard one case.
- On the top row is pressure.
- Ask first whether someone outside is offering something or pushing for something.
- Then ask whether it could reasonably bend your judgement or anyone else's.
- If so, decline, or disclose where the Standards allow it.
- On the bottom row is presentation.
- Ask whether every claim you make is true and has a source.
- Ask whether you have the skill to do what you are describing.
- And ask whether the whole picture is honest, not only each sentence.
- If the answers are yes, the case is probably acceptable.
- If any is no, find the subsection and the fix.

20 I(A): which rule wins

Which rule applies, and what Ines does

Situation	Action
Law stricter than the Code	Follow the law
Code stricter than the law	Follow the Code
Colleague breaks either	Raise, then step back
Keeps quiet and carries on	Not enough

IN THE LESSON

- Start with one A.
- Brindle Quay manages money in several countries, and the rules do not always agree.
- When the local law is stricter than the Code, Ines follows the law.
- When the Code is stricter than the local law, she follows the Code, because the Code applies to her wherever she works.
- She also must not knowingly take part in, or help, a breach of the law or the Code by anyone else.
- If a colleague does, she must dissociate.
- In practice, that means raising it with compliance first.
- If nothing changes, she may need to step back from the work, and in the worst case consider leaving.
- Silence is not dissociation.

21 I(B) case: the broker's trip

Alder trades 200m a year; Kestrel offers a trip

Value traded each year	Alder Pension Plan	**200m**
Best-execution cost	6 basis points	**120,000**
Kestrel's cost	8 basis points	**160,000**
Extra cost to clients	160,000 − 120,000	**40,000**
Value of the trip offered	to Ines	**6,400**

IN THE LESSON

- Now one B, independence and objectivity.
- A broker, Kestrel Securities, invites Ines to a trip worth six thousand four hundred, and hints it would like more of the Alder Pension Plan's orders.
- The plan trades two hundred million a year.
- The best broker costs six basis points, a basis point being a hundredth of one per cent, which is one hundred and twenty thousand.
- Kestrel costs eight, which is one hundred and sixty thousand.
- So the extra cost to the plan is forty thousand.
- The trip is worth six thousand four hundred, so clients would pay more than six times the gift to fund it.
- She should decline, and choose brokers on execution quality alone.

22 I(B): accept, decline or disclose

Three pressures, three answers

Situation	Verdict
Broker trip tied to order flow	Decline
Sponsor pushes its own shares	Resist, record
Client's thank-you gift	Disclose, may keep

IN THE LESSON

- More pressure cases under one B.
- Tarn Industries, the sponsor of the Alder Pension Plan, presses Ines to buy Tarn's own shares for the plan.
- The plan's client is its beneficiaries, so she must judge the shares on merit, resist the pressure, and keep a record of why.
- Next, a long standing client sends a thank you gift after good service.
- A gift from a client is acceptable, but she should disclose it to her employer.
- Compare these with the broker's trip, which was offered to win business and could reasonably bend her judgement.
- That one she declines.
- The principle is simple: would it reasonably be expected to compromise independence?

23 I(C) case: the guaranteed return

Illustration: expected return 8%, volatility 14%

Expected return	illustration	**8%**
Volatility	one standard deviation	**14%**
Low end of a typical range	8 − 14	**−6%**
High end	8 + 14	**22%**
The word 'guaranteed'	no guarantee exists	**I(C)**

IN THE LESSON

- Now one C, misrepresentation.
- A Brindle Quay brochure says its equity strategy is guaranteed to return eight per cent.
- Look at the model's own numbers.
- The expected return is eight per cent, and the volatility is fourteen.
- One standard deviation either side gives a range from minus six to twenty two, and most years should land inside it.
- So a loss is entirely possible, and no guarantee exists.
- The word guaranteed is a false statement.
- Other I C breaches are naming a fund sustainable when no E S G process is applied, and passing off another firm's model as your own.
- The cure is to state expected return and risk plainly.

24 Match the act to the subsection

Which subsection is engaged?

Sustainable label, no ESG process	**I(C)**
Other firm's model shown as ours	I(C)
Expense claim padded by 900	I(D)
Takes an overlay with no training	I(E)
Sponsor pressure to buy its shares	I(B)

IN THE LESSON

- Here is a matching drill across the whole Standard.
- A fund called sustainable, with no E S G process behind the label: that is one C.
- Showing another firm's model as the firm's own: also one C.
- Padding an expense claim by nine hundred is dishonesty, so one D, and it counts even though no client is harmed, because it reflects on the member's integrity.
- Taking over a derivatives overlay without the training: that is one E.
- And the sponsor's pressure to buy its shares is one B.
- Notice that one D is broad.
- It covers dishonest acts linked to professional life, whether or not they are covered by another subsection.

25 I(E) case: the overlay she did not understand

Hedge half of 150m of equities with futures

Equity to protect	Alder Pension Plan	**150m**
Target hedge	50% of 150m	**75m**
Contracts needed	75m ÷ 0.5m each	**150**
Contracts she sells	units mixed up	**300**
Hedge she ends up with	300 × 0.5m	**150m, 100%**

IN THE LESSON

- Finally one E, competence.
- The Alder Pension Plan holds one hundred and fifty million in equities, and the trustees ask Ines to hedge half with futures.
- She has never run an overlay.
- Half of one hundred and fifty million is seventy five million.
- Each contract covers half a million, so she needs one hundred and fifty contracts.
- But she mixes up units and sells three hundred.
- That is one hundred and fifty million of cover, a full hedge, and it will cancel all the plan's equity exposure.
- The competent response was to say she needed training or help first, and to take on the overlay only once someone qualified had checked her work.

