Book 1 – Ethical and Professional Standards and Quantitative Methods

SCHWESERNOTES™ 2015 CFA LEVEL I BOOK 1: ETHICAL AND PROFESSIONAL STANDARDS AND QUANTITATIVE METHODS

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Welcome to the 2015 SchweserNotes™

Thank you for trusting Kaplan Schweser to help you reach your goals. We are all very pleased to be able to help you prepare for the Level I CFA Exam. In this introduction, I want to explain the resources included with the SchweserNotes, suggest how you can best use Schweser materials to prepare for the exam, and direct you toward other educational resources you will find helpful as you study for the exam.

Besides the SchweserNotes themselves, there are many educational resources available at Schweser.com. Just log in using the individual username and password that you received when you purchased the SchweserNotes. Most candidates find our Online Resource Library video "How to Pass the Level I CFA Exam" very helpful in both planning and executing a successful study strategy.

SchweserNotes™
These consist of five volumes that include complete coverage of all 18 Study Sessions and all Learning Outcome Statements (LOS) with examples, Concept Checkers (multiple-choice questions for every topic review), and Challenge Problems for many topic reviews to help you master the material and check your progress. At the end of each major topic area, we include a Self-test. Self-test questions are created to be exam-like in format and difficulty in order for you to evaluate how well your study of each topic has prepared you for the actual exam.

Practice Questions
To retain what you learn, it is important that you quiz yourself often. We offer online and offline versions of the SchweserPro™ QBank, which contains thousands of Level I practice questions and explanations. Quizzes are available for each LOS, topic, or Study Session. Build your own exams by specifying the topics and the number of questions you choose.

Practice Exams
Schweser offers six full 6-hour practice exams. Practice Exams Volume 1 and Volume 2 each contain three full 240-question exams. These are important tools for gaining the speed and skills you will need to pass the exam. Each book contains answers with full explanations for self-grading and evaluation. By entering your answers at Schweser.com, you can use our Performance Tracker to find out how you have performed compared to other Schweser Level I candidates.

Schweser Library
We have created reference videos, some of which are available to all SchweserNotes purchasers. Schweser Library volumes are typically between 20 and 60 minutes in length and cover such topics as: "CFA Level I Exam Overview," "Calculator Basics," "Code and Standards Overview," and "Time Value of Money." The full Schweser Library is included with our 16-week live or online classes and with our video instruction (online or CDs).

Online Schweser Study Calendar
Use your Online Access to tell us when you will start and what days of the week you can study. The online Schweser Study Calendar will create a study plan just for you,

breaking each study session into daily and weekly tasks to keep you on track and help you monitor your progress through the curriculum.

The Level I CFA exam is a formidable challenge (63 topic reviews and more than 500 Learning Outcome Statements), and you must devote considerable time and effort to be properly prepared. There is no shortcut! You must learn the material, know the terminology and techniques, understand the concepts, and be able to answer 240 questions quickly and (at least 70%) correctly. Fifteen to 20 hours per week for 20 weeks is a good estimate of the study time required on average, but some candidates will need more or less time, depending on their individual backgrounds and experience.

To help you master this material and be well prepared for the CFA Exam, we offer several other educational resources, including:

Live Weekly Classroom Programs
We offer weekly classroom programs around the world. Please check Schweser.com for locations, dates, and availability.

Online Class
Our Online Classes are available at New York time (6:30–9:30 pm) or London time (6:00–9:00 pm) beginning in January and July. The approximate schedule for the Level I Online Classes (3-hour sessions) is as follows:

Class #	Class #
1 Exam Intro/Quantitative Methods SS2	9 Financial Reporting & Analysis SS10
2 Quantitative Methods SS3	10 Corporate Finance SS11
3 Economics SS4, 5	11 Equity Investments SS13, 14
4 Economics SS5, 6	12 Fixed Income SS15
5 Financial Reporting & Analysis SS7	13 Fixed Income SS16
6 Financial Reporting & Analysis SS8	14 Derivatives SS17
7 Financial Reporting & Analysis SS8, 9	15 Portfolio Management & Alternative Investments SS12, 18
8 Financial Reporting & Analysis SS9	

Archived classes are available for viewing at any time throughout the season. Candidates enrolled in the Online Classes also have full access to supplemental on-demand video instruction in the Schweser Library and an e-mail address to use to send questions to the instructor at any time.

