

**Level III
of the
CFA® Program**

Ethics and Professional Standards

**GUIDANCE FOR STANDARDS I–VII &
APPLICATION OF THE CODE AND STANDARDS: LEVEL III**

Standards of Professional Conduct

- Standard I – Professionalism
- Standard II – Integrity of Capital Markets**
 - **(A) Material Nonpublic information**
 - **(B) Market Manipulation**
- Standard III – Duties to Clients and Prospective Clients
- Standard IV – Duties to Employers
- Standard V – Investment Analysis, Recommendations, and Actions
- Standard VI – Conflicts of Interest
- Standard VII – Responsibilities as a CFA Institute Member or CFA Candidate

Learning Outcome Statements

LOS : Demonstrate a thorough knowledge of the CFA Institute Code of Ethics and Standards of Professional Conduct by **interpreting the Code and Standards** in various situations involving **issues of professional integrity**

LOS : Recommend practices and procedures designed to **prevent violations** of the Code and Standards.

LOS : Evaluate practices, policies, and conduct relative to the CFA Institute Code of Ethics and Standards of Professional Conduct.

LOS : Explain how the practices, policies, or conduct **does or does *not* violate** the CFA Institute Code of Ethics and Standards of Professional Conduct.

Standard II(A) – Material Nonpublic Information

According to the Standards of Practice Handbook:

*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.*



Standard II(A) – Material Nonpublic Information

Example Question

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.

Has Peter **violated** Standard II(A)?

Solution

Standard II(A) – Material Nonpublic Information

Example Question

Solution

Has Peter violated Standard II(A)?

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**.

Standard II(A) – Material Nonpublic Information

Guidance

What Constitutes Material Information?

- Information is considered material if its disclosure would **affect a security's price.**
- OR*
- If any reasonable investor **would want the information before taking investment action**
- Pieces of material information may include:
 - Periodic earnings.
 - New/innovative products about to be launched.
 - Impending management shakeups.
 - Bankruptcies, etc.

Standard II(A) – Material Nonpublic Information

Guidance

What Constitutes Nonpublic Information?

- Any information that's **yet to be disseminated** to the marketplace in general
 - Financial results of a firm are considered **nonpublic until they have been distributed** widely via press releases, online platforms, or print media.
- There must be a **reasonable expectation** that the released information has had a **wide reach before it can be considered 'public.'**
- Members and candidates may use insider information that is issued by the **source company** for the specific **purpose** of **conducting due diligence** on activities such as mergers and credit ratings.
 - Within the confines of the **business agreement** between the parties.
 - Using the provided information to **trade** or **cause** others to trade violates Standard II(A).

Standard II(A) – Material Nonpublic Information

Guidance

Mosaic Theory

Allows analysts to scour information from a combination of **public** and **nonpublic nonmaterial** sources – for purposes of issuing reports or recommendations – without violating Standard II(A).

To come up with meaningful recommendations for their clients, analysts generally knit together bits of information not **generally known to the market** and then analyze the information to draw informed conclusions.

- By so doing, a member or candidate does not violate Standard II(A), **unless** the information received **directly come** from subject companies.

However, analysts **must keep records of their research activity** as evidence that their reports/recommendations are based on mosaic information, and not material nonpublic sources.

Standard II(A) – Material Nonpublic Information

Guidance

The Use of Social Media

- Members and candidates acting on information disseminated via online platforms with membership limitations must ensure **such information is publicly available** – e.g., on company webpages, print media, or press releases.
 - If not, basing reports of recommendations on such information violates Standard II(A).
- Members or candidates disseminating information via social media must ensure that the information **reaches all clients or is open to the investing public**.
 - Social media must not benefit a few at the expense of the majority.

Standard II(A) – Material Nonpublic Information

Guidance

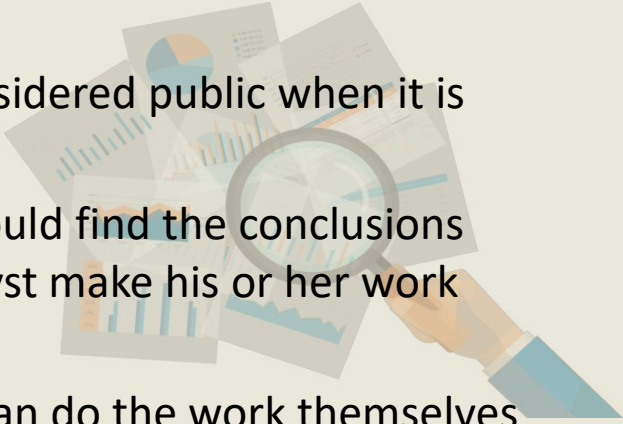
Should Members and Candidates Leverage the Insights of Industry Experts?

