LM01 · ETHICAL AND PROFESSIONAL STANDARDS · CFA LEVEL I

Ethics and Trust in the Investment Profession

Why ethics is the foundation of capital markets — and the single most important topic area on the Level I exam

Why This Module Matters

Ethics is **15%–20%** of the Level I examination. Unlike topic areas you can partially skip, Ethics is "extremely important to your overall success." You can fail a topic area and still pass the exam, but failing Ethics is not recommended. Many ethics questions turn on small details, and the day-before-exam strategy is to re-read the ethics material from the curriculum.

What You Will Learn

1. The definition of **ethics**, **ethical conduct**, and a **code of ethics**
2. What makes an occupation a **profession** and how professions establish trust
3. The distinction between **ethical** and **legal** standards
4. Why **trust** is the cornerstone of investment management
5. **Suitability** vs **fiduciary** standards
6. Challenges to ethical behaviour: overconfidence, situational influences, rules-based culture
7. A four-step **framework for ethical decision-making**
8. The role of the **Standards of Practice Handbook** and the CFA Institute Professional Conduct Program

Exam Tip: On exam day the first session begins with Ethics. Read the full question carefully — questions often use phrases like *most accurate*, *least likely*, or *closest to*. Words like *true*, *false*, and *except* will not appear.

CORE DEFINITIONS

What is Ethics?

FROM CHARACTER TO CONDUCT

ETHICS

Greek: "ethos" = character

Shared beliefs about good or bad behaviour

A set of moral principles and rules of conduct that guide behaviour

ETHICAL CONDUCT

Follows moral principles

Consistent with society's ethical expectations

Improves outcomes for stakeholders

CODE OF ETHICS

A written set of moral principles

Communicates an org's values & expectations

May include rules or minimum standards

The Three Layers

Ethics	From the Greek word *ethos* meaning **character**. Ethics means making good choices — a set of moral principles and rules of conduct that help guide our behaviour. It can also be described as **shared beliefs about what behaviour is good or acceptable**.
Ethical conduct	Behaviour that (a) follows moral principles, (b) is consistent with society's ethical expectations, and (c) **improves outcomes for stakeholders** — those who are directly or indirectly affected by the conduct.
Code of ethics	A **written set** of moral principles that can guide behaviour. A code is a way to communicate an organization's values, principles, and expectations. Some codes include **rules or standards** that require a minimum level of ethical behaviour.

Stakeholders — remember the breadth

Stakeholders are not just clients. They include employees, the employer, colleagues in the investment profession, other market participants, regulators, and society at large. Ethical conduct is measured by its effect on *all* of them.

ETHICAL VS LEGAL STANDARDS

Law Is Not the Same as Ethics

Not all unethical actions are illegal, and not all illegal actions are unethical. Ethical principles often set a *higher* standard of behaviour than laws and regulations.

Illegal but arguably ethical

Civil disobedience — protesting laws or policies you believe are unjust, even if you get arrested.

Whistleblowing — disclosing otherwise-confidential information to authorities to expose wrongdoing or protect the integrity of financial markets.

Legal but arguably unethical

Preferential allocation of oversubscribed IPO shares to favoured clients.

Recommending investment in a relative's firm without disclosure may not be illegal, but many would consider it unethical.

Why Law Is Not Always Enough

1. Legal standards are often created **in reaction to past ethical failings**. They do not provide direction for an ever-changing and increasingly complex world.
2. Laws are often **rule-based** — focused on the letter rather than the spirit.
3. Laws **vary across countries**, so an action that is legal in one jurisdiction may be illegal in another.
4. Ethical decisions require **more judgment** and consideration of impact on many stakeholders than legal decisions.

Exam Tip: On the exam, look for distractors that equate "legal" with "ethical." The CFA framework is explicit: **ethical conduct goes beyond legal standards**. If a recommendation is legal but creates an undisclosed conflict of interest, it is still unethical.