Late Season Review
Whether you use self-study or in-class, online, or video instruction to learn the CFA curriculum, a late-season review and exam practice can make all the difference. Our most complete late-season review course is our residence program in Windsor, Ontario (WindsorWeek) where we cover the entire curriculum over seven days (May 2–8, 2015) at all three levels. We offer 3-Day Live Exam Review Workshops in many cities (and online) that combine curriculum review with an equal component of hands-on practice with hundreds of questions and problem-solving techniques. We also offer Exam Review Workshops in a 5-day format in Dallas/Fort Worth and New York. Please visit us at

Schweser.com for complete listings and course descriptions for all our late-season review offerings.

Mock Exam and Multimedia Tutorial

The Schweser Mock Exam will be offered live in over 100 locations around the world in late May and late November, and as an online exam as well. The included Exam Tutorial provides extended explanations and topic tutorials to get you exam-ready in topic areas where you miss questions on the Mock Exam. Please visit Schweser.com for a listing of cities and locations.

Topic Weighting

In preparing for the exam, you must pay attention to the weights assigned to each topic within the curriculum. The Level I topic weights are as follows:

Topic	*Exam Weight*
Ethical and Professional Standards	15%
Quantitative Methods	12%
Economics	10%
Financial Reporting and Analysis	20%
Corporate Finance	7%
Portfolio Management	7%
Equity Investments	10%
Fixed Income	10%
Derivatives	5%
Alternative Investments	4%
Total	**100%**

How to Succeed

There are no shortcuts; depend on the fact that CFA Institute will test you in a way that will reveal how well you know the Level I curriculum. You should begin early and stick to your study plan. You should first read the SchweserNotes and complete the Concept Checkers and Challenge Problems for each topic review. You should prepare for and attend a live class, an online class, or a study group each week. You should take quizzes often using SchweserPro Qbank and go back to review previous topics and Study Sessions as well. At the end of each topic area, you should take the Self-test to check your progress. You should finish the overall curriculum at least four weeks (preferably longer) before the Level I exam so that you have sufficient time for Practice Exams and for further review of those topics that you have not yet mastered.

I would like to thank Craig Prochaska, CFA, Content Specialist, for his contributions to producing the Level I SchweserNotes for the CFA Exam.

Best regards,

Doug Van Eaton

Dr. Douglas Van Eaton, CFA
SVP of CFA Education and Level I Manager

Kaplan Schweser

Reading Assignments and Learning Outcome Statements

The following material is a review of the Ethical and Professional Standards and Quantitative Methods principles designed to address the learning outcome statements set forth by CFA Institute.

Study Session 1

Reading Assignments

Ethical and Professional Standards and Quantitative Methods, CFA Program Level I 2015 Curriculum, Volume 1 (CFA Institute, 2014)

Study Session 2

Reading Assignments

Ethical and Professional Standards and Quantitative Methods, CFA Program Level I 2015 Curriculum, Volume 1 (CFA Institute, 2014)

Study Session 3

Reading Assignments

Ethical and Professional Standards and Quantitative Methods, CFA Program Level I 2015 Curriculum, Volume 1 (CFA Institute, 2014)

Learning Outcome Statements (LOS)

Study Session 1

The topical coverage corresponds with the following CFA Institute assigned reading:

1. **Code of Ethics and Standards of Professional Conduct**
   The candidate should be able to:
   a. describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards. (page 15)
   b. state the six components of the Code of Ethics and the seven Standards of Professional Conduct. (page 16)
   c. explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard. (page 17)
2. **Guidance for Standards I–VII**
   The candidate should be able to:
   a. demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity. (page 20)
   b. distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards. (page 20)
   c. recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct. (page 20)
3. **Introduction to the Global Investment Performance Standards (GIPS®)**
   The candidate should be able to:
   a. explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards. (page 85)
   b. explain the construction and purpose of composites in performance reporting. (page 86)
   c. explain the requirements for verification. (page 86)
4. **The GIPS Standards**
   The candidate should be able to:
   a. describe the key features of the GIPS standards and the fundamentals of compliance. (page 87)
   b. describe the scope of the GIPS standards with respect to an investment firm's definition and historical performance record. (page 89)
   c. explain how the GIPS standards are implemented in countries with existing standards for performance reporting and describe the appropriate response when the GIPS standards and local regulations conflict. (page 89)
   d. describe the nine major sections of the GIPS standards. (page 89)