- In their search for insights on an industry or product, members are **allowed** to **consult experts** and even **compensate** them without violating Standard II(A).
 - However, members and candidates are ultimately responsible for **ensuring** that they are **not requesting** or acting on confidential information received from external experts .
- Firms that connects members and candidates with the experts usually require both parties to sign **disclosure agreements** – **even** with these agreements, a member or candidate should **not** act on information given by the experts, which is considered as material nonpublic information, **until** it is considered public.

Standard II(A) – Material Nonpublic Information

Guidance

Investment Research Reports

- ◀● A report/recommendation change issued by a **renowned analyst** may be considered **material** if that information may cause **significant market movement**.
 - As per Standard II(A), such report is considered public when it is distributed to the clients.
 - 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 analyst's clients can do the work themselves or become analyst's clients to access the report.
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Standard II(A) – Material Nonpublic Information

Recommended Procedures for Compliance with Standard I(A)

1

Achieve Public Dissemination

- If a member or candidate concludes that the information is material, the member or candidate should make reasonable efforts to achieve **public dissemination**.
 - **Encouraging the source company** to make the information public
- Public dissemination **not possible?**
 - Communicate the information only to **designated** supervisory and compliance personnel.
 - Must not take investment action or alter investment recommendations.

Standard II(A) – Material Nonpublic Information

Recommended Procedures for Compliance with Standard I(A)

2

Adopt Compliance Procedures

- Members and candidate should motivate their firms to **adopt** compliance **procedures**.
 - **Averts misuse** of material nonpublic information.
 - Depends on the specific features of a firm.

Standard II(A) – Material Nonpublic Information

Recommended Procedures for Compliance with Standard I(A)

3

Adopt Disclosure Procedures

- Members and candidate should **encourage** their firms to **develop** and follow **disclosure policies**.
 - Guarantee **equitable** dissemination of **information** to the market.

4

Issue Press Releases

- Companies are **encouraged** to issue press releases **before** analyst meetings and conference calls.
- If material non-public information leaks in an analyst meeting or call, the company should **issue press** release **immediately** or otherwise make the information public.

Standard II(A) – Material Nonpublic Information

Recommended Procedures for Compliance with Standard I(A)

4

Firewalls Elements

- Makes sure **confidential information reaches** to only those **who need to know** to execute their responsibilities effectively.
 - **Control** of interdepartmental communications.
 - **Gauging** employee trading through watch, restricted and rumor lists.
 - Developing **procedures to limit** interdepartmental information flow.
 - Cautious **review** or **restriction** of **proprietary trading** while in possession of material nonpublic information

Standard II(A) – Material Nonpublic Information

Recommended Procedures for Compliance with Standard I(A)

5

Appropriate Interdepartmental Communications

- Firms of all sizes should **develop** and **formalize procedures** regarding **interdepartmental communication**, review of trading activity and investigation of possible violations.

6

Physical Separation of Departments

- Physical **separation** of **departments** and **files**.
 - Prevents communication of **delicate** information that should **not be shared**.

Standard II(A) – Material Nonpublic Information

Other Recommended Procedures for Compliance with Standard II(A)

- ◆ Avoid personnel **overlap** between the **investment banking** and **corporate** areas of a brokerage firm and the sales and research departments
 - Or **commercial lending department** and **trust and research** departments of a bank
- ◆ Establish a **reporting system** where only authorized personnel review and approve communications between departments
- ◆ Firms should **limit personal trading by employees**
- ◆ **Maintain a record** of communications between departments

Standard II(A) – Material Nonpublic Information

Application of Standard II(A)

Jamal Saadiq is a **portfolio manager** at Sanford Asset Managers. She specializes in technology stocks and wants to get deeper insights into the sector. Saadiq **hires** an **industry expert** and **compensates** him for his time. Saadiq leaves their session better informed and enhances her research reports and conclusions.

Would Saadiq's actions **violate** Standard II(A) – Material Nonpublic Information?

- A. Yes, because she is using the knowledge of the expert to enhance her research.
- B. No, because she is allowed to hire industry experts to enhance her knowledge.
- C. Yes, because she compensated the industry expert for insider information.

Standard II(A) – Material Nonpublic Information

Application of Standard II(A)

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Would Saadiq's actions **violate** Standard II(A) – Material Nonpublic Information?