CODE OF ETHICS VS STANDARDS OF PROFESSIONAL CONDUCT

Two Related but Distinct Documents

FEATURE	CODE OF ETHICS	STANDARDS OF PROFESSIONAL CONDUCT
What it is	Statement of moral principles & values	Specific rules applying the Code to real situations
Tone	Aspirational — the ethical ideals members commit to	Prescriptive — what members must and must not do
Coverage	Six broad commitments (integrity, diligence, independence, etc.)	Seven numbered Standards (I – VII), each with sub-parts (A, B, C…)
Tested as	Recognition of principles	Application questions — given a scenario, identify the violation

The Six Commitments in the CFA Institute Code of Ethics

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

1. 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.
2. **Place the integrity of the investment profession and the interests of clients above their own personal interests.**
3. Use **reasonable care and independent, professional judgment** when conducting investment analysis, making recommendations, taking investment actions, and other professional activities.
4. **Practice and encourage others** to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
5. **Promote the integrity and viability of the global capital markets** for the ultimate benefit of society.
6. **Maintain and improve their professional competence** and strive to maintain and improve the competence of other investment professionals.

The Seven Standards of Professional Conduct

I. Professionalism

A. Knowledge of the Law · B. Independence & Objectivity · C. Misrepresentation · D. Misconduct · E. Competence

II. Integrity of Capital Markets

A. Material Nonpublic Information · B. Market Manipulation

III. Duties to Clients

A. Loyalty, Prudence & Care · B. Fair Dealing · C. Suitability · D. Performance Presentation · E. Preservation of Confidentiality

IV. Duties to Employers

A. Loyalty · B. Additional Compensation Arrangements · C. Responsibilities of Supervisors

V. Investment Analysis, Recommendations & Actions

A. Diligence & Reasonable Basis · B. Communication with Clients · C. Record Retention

VI. Conflicts of Interest

A. Avoid or Disclose Conflicts · B. Priority of Transactions · C. Referral Fees

VII. Responsibilities as a CFA Institute Member or CFA Candidate

A. Conduct as Participants in CFA Institute Programs · B. Reference to CFA Institute, the CFA Designation, and the CFA Program

Exam Tip: You are *not* required to know the Standards by number — just by name. Questions will give you a situation and ask you to identify whether a violation occurs, what it is, or the appropriate course of action.

WHAT IS A PROFESSION?

Professions and the Establishment of Trust

A **profession** is an occupational community having specialized knowledge and skills. A profession is different from craft guilds and trade bodies in two ways: unlike trade bodies, members of professions are required to **uphold high ethical standards** and their mission is to **serve society**.

Characteristics That Define a Profession

1. Normalize practitioner behaviour via a **code and standards**
2. Provide a **service to society**
3. Have **high entry standards** and a body of expert knowledge
4. Are **client-focused** — put client interests first
5. Encourage and facilitate **continuing education**
6. **Monitor professional conduct** to maintain integrity and reputation of the industry
7. Are **collegial** — respect the rights, dignity, and autonomy of others
8. Have **recognized oversight bodies**
9. Encourage the **engagement of members**
10. Mentor and inspire others in the profession

How Professions Establish Trust

- Require **high standards of expertise, knowledge, and skill**
- Establish **standards of ethical behaviour**
- **Monitor professional conduct**
- Encourage continuing education to maintain and increase competence
- Focus on **clients' needs**
- Mentor and inspire others

CFA Institute as a Professional Body

CFA Institute is the largest body for investment management professionals. CFA Institute candidates and charterholders are required to meet the **highest standards** among those established by CFA Institute, regulators, or the employer.

QUIZ 1 · CHECKPOINT

Test Your Understanding: Foundations of Ethics

Q1. The Greek word *ethos*, from which "ethics" is derived, most closely means:

Q2. Ethical conduct is *best* described as behaviour that:

Q3. Which of the following is *least likely* a reason that law is an imperfect mechanism for ensuring ethical behaviour?

Q4. A code of ethics is *best* described as:

Q5. Which of the following is *most likely* a characteristic of a profession?

CHALLENGES TO ETHICAL BEHAVIOUR

Why Good People Still Make Bad Decisions

The Overconfidence Trap

A key challenge is that individuals tend to **overrate the ethical quality of their own behaviour** and **overemphasize personal traits** in determining that quality. In other words, people tend to believe their ethical standards are above average — which leads to overconfidence bias. They place too much importance on internal traits (character, values) and too little on the external pressures shaping their decisions.