26 A control for each subsection

Law and independence

Legal map of every market →
Gifts limit and a log →
Brokers chosen on execution

Truth and skill

Compliance reviews claims →
Hiring checks, discipline →
Training before new work

IN THE LESSON

- Now the firm's side.
- People breach Standard one, but firms create the conditions that make it more or less likely.
- A good set of controls makes the right behaviour routine, so nobody has to rely on memory or courage.
- On the top row are the controls for the law and independence: a legal map of every market where the firm manages money, which protects one A, then a gifts limit with a log, and brokers chosen on execution quality, which protect one B.
- On the bottom row are the controls for truth and skill: compliance review of claims before release, hiring checks with a clear disciplinary policy, and training before anyone takes on a strategy that is new to them.

27 Each control protects a subsection

Control and the subsection it protects

Legal map of every market	**I(A)**
Gifts limit and log; broker rules	I(B)
Compliance review, sources kept	I(C)
Hiring checks and discipline	I(D)
Training plan for new strategies	I(E)

IN THE LESSON

- A good answer ties each control to the subsection it protects.
- Compliance keeps an up to date map of the laws in every market, so Ines always applies the stricter rule: that is one A.
- A written gifts and entertainment policy with a value limit, and a log of anything accepted, protects one B, as does choosing brokers on execution quality.
- Prior review of brochures, E S G labels and performance claims, with sources kept, protects one C.
- Reference checks at hiring and a clear disciplinary policy protect one D.
- A training plan for staff who move into unfamiliar strategies protects one E.
- A confidential route for raising concerns supports every one of them.

28 Are the controls worth their cost

Review of 12 documents a month, 120 an hour

Review hours a month	12 × 0.5	**6**
Cost a month	6 × 120	**720**
Cost a year	720 × 12	**8,640**
Yearly cost of the broker favour	from the trip case	**40,000**
Cost of the control as a share	8,640 ÷ 40,000	**22%**

IN THE LESSON

- A fair question from the partners is whether the controls are worth the effort.
- Take just one: compliance review of marketing.
- Brindle Quay issues twelve documents a month, and each takes half an hour to review, so six hours a month.
- At a hundred and twenty an hour that is seven hundred and twenty a month, or eight thousand six hundred and forty a year.
- Compare that with the forty thousand a year the plan would have lost to the broker favour.
- Cost is not the whole argument, because reputation and the risk of sanction matter too.
- But a control that costs a fraction of one avoidable lapse is easy to defend.

29 How to justify a control

- Name the subsection at risk
- Say how the breach could happen
- Name the control and how you will know it works
- Add who owns it and what happens if broken

IN THE LESSON

- When the exam asks you to propose a procedure, a bare list earns little.
- A strong answer has three parts.
- First, name the subsection at risk, for example one B.
- Second, say how the breach could happen, such as a broker trading favours for order flow.
- Third, name the control and how you would know it works: a gifts limit, a log, and a periodic review of broker choices by compliance.
- Add who is responsible, and what happens if the rule is broken.
- Finally, remember that controls do not replace character.
- They simply make good conduct easier and bad conduct easier to spot, which is what protects clients.

30 Recap: the lesson in five lines

Remember these

Who hears a rejected charge	Hearing panel
Subsections in all	23
Local law or the Code	The stricter
Broker trip tied to orders	Decline
Claims to clients	True, sourced

IN THE LESSON

- Let us pull it together.
- First, a rejected charge goes to a hearing panel, and most cases end before that.
- Second, the Code and Standards hold twenty three subsections in seven Standards, and one act can engage several.
- Third, under one A, where law and Code differ, follow the stricter.
- Fourth, under one B, decline anything offered to win business, such as the broker's trip, and disclose a client's gift to your employer.
- Fifth, under one C, every claim to clients must be true and sourced, so never promise a guaranteed return from a risky strategy.
- And for the firm, each control must be tied to the subsection it protects.

31 Try three quick questions

1. A member rejects the charges proposed. Who decides next?
   Answer: A hearing panel of volunteer committee members
2. A client gives Ines a thank-you gift. May she keep it?
   Answer: Yes, once disclosed to her employer: I(B)
3. A brochure says an equity strategy is guaranteed 8%. OK?
   Answer: No: false claim, a breach of I(C)

IN THE LESSON

- Now try three questions yourself.
- Pause after each one.
- Question one.
- A member rejects the charges the staff propose.
- Who decides next?
- A hearing panel, made up of volunteers from the Disciplinary Review Committee.
- Question two.
- After good service a client gives Ines a thank you gift.
- May she keep it?
- Yes, once she has told her employer about it, under one B.
- Question three.
- A brochure says an equity strategy is guaranteed to return eight per cent a year.
- Is that acceptable?
- No.
- No such guarantee exists, so it is a misrepresentation under one C, and the firm should have caught it before release.

Summary notes for the Charta whiteboard lesson. Figures are from the lesson's made-up examples.