- A. Yes, because she is using the knowledge of the expert to enhance her research.
- B. No, because she is allowed to hire industry experts to enhance her knowledge.**
- C. Yes, because she compensated the industry expert for insider information.

The correct answer is **B**.

Saadiq has not violated Standard II(A) – Material Nonpublic Information. She has not received any information that could be considered material and nonpublic. Saadiq is **permitted to seek advice from industry experts** to enhance her research.

Standard II(B) – Market Manipulation

According to the practice handbook:

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

Standard II(B) – Market Manipulation

Example Question

Pietro, president of Local Bank, has hired the bank's market maker, Vogt, to seek a merger partner. Local is currently 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.

Solution

Standard II(B) – Market Manipulation

Example Question

Solution

Which of the following actions would *most likely* be a **violation** of the Code and Standards?

- B. Pietro could place a buy order for 2,000 shares (or four times the average weekly volume) through Vogt for his personal account.**

Through placing a personal purchase order that is significantly greater than the average volume, Pietro is violating Standard II(B) – 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.

Standard II(B) – Market Manipulation

What is Market Manipulation?

- Practices that distort security prices or trading volume with the intent to **deceive market participants** or entities that rely on information in the market.
 - *Consequence:* It damages **investor confidence** and **distorts information signals** of market prices.

Standard II(B) – Market Manipulation

There are Two Types:

1 → Information-based manipulation

2 → Transaction-based manipulation



Standard II(B) – Market Manipulation

1 Information-based manipulation

- Distribution of false or misleading information as a means of distorting **volume trading**, and **market price valuation**.
 - Example: Pump and Dump
- **Social media networks** are a particularly viable target for such practices
 - Example: Creating many social media accounts to spread damaging rumors about a particular publicly traded company.

Standard II(B) – Market Manipulation

2 Transaction-based manipulation

- **Making trades** that would trigger a falsification in price-setting mechanisms, thereby misleading market participants
 - Example: Back-and-forth trades between two individuals which may give the impression of high level of trading activity.
- Smaller firms are more easily manipulated based upon lighter trading and low liquidity
 - Prudence in releasing public information is critical.
 - As a reminder, all research must include a disclaimer as required by the SEC.

Please Note!

Legitimate trading strategies are *not* a violation of Standard II(B) – Market Manipulation. The key to identifying a violation is evaluating the *intent* of the action!

Standard II(B) – Market Manipulation

Application of Standard II(B)

John Reynolds, CFA and **CEO** of Naxis Future Exchange (NFE), **introduces a new equity index futures** contract into the market. In an attempt to **attract** individuals and major brokers to trade on its exchange, Naxis offers **significant discounts** on its trading fees.

To be eligible for the reduction in trading fees, firms must **agree to a minimum trading volume** of the new contract over the next six months. Naxis hopes that the demonstration of **consistently large liquidity** will attract new brokerages and retail traders to its exchange.

Are Reynolds's actions **in conflict** with Standard II(B) – Market Manipulation?

- A. No, Reynolds is allowed to offer discounts on trading fees.
- B. No, the firms or retail traders who engage with Reynolds' exchange on this offer are in violation.
- C. Yes, because Reynolds is attempting to mislead investors about the liquidity of the contract.

Solution

Standard II(B) – Market Manipulation

Example Question

Are Reynolds's actions **in conflict** with Standard II(B) – Market Manipulation?

- A. No, Reynolds is allowed to offer discounts on trading fees.
- B. No, the firms or retail traders who engage with Reynolds' exchange on this offer are in violation.
- C. Yes, because Reynolds is attempting to mislead investors about the liquidity of the contract.**

- Investors may be **misled** by the artificial liquidity generated by Naxis through the discounts offered.
 - The expiry of the discount after six months could potentially **reduce** the liquidity of the contract.
 - Because Reynolds **failed to disclose this agreement with all its clients and potential clients**, he has violated Standard II(B) – Market Manipulation. Disclosure of the arrangement to *all* investors would comply with Standard II(B) – Market Manipulation.
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Standards of Professional Conduct

- Standard I – Professionalism
- Standard II – Integrity of Capital Markets
- Standard III – Duties to Clients and Prospective Clients**
 - **(A) Loyalty, Prudence, and Care**
 - **(B) Fair Dealing**
 - **(C) Suitability**
 - **(D) Performance Presentation**
 - **(E) Preservation of Confidentiality**
- Standard IV – Duties to Employers
- Standard V – Investment Analysis, Recommendations, and Actions
- Standard VI – Conflicts of Interest
- Standard VII – Responsibilities as a CFA Institute Member or CFA Candidate