SELF-PERCEPTION VS REALITY

WHAT PEOPLE BELIEVE

"My ethics are above average"

"I would never do that"

"My character will carry me"

Focus: internal traits

→

WHAT STUDIES SHOW

External / situational factors are the main determinant of ethical behaviour

They shift focus from long-term to immediate impacts

Two Root Causes of Ethical Failure

1. **Overconfidence bias** — Believing your own ethical standards exceed others'. You underestimate how much you are influenced by environment.
2. **Overweighting internal traits** — Believing personality, values, and character alone will steer you right. Research shows *external / situational influences* dominate.

Rules-Based Compliance Culture — A Hidden Trap

A **rules-based compliance culture** can itself be a challenge to ethical conduct. When employees focus on "following the rule" rather than the spirit of ethics, they may miss situations the rules don't explicitly cover — or find loopholes. Ethical culture is stronger than a checklist.

EXTERNAL FACTORS THAT PUSH US OFF COURSE

The Three Main Situational Influences

External or situational influences have a **greater effect** on the ethical quality of behaviour than personal traits. They shift our focus to the *immediate* rather than the *long-term* impacts of a decision.

#1

Money & Prestige

The prospect of acquiring **more money or greater prestige** can distort judgment. Bonuses, promotions, and status are powerful short-term incentives that obscure long-term ethical costs.

#2

Loyalty

Social pressure from **employer and/or colleagues**. "Go along to get along" — loyalty to a team can override loyalty to clients, the profession, or the integrity of the markets.

#3

Strong Compliance Culture

A **strong (rules-based) compliance culture** — counter-intuitively a challenge, because people stop asking "is this ethical?" and start asking only "is this within the rule?"

Why Situational Pressure Wins

Situational influences shift focus to **immediate rather than long-term impacts**. An immediate bonus feels real; the long-term cost to trust, career, and capital markets is abstract. This is why a good decision-making *framework* matters — it forces you to surface the long-term view before you act.

Exam Tip: Memorize the three situational influences: **money & prestige · loyalty · strong (rules-based) compliance culture**. A common distractor is "personal traits" — which is the *opposite* of a situational influence.

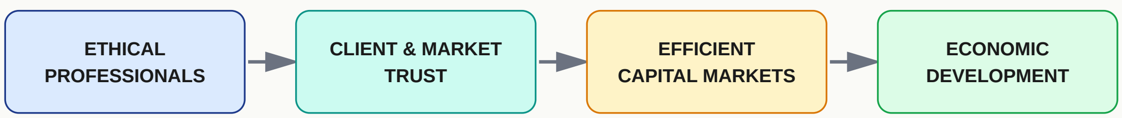
WHY ETHICS MATTERS IN INVESTMENT MANAGEMENT

Trust Is the Product

Trust is the key in investment management, and that trust is established by acting with **care, due diligence, and judgment** for clients. The investment management profession — combined with ethical corporate governance — plays a vital role in the growth and development of the capital market.

The Trust → Growth Chain

FROM INDIVIDUAL ETHICS TO ECONOMIC DEVELOPMENT



Why Investment Professionals Are Different

Investment professionals have a **special responsibility** because they are **entrusted with their clients' wealth**. Because investment advice and management are **intangible products**, the quality and value received are more difficult to evaluate than for tangible products — so trust takes on an even greater importance.

When Trust Is Present

Investors commit capital · Cost of raising capital falls · Markets function smoothly · Economic development accelerates

When Trust Breaks Down

Investors withhold funds · Cost of capital rises · Firms and professionals suffer · Allocation of capital is distorted by false or misleading information

Knock-on Effects of Unethical Behaviour

Failure to act in a highly ethical manner can damage not only *client wealth* but also impede the success of investment firms and professionals — potential clients will be less likely to use their services. For society as a whole, a lack of trust reduces funds entrusted to advisors and **increases the cost of raising capital** for business investment and growth. Unethical behaviour — providing incomplete, misleading, or false information — can **distort the allocation of capital**.

STANDARDS OF CARE

Suitability vs Fiduciary Standards

Financial professionals may be held to different levels of responsibility to their clients. The two principal standards are **suitability** and, more demanding, **fiduciary**.