Study Session 2

5. **The Time Value of Money**
   The candidate should be able to:
   a. interpret interest rates as required rates of return, discount rates, or opportunity costs. (page 104)
   b. explain an interest rate as the sum of a real risk-free rate, and premiums that compensate investors for bearing distinct types of risk. (page 105)
   c. calculate and interpret the effective annual rate, given the stated annual interest rate and the frequency of compounding. (page 105)

d. solve time value of money problems for different frequencies of compounding. (page 107)
e. calculate and interpret the future value (FV) and present value (PV) of a single sum of money, an ordinary annuity, an annuity due, a perpetuity (PV only), and a series of unequal cash flows. (page 108)
f. demonstrate the use of a time line in modeling and solving time value of money problems. (page 123)

6. Discounted Cash Flow Applications

The candidate should be able to:

a. calculate and interpret the net present value (NPV) and the internal rate of return (IRR) of an investment. (page 143)
b. contrast the NPV rule to the IRR rule, and identify problems associated with the IRR rule. (page 146)
c. calculate and interpret a holding period return (total return). (page 148)
d. calculate and compare the money-weighted and time-weighted rates of return of a portfolio and evaluate the performance of portfolios based on these measures. (page 148)
e. calculate and interpret the bank discount yield, holding period yield, effective annual yield, and money market yield for US Treasury bills and other money market instruments. (page 152)
f. convert among holding period yields, money market yields, effective annual yields, and bond equivalent yields. (page 155)

7. Statistical Concepts and Market Returns

The candidate should be able to:

a. distinguish between descriptive statistics and inferential statistics, between a population and a sample, and among the types of measurement scales. (page 168)
b. define a parameter, a sample statistic, and a frequency distribution. (page 169)
c. calculate and interpret relative frequencies and cumulative relative frequencies, given a frequency distribution. (page 171)
d. describe the properties of a data set presented as a histogram or a frequency polygon. (page 174)
e. calculate and interpret measures of central tendency, including the population mean, sample mean, arithmetic mean, weighted average or mean, geometric mean, harmonic mean, median, and mode. (page 175)
f. calculate and interpret quartiles, quintiles, deciles, and percentiles. (page 180)
g. calculate and interpret 1) a range and a mean absolute deviation and 2) the variance and standard deviation of a population and of a sample. (page 181)
h. calculate and interpret the proportion of observations falling within a specified number of standard deviations of the mean using Chebyshev's inequality. (page 185)
i. calculate and interpret the coefficient of variation and the Sharpe ratio. (page 186)
j. explain skewness and the meaning of a positively or negatively skewed return distribution. (page 188)
k. describe the relative locations of the mean, median, and mode for a unimodal, nonsymmetrical distribution. (page 189)
l. explain measures of sample skewness and kurtosis. (page 190)
m. compare the use of arithmetic and geometric means when analyzing investment returns. (page 192)

8. Probability Concepts

The candidate should be able to:

a. define a random variable, an outcome, an event, mutually exclusive events, and exhaustive events. (page 207)
b. state the two defining properties of probability and distinguish among empirical, subjective, and a priori probabilities. (page 207)
c. state the probability of an event in terms of odds for and against the event. (page 208)
d. distinguish between unconditional and conditional probabilities. (page 209)
e. explain the multiplication, addition, and total probability rules. (page 209)
f. calculate and interpret 1) the joint probability of two events, 2) the probability that at least one of two events will occur, given the probability of each and the joint probability of the two events, and 3) a joint probability of any number of independent events. (page 210)
g. distinguish between dependent and independent events. (page 213)
h. calculate and interpret an unconditional probability using the total probability rule. (page 214)
i. explain the use of conditional expectation in investment applications. (page 218)
j. explain the use of a tree diagram to represent an investment problem. (page 218)
k. calculate and interpret covariance and correlation. (page 219)
l. calculate and interpret the expected value, variance, and standard deviation of a random variable and of returns on a portfolio. (page 223)
m. calculate and interpret covariance given a joint probability function. (page 224)
n. calculate and interpret an updated probability using Bayes' formula. (page 228)
o. identify the most appropriate method to solve a particular counting problem, and solve counting problems using factorial, combination, and permutation concepts. (page 230)

STUDY SESSION 3

9. Common Probability Distributions

The candidate should be able to:

a. define a probability distribution and distinguish between discrete and continuous random variables and their probability functions. (page 251)
b. describe the set of possible outcomes of a specified discrete random variable. (page 251)
c. interpret a cumulative distribution function. (page 253)
d. calculate and interpret probabilities for a random variable, given its cumulative distribution function. (page 253)
e. define a discrete uniform random variable, a Bernoulli random variable, and a binomial random variable. (page 254)
f. calculate and interpret probabilities given the discrete uniform and the binomial distribution functions. (page 254)
g. construct a binomial tree to describe stock price movement. (page 257)
h. calculate and interpret tracking error. (page 259)
i. define the continuous uniform distribution and calculate and interpret probabilities, given a continuous uniform distribution. (page 259)
j. explain the key properties of the normal distribution. (page 261)
k. distinguish between a univariate and a multivariate distribution, and explain the role of correlation in the multivariate normal distribution. (page 261)

l. determine the probability that a normally distributed random variable lies inside a given interval. (page 262)
m. define the standard normal distribution, explain how to standardize a random variable, and calculate and interpret probabilities using the standard normal distribution. (page 264)
n. define shortfall risk, calculate the safety-first ratio, and select an optimal portfolio using Roy's safety-first criterion. (page 267)
o. explain the relationship between normal and lognormal distributions and why the lognormal distribution is used to model asset prices. (page 269)
p. distinguish between discretely and continuously compounded rates of return, and calculate and interpret a continuously compounded rate of return, given a specific holding period return. (page 270)
q. explain Monte Carlo simulation and describe its applications and limitations. (page 272)
r. compare Monte Carlo simulation and historical simulation. (page 273)

10. Sampling and Estimation

The candidate should be able to:
a. define simple random sampling and a sampling distribution. (page 287)
b. explain sampling error. (page 287)
c. distinguish between simple random and stratified random sampling. (page 288)
d. distinguish between time-series and cross-sectional data. (page 289)
e. explain the central limit theorem and its importance. (page 289)
f. calculate and interpret the standard error of the sample mean. (page 290)
g. identify and describe desirable properties of an estimator. (page 292)
h. distinguish between a point estimate and a confidence interval estimate of a population parameter. (page 292)
i. describe properties of Student's *t*-distribution and calculate and interpret its degrees of freedom. (page 292)
j. calculate and interpret a confidence interval for a population mean, given a normal distribution with 1) a known population variance, 2) an unknown population variance, or 3) an unknown variance and a large sample size. (page 294)
k. describe the issues regarding selection of the appropriate sample size, data-mining bias, sample selection bias, survivorship bias, look-ahead bias, and time-period bias. (page 299)

11. Hypothesis Testing

The candidate should be able to:
a. define a hypothesis, describe the steps of hypothesis testing, and describe and interpret the choice of the null and alternative hypotheses. (page 310)
b. distinguish between one-tailed and two-tailed tests of hypotheses. (page 311)
c. explain a test statistic, Type I and Type II errors, a significance level, and how significance levels are used in hypothesis testing. (page 315)
d. explain a decision rule, the power of a test, and the relation between confidence intervals and hypothesis tests. (page 317)
e. distinguish between a statistical result and an economically meaningful result. (page 319)
f. explain and interpret the *p*-value as it relates to hypothesis testing. (page 320)
g. identify the appropriate test statistic and interpret the results for a hypothesis test concerning the population mean of both large and small samples when the population is normally or approximately distributed and the variance is 1) known or 2) unknown. (page 321)

h. identify the appropriate test statistic and interpret the results for a hypothesis test concerning the equality of the population means of two at least approximately normally distributed populations, based on independent random samples with 1) equal or 2) unequal assumed variances. (page 324)
i. identify the appropriate test statistic and interpret the results for a hypothesis test concerning the mean difference of two normally distributed populations. (page 328)
j. identify the appropriate test statistic and interpret the results for a hypothesis test concerning 1) the variance of a normally distributed population, and 2) the equality of the variances of two normally distributed populations based on two independent random samples. (page 332)
k. distinguish between parametric and nonparametric tests and describe situations in which the use of nonparametric tests may be appropriate. (page 339)