FEATURE	SUITABILITY STANDARD	FIDUCIARY STANDARD
Requirement	Match between client's return requirements and risk tolerance and the characteristics of recommended securities	Use knowledge and expertise to **act in the best interests of the client**
Strength	Lower bar	**Stronger** — higher ethical obligation
Implied by	Broker-dealer-style duty	Advisory relationships, trust/retirement accounts

CFA Framing

Under the CFA Institute Standards, a member in an advisory relationship must make **suitable recommendations** in a **portfolio context** (Standard III-C) while also placing clients' interests above their own (Standard III-A, Loyalty, Prudence, and Care). In substance, CFA members are held to a fiduciary-style standard of care.

Exam Tip: On the exam, if a scenario says "broker recommended investment X that matches the client's risk tolerance and return needs" — that satisfies suitability. If the question asks whether the recommendation was in the client's *best interest*, look for conflicts (commissions, proprietary products) — that triggers the fiduciary lens.

FRAMEWORK FOR ETHICAL DECISION-MAKING

A Four-Step Framework

A framework for ethical decision-making helps people look at and assess a decision from **different perspectives**. This enables them to make good decisions and to limit unplanned consequences. Ethical decisions are improved when ethics are integrated into a firm's decision-making process.

THE FOUR-STEP ETHICAL DECISION-MAKING FRAMEWORK

1 IDENTIFY	2 CONSIDER	3 DECIDE & ACT	4 REFLECT
Relevant facts Stakeholders Duties owed Ethical principles Conflicts of interest	Situational influences Additional guidance Alternative actions	Choose the ethical option and implement it	Was the outcome as anticipated? Why or why not?

Step-by-Step Detail

1. **Identify** — Relevant facts, stakeholders and duties owed, ethical principles, and conflicts of interest.
2. **Consider** — Situational influences, additional guidance (from the Code, Standards, compliance officer, outside counsel), and alternative actions.
3. **Decide and act** — Choose the ethical course and implement it.
4. **Reflect** — Was the outcome as anticipated? Why or why not? Feed the lesson back into future decisions.

Why Reflect Matters

Reflection closes the loop. Without it, even well-intentioned professionals repeat mistakes. The reflect step converts experience into learning — and learning into the character traits that resist situational pressure.

QUIZ 2 · CHECKPOINT

Test Your Understanding: Challenges, Trust & Framework

Q6. Research on ethical behaviour shows that the *main determinant* of whether individuals act ethically is:

Q7. Which of the following is *not* one of the three main types of situational influences on ethical behaviour?

Q8. The suitability standard and the fiduciary standard differ in that only the fiduciary standard requires the professional to:

Q9. In the CFA Level I ethical decision-making framework, identifying the *relevant facts, stakeholders and duties owed, ethical principles, and conflicts of interest* is part of which step?

Q10. Unethical behaviour by investment professionals is *most likely* to:

APPLYING THE FRAMEWORK

Ethical Dilemma Scenarios

Ethics questions at Level I are almost always *application* questions. Work through the following scenarios using the four-step framework before reading the solution.

SCENARIO 1 Gift from a Grateful Client

• FACTS

Anika manages a portfolio for a long-standing individual client. After a strong year, the client sends Anika two expensive tickets to a sporting event and a handwritten thank-you note. The tickets are clearly a gift for *past* performance. Anika's firm policy is silent on gifts from clients. Anika is also managing the accounts of several other clients.

? THE QUESTION

May Anika accept the tickets? What must she do?

SOLUTION

→ APPLY THE FRAMEWORK

1. **Identify** — Stakeholders: the client, the employer, the other clients. Duty owed: independence and objectivity; must not be unduly influenced in the treatment of other clients.

2. **Consider** — Situational influence: "money / prestige" pressure. A modest gift is permissible, but the *appearance* of differential treatment matters. The curriculum explicitly states that a member *may accept gifts from clients, but must disclose to employer*. If a gift is tied to *future* performance, written permission from the employer is required in advance.

3. **Decide & act** — Anika may accept the gift because it is for past performance and from an existing client, but she must **disclose it to her employer**. If the gift had been offered as an inducement for future performance, she would need *written permission* from the employer before accepting.

4. **Reflect** — Did the gift subtly change how she treats this client vs others? The disclosure obligation is what preserves independence.

★ **KEY POINT**

You *can* accept gifts from clients and referral fees — **as long as they are properly disclosed**. The issue is never the gift itself but the undisclosed potential to compromise objectivity in the treatment of other clients.