12. Technical Analysis

The candidate should be able to:

a. explain principles of technical analysis, its applications, and its underlying assumptions. (page 350)
b. describe the construction of different types of technical analysis charts and interpret them. (page 351)
c. explain uses of trend, support, resistance lines, and change in polarity. (page 354)
d. describe common chart patterns. (page 355)
e. describe common technical analysis indicators (price-based, momentum oscillators, sentiment, and flow of funds). (page 357)
f. explain how technical analysts use cycles. (page 362)
g. describe the key tenets of Elliott Wave Theory and the importance of Fibonacci numbers. (page 362)
h. describe intermarket analysis as it relates to technical analysis and asset allocation. (page 363)

The following is a review of the Ethical and Professional Standards principles designed to address the learning outcome statements set forth by CFA Institute. This topic is also covered in:

CFA Institute Code of Ethics and Standards of Professional Conduct Guidance for Standards I–VII

Study Session 1

Exam Focus

In addition to reading this review of the ethics material, we strongly recommend that all candidates for the CFA® examination read the *Standards of Practice Handbook 11th Edition* (2014) multiple times. As a Level I CFA candidate, it is your responsibility to comply with the *Code and Standards*. The complete *Code and Standards* are reprinted in Volume 1 of the CFA Program Curriculum.

LOS 1.a: Describe the structure of the CFA Institute Professional Conduct Program and the process for the enforcement of the Code and Standards.

CFA® Program Curriculum, Volume 1, page 9

The CFA Institute Professional Conduct Program is covered by the CFA Institute Bylaws and the Rules of Procedure for Proceedings Related to Professional Conduct. The Program is based on the principles of fairness of the process to members and candidates and maintaining the confidentiality of the proceedings. The Disciplinary Review Committee of the CFA Institute Board of Governors has overall responsibility for the Professional Conduct Program and enforcement of the Code and Standards.

The CFA Institute Professional Conduct staff conducts inquiries related to professional conduct. Several circumstances can prompt such an inquiry:

1. Self-disclosure by members or candidates on their annual Professional Conduct Statements of involvement in civil litigation or a criminal investigation, or that the member or candidate is the subject of a written complaint.

2. Written complaints about a member or candidate's professional conduct that are received by the Professional Conduct staff.

3. Evidence of misconduct by a member or candidate that the Professional Conduct staff received through public sources, such as a media article or broadcast.

4. A report by a CFA exam proctor of a possible violation during the examination.

5. Analysis of exam materials and monitoring of social media by CFA Institute.

Once an inquiry has begun, the Professional Conduct staff may request (in writing) an explanation from the subject member or candidate and may: (1) interview the subject member or candidate, (2) interview the complainant or other third parties, and/or (3) collect documents and records relevant to the investigation.

The Professional Conduct staff may decide: (1) that no disciplinary sanctions are appropriate, (2) to issue a cautionary letter, or (3) to discipline the member or candidate. In a case where the Professional Conduct staff finds a violation has occurred and proposes a disciplinary sanction, the member or candidate may accept or reject the sanction. If the member or candidate chooses to reject the sanction, the matter will be referred to a disciplinary review panel of CFA Institute members for a hearing. Sanctions imposed may include condemnation by the member's peers or suspension of candidate's continued participation in the CFA Program.

LOS 1.b: State the six components of the Code of Ethics and the seven Standards of Professional Conduct.

CFA® Program Curriculum, Volume 1, page 15

Code of Ethics

Members of CFA Institute [including Chartered Financial Analyst® (CFA®) charterholders] and candidates for the CFA designation ("Members and Candidates") must:[1]

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

The Standards of Professional Conduct

I: Professionalism
II: Integrity of Capital Markets
III: Duties to Clients
IV: Duties to Employers
V: Investment Analysis, Recommendations, and Actions
VI: Conflicts of Interest
VII: Responsibilities as a CFA Institute Member or CFA Candidate

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LOS 1.c: Explain the ethical responsibilities required by the Code and Standards, including the sub-sections of each Standard.

CFA® Program Curriculum, Volume 1, page 15

Standards of Professional Conduct[2]

I. PROFESSIONALISM

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

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

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

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

II. INTEGRITY OF CAPITAL MARKETS

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

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

III. DUTIES TO CLIENTS

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

2. Ibid.

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

C. **Suitability.**

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

   a. Make a reasonable inquiry into a client's or prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

   c. Judge the suitability of investments in the context of the client's total portfolio.

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

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

E. **Preservation of Confidentiality.** Members and Candidates must keep information about current, former, and prospective clients confidential unless:

1. The information concerns illegal activities on the part of the client or prospective client,

2. Disclosure is required by law, or

3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

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

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

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

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. **Diligence and Reasonable Basis.** Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. **Communication with Clients and Prospective Clients.** Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

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

3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. **Record Retention.** Members and Candidates must develop and maintain appropriate records to support their investment analysis, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

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

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

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

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

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

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

LOS 2.a: Demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity.

LOS 2.b: Distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards.

LOS 2.c: Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

CFA® Program Curriculum, Volume 1, page 21

I Professionalism

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

Professor's Note: While we use the term "members" in the following, note that all of the Standards apply to candidates as well.

Guidance—Code and Standards vs. Local Law

Members must know the laws and regulations relating to their professional activities in all countries in which they conduct business. Members must comply with applicable laws and regulations relating to their professional activity. Do not violate Code or Standards even if the activity is otherwise legal. Always adhere to the most strict rules and requirements (law or CFA Institute Standards) that apply.

Guidance—Participation or Association With Violations by Others

Members should dissociate, or separate themselves, from any ongoing client or employee activity that is illegal or unethical, even if it involves leaving an employer (an extreme case). While a member may confront the involved individual first, he must approach his supervisor or compliance department. Inaction with continued association may be construed as knowing participation.

Recommended Procedures for Compliance—Members

- Members should have procedures to keep up with changes in applicable laws, rules, and regulations.
- Compliance procedures should be reviewed on an ongoing basis to assure that they address current law, CFAI Standards, and regulations.
- Members should maintain current reference materials for employees to access in order to keep up to date on laws, rules, and regulations.
- Members should seek advice of counsel or their compliance department when in doubt.
- Members should document any violations when they disassociate themselves from prohibited activity and encourage their employers to bring an end to such activity.
- There is no requirement under the Standards to report violations to governmental authorities, but this may be advisable in some circumstances and required by law in others.
- Members are strongly encouraged to report other members' violations of the Code and Standards.

Recommended Procedures for Compliance—Firms

Members should encourage their firms to:

- Develop and/or adopt a code of ethics.
- Make available to employees information that highlights applicable laws and regulations.
- Establish written procedures for reporting suspected violation of laws, regulations, or company policies.

Members who supervise the creation and maintenance of investment services and products should be aware of and comply with the regulations and laws regarding such services and products both in their country of origin and the countries where they will be sold.

Application of Standard I(A) Knowledge of the Law[3]

Example 1:

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

Comment:

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

Example 2:

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

Comment:

Misrepresenting performance is a violation of the Code and Standards. Although she did not calculate the performance herself, Washington would be assisting in violating this standard if she were to use the inflated performance number when soliciting clients. She must dissociate herself from the activity. She can bring the misleading number to the attention of the person responsible for calculating performance, her supervisor, or the compliance department at her firm. If her firm is unwilling to recalculate performance, she must refrain from using the misleading promotional material and should notify the firm of her reasons. If the firm insists that she use the material, she should consider whether her obligation to dissociate from the activity would require her to seek other employment.

Example 3:

An employee of an investment bank is working on an underwriting and finds out the issuer has altered their financial statements to hide operating losses in one division. These misstated data are included in a preliminary prospectus that has already been released.

Comment:

The employee should report the problem to his supervisors. If the firm doesn't get the misstatement fixed, the employee should dissociate from the underwriting and, further, seek legal advice about whether he should undertake additional reporting or other actions.

3. Ibid.

Example 4:

Laura Jameson, a U.S. citizen, works for an investment advisor based in the United States and works in a country where investment managers are prohibited from participating in IPOs for their own accounts.