SCENARIO 2 Overheard Material Nonpublic Information

• **FACTS**

Dev, a portfolio manager, is in a coffee shop when he overhears two executives from a publicly listed pharmaceutical company loudly discuss an imminent — and still unannounced — FDA rejection of their lead drug. Dev has a position in the stock and his clients do as well.

? **THE QUESTION**

What may Dev do with the information?

SOLUTION

→ **APPLY THE FRAMEWORK**

1. **Identify** — The information is clearly *material* (disclosure would move the price) and *nonpublic* (not yet released to the market). Stakeholders: Dev's clients, the pharma company's other shareholders, the integrity of the capital markets.

2. **Consider** — Standard II(A) requires that members in possession of material nonpublic information **must not act or cause others to act** on it. Dev's duty to clients does *not* override this — he cannot rationalize trading on the information as "helping clients." The Mosaic Theory does not apply; this is a single material, nonpublic piece.

3. **Decide & act** — Dev must **not trade** (for himself or clients), must **not tip** others, and should consult his firm's compliance officer. He may encourage the issuer to disclose publicly, but he cannot act until the information is available to the marketplace.

4. **Reflect** — The client may ultimately lose money when the news breaks. That consequence, painful as it is, is less damaging than violating market integrity — which is a duty owed to the public, not just to

Dev's book.

★ **KEY POINT**

Do **not** act or cause others to act on material nonpublic information. Information is nonpublic until made available to investors in general. You *can* combine several pieces of *nonmaterial, nonpublic* information to build recommendations — that is the **Mosaic Theory**.

SCENARIO 3 Relative's Firm and an Undisclosed Conflict

• **FACTS**

Priya, an adviser, believes her brother's private investment firm is a genuinely attractive opportunity. She recommends it to several clients without telling them her brother owns the firm. The investment is legal in her jurisdiction and consistent with the clients' risk tolerances.

? **THE QUESTION**

Has Priya acted ethically?

SOLUTION

→ **APPLY THE FRAMEWORK**

1. **Identify** — The recommendation is legal and may even be suitable. But Priya has an obvious **conflict of interest** (family tie to issuer) that she has not disclosed.
2. **Consider** — Ethical principles often set a higher standard than laws. Ethical conduct requires avoiding or *fully disclosing* matters that could impair independence and objectivity, so clients can judge biases for themselves.
3. **Decide & act** — Priya must **disclose** the family relationship to clients (and to her employer) *before* any investment is made. Clients who are family members must be treated as any other client.

4 **Reflect** — Even if the investment performs well, undisclosed conflicts corrode trust. If it performs poorly, litigation and reputational damage are almost certain.

★ **KEY POINT**

Legal ≠ ethical. Recommending investment in a relative's firm without disclosure is a classic case of behaviour that may be legal but is widely considered unethical. The cure is disclosure — let clients judge the effects of any conflict for themselves.

Exam Tip: For every ethics vignette, ask: "Who are the stakeholders? What duty is owed to each? Is there an undisclosed conflict?" These three questions will drive the correct answer on nearly every exam question.

STANDARDS OF PRACTICE HANDBOOK & THE PCP

The Role of the Standards of Practice Handbook

The **Standards of Practice Handbook** (currently 12th Edition, updated 2024) is the authoritative guide to applying the CFA Institute Code and Standards. Most ethics questions on the exam will likely come **directly from the text and examples in the Handbook**. Candidates should read both the summaries and the original Handbook, working through all the examples.

What the Handbook Contains

1. The **Code of Ethics** — six high-level commitments
2. The **Seven Standards of Professional Conduct**, each broken into lettered sub-standards
3. **Guidance** — interpretation and clarification of each Standard
4. **Recommended Procedures for Compliance** — operational practices firms can adopt
5. **Application** — numerous worked examples of violations and proper conduct

The CFA Institute Professional Conduct Program (PCP)

The PCP is covered by the CFA Institute **Bylaws** and the **Rules of Procedure for Proceedings Related to Professional Conduct**. The **Disciplinary Review Committee** of the CFA Institute Board of Governors has overall responsibility for the PCP and enforcement of the Code and Standards. Professional Conduct staff conduct inquiries.