Comment:

Jameson must comply with the strictest requirements among U.S. law (where her firm is based), the CFA Institute Code and Standards, and the laws of the country where she is doing business. In this case that means she must not participate in any IPOs for her personal account.

Example 5:

A junior portfolio manager suspects that a broker responsible for new business from a foreign country is being allocated a portion of the firm's payments for third-party research and suspects that no research is being provided. He believes that the research payments may be inappropriate and unethical.

Comment:

He should follow his firm's procedures for reporting possible unethical behavior and try to get better disclosure of the nature of these payments and any research that is being provided.

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

Guidance

Do not let the investment process be influenced by any external sources. Modest gifts are permitted. Allocation of shares in oversubscribed IPOs to personal accounts is NOT permitted. Distinguish between gifts from clients and gifts from entities seeking influence to the detriment of the client. Gifts must be disclosed to the member's employer in any case, either prior to acceptance if possible, or subsequently.

Guidance—Investment Banking Relationships

Do not be pressured by sell-side firms to issue favorable research on current or prospective investment-banking clients. It is appropriate to have analysts work with investment bankers in "road shows" only when the conflicts are adequately and effectively managed and disclosed. Be sure there are effective "firewalls" between research/investment management and investment banking activities.

Guidance—Public Companies

Analysts should not be pressured to issue favorable research by the companies they follow. Do not confine research to discussions with company management, but rather use a variety of sources, including suppliers, customers, and competitors.

Guidance—Buy-Side Clients

Buy-side clients may try to pressure sell-side analysts. Portfolio managers may have large positions in a particular security, and a rating downgrade may have an effect on the portfolio performance. As a portfolio manager, there is a responsibility to respect and foster intellectual honesty of sell-side research.

Guidance—Fund Manager and Custodial Relationships

Members responsible for selecting outside managers should not accept gifts, entertainment, or travel that might be perceived as impairing their objectivity.

Guidance—Performance Measurement and Attribution

Performance analysts may experience pressure from investment managers who have produced poor results or acted outside their mandate. Members and candidates who analyze performance must not let such influences affect their analysis.

Guidance—Manager Selection

Members and candidates must exercise independence and objectivity when they select investment managers. They should not accept gifts or other compensation that could be seen as influencing their hiring decisions, nor should they offer compensation when seeking to be hired as investment managers. The responsibility to maintain independence and objectivity applies to all a member or candidate's hiring and firing decisions, not just those that involve investment management.

Guidance—Credit Rating Agencies

Members employed by credit rating firms should make sure that procedures prevent undue influence by the firm issuing the securities. Members who use credit ratings should be aware of this potential conflict of interest and consider whether independent analysis is warranted.

Guidance—Issuer-Paid Research

Remember that this type of research is fraught with potential conflicts. Analysts' compensation for preparing such research should be limited, and the preference is for a flat fee, without regard to conclusions or the report's recommendations.

Guidance—Travel

Best practice is for analysts to pay for their own commercial travel when attending information events or tours sponsored by the firm being analyzed.

Recommended Procedures for Compliance

- Protect the integrity of opinions—make sure they are unbiased.
- Create a restricted list and distribute only factual information about companies on the list.
- Restrict special cost arrangements—pay for one's own commercial transportation and hotel; limit use of corporate aircraft to cases in which commercial transportation is not available.
- Limit gifts—token items only. Customary, business-related entertainment is okay as long as its purpose is not to influence a member's professional independence or objectivity. Firms should impose clear value limits on gifts.
- Restrict employee investments in equity IPOs and private placements. Require pre-approval of IPO purchases.
- Review procedures—have effective supervisory and review procedures.
- Firms should have formal written policies on independence and objectivity of research.
- Firms should appoint a compliance officer and provide clear procedures for employee reporting of unethical behavior and violations of applicable regulations.

Application of Standard I(B) Independence and Objectivity

Example 1:

Steven Taylor, a mining analyst with Bronson Brokers, is invited by Precision Metals to join a group of his peers in a tour of mining facilities in several western U.S. states. The company arranges for chartered group flights from site to site and for accommodations in Spartan Motels, the only chain with accommodations near the mines, for three nights. Taylor allows Precision Metals to pick up his tab, as do the other analysts, with one exception—John Adams, an employee of a large trust company who insists on following his company's policy and paying for his hotel room himself.