Circumstances That Can Prompt an Inquiry

- **Self-disclosure** on the annual Professional Conduct Statement (civil litigation, criminal investigation, written complaint)
- **Written complaints** about a member or candidate's professional conduct
- Evidence of **misconduct from public sources** — media articles, broadcasts
- A **report by a CFA exam proctor** of a possible violation during the examination
- **Analysis of exam scores and materials**, and monitoring of websites and social media by CFA Institute

Possible Outcomes of an Inquiry

No sanction

Cautionary letter

Discipline

Staff determines no disciplinary action is appropriate.	A formal caution issued by Professional Conduct staff.	Sanctions may include *condemnation by peers* or *suspension of candidacy* in the CFA Program. The member or candidate may accept or reject the sanction; rejection triggers a hearing panel.

Exam Tip: The PCP details are frequently tested as recognition questions. Memorize the **six triggers** for an inquiry and the **three possible outcomes**.

QUIZ 3 · CHECKPOINT

Test Your Understanding: Handbook, Applications & Integration

Q11. A portfolio manager overhears material nonpublic information about a company in which her clients are invested. She should *most likely*:

Q12. Which of the following gifts is *most likely* permissible under the CFA Institute Standards without seeking advance written permission from an employer?

Q13. Which of the following is *least likely* a circumstance that can prompt a CFA Institute Professional Conduct inquiry?

Q14. An adviser recommends a relative's investment firm to several clients without disclosing the family connection. The recommendation is legal and suits the clients' risk profiles. This conduct is *best* described as:

MODULE COMPLETE

Your Scorecard

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LM01 Key Takeaways — Exam-Ready Cheat Sheet

Core Definitions

1. **Ethics** (from Greek *ethos* = character): shared beliefs about good/acceptable behaviour; a set of moral principles and rules of conduct guiding behaviour.
2. **Ethical conduct**: follows moral principles, consistent with society's expectations, improves outcomes for stakeholders.
3. **Code of ethics**: a written set of moral principles; may include rules/standards for minimum behaviour. **Standards** apply the Code to specific situations.

Ethical vs Legal

4. Not all unethical acts are illegal; not all illegal acts are unethical. **Civil disobedience** and **whistleblowing** may be illegal but ethical; preferential IPO allocation may be legal but unethical.
5. Law is imperfect because: reactive to past failures · rule-based · varies by country.

Professions, Trust & Standards of Care

6. A **profession**: specialized knowledge, high ethical standards, serves society, client-focused, has oversight body, requires continuing education, monitors conduct.
7. **Trust** is the key in investment management because advice/management are *intangible*. Trust → efficient capital markets → economic development.

8. **Suitability**: match client risk/return to recommendations. **Fiduciary** (stronger): act in the client's best interests.

Challenges & Framework

9. **Overconfidence bias**: people overrate their own ethics and overemphasize internal traits.
10. **Three situational influences** (external): (1) money & prestige, (2) loyalty to employer/colleagues, (3) strong (rules-based) compliance culture.
11. **Four-step framework**: **Identify** (facts, stakeholders, duties, conflicts) → **Consider** (situational influences, guidance, alternatives) → **Decide & act** → **Reflect**.

Handbook & PCP

12. **Standards of Practice Handbook** (12th Ed., 2024): source of Code, Seven Standards, Guidance, Recommended Procedures, and Application examples. Most exam ethics questions come from Handbook text/examples.
13. **PCP triggers**: self-disclosure · written complaints · public-source evidence · proctor reports · analysis of exam scores and website/social-media monitoring.
14. **PCP outcomes**: no sanction · cautionary letter · discipline (peer condemnation, suspension of candidacy).

Last-Minute Exam Checklist

Ethics = 15–20% of Level I · Read the original Handbook · Re-read Ethics the day before the exam

Ethical conduct: principles · society's expectations · improves stakeholder outcomes

Situational influences: money/prestige · loyalty · strong (rules-based) compliance culture

Framework: Identify → Consider → Decide & Act → Reflect

Gifts: client gifts OK with disclosure; future-performance gifts need *written* employer permission

MNPI: do not act, do not tip — Mosaic Theory applies only to *non-material* non-public pieces

Disclose conflicts so clients can judge biases themselves

Step 1 of 16