Comment:

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

Example 2:

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

Comment:

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

Example 3:

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

Comment:

Although Wayne can probably put to good use the knowledge he gained from the trip in selecting portfolio managers and in other areas of managing the pension plan, his recommendation of Penguin Advisors may be tainted by the possible conflict incurred when he participated in a trip paid for partly by Penguin Advisors and when he was in the daily company of the president of Penguin Advisors. To avoid violating Standard I(B), Wayne's basic expenses for travel and accommodations should have been paid by his employer or the pension plan; contact with the president of Penguin Advisors should have been limited to informational or educational events only; and the trip, the organizer, and the sponsor should have been made a matter of public record. Even if his actions were not in violation of Standard I(B), Wayne should have been sensitive to the public perception of the trip when reported in the newspaper and the extent to which the subjective elements of his decision might have been affected by the familiarity that the daily contact of such a trip would encourage. This advantage would probably not be shared by competing firms.

Example 4:

An analyst in the corporate finance department promises a client that her firm will provide full research coverage of the issuing company after the offering.

Comment:

This is not a violation, but she cannot promise favorable research coverage. Research must be objective and independent.

Example 5:

An employee's boss tells him to assume coverage of a stock and maintain a buy rating.

Comment:

Research opinions and recommendations must be objective and arrived at independently. Following the boss's instructions would be a violation if the analyst determined a buy rating is inappropriate.

Example 6:

A money manager receives a gift of significant value from a client as a reward for good performance over the prior period and informs her employer of the gift.

Comment:

No violation here because the gift is from a client and is not based on performance going forward, but the gift must be disclosed to her employer. If the gift were contingent on future performance, the money manager would have to obtain permission from her employer. The reason for both the disclosure and permission requirements is that the employer must ensure that the money manager does not give advantage to the client giving or offering additional compensation, to the detriment of other clients.

Example 7:

An analyst enters into a contract to write a research report on a company, paid for by that company, for a flat fee plus a bonus based on attracting new investors to the security.

Comment:

This is a violation because the compensation structure makes total compensation depend on the conclusions of the report (a favorable report will attract investors and increase compensation). Accepting the job for a flat fee that does not depend on the report's conclusions or its impact on share price is permitted, with proper disclosure of the fact that the report is funded by the subject company.

Example 8:

A trust manager at a bank selects mutual funds for client accounts based on the profits from "service fees" paid to the bank by the mutual fund sponsor.

Comment:

This is a violation because the trust manager has allowed the fees to affect his objectivity.

Example 9:

An analyst performing sensitivity analysis for a security does not use only scenarios consistent with recent trends and historical norms.

Comment:

This is a good thing and is not a violation.

Example 10

A member whose firm is seeking to become an investment manager for a labor union contributes a large sum to the union leader's re-election campaign. After the union hires the member's firm, the member continues to spend significant amounts on entertainment for the union leader and his family.

Comment:

Offering gifts or other compensation to influence a decision to hire an investment manager is a violation of Standard I(B).

Example 11

A member who is a performance analyst notices that one of her firm's top investment managers has changed his composite construction, removing a poorly performing large account and placing it in a different composite. Knowing that the investment manager is important to the firm and a close friend of the firm's CEO, the member does not disclose this change in her performance report.

Comment:

The member violated Standard I(B) by failing to exercise independence and objectivity in her analysis. Altering composites to conceal poor performance also violates Standard III(D) Performance Presentation and may violate Standard I(C) Misrepresentation.

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

Guidance

Trust is a foundation in the investment profession. Do not make any misrepresentations or give false impressions. This includes oral, electronic, and social media communications. Misrepresentations include guaranteeing investment performance and plagiarism. Plagiarism encompasses using someone else's work (reports, forecasts, models, ideas, charts, graphs, and spreadsheet models) without giving them credit. Knowingly omitting information that could affect an investment decision or performance evaluation is considered misrepresentation.

Models and analysis developed by others at a member's firm are the property of the firm and can be used without attribution. A report written by another analyst employed by the firm cannot be released as another analyst's work.

Recommended Procedures for Compliance

A good way to avoid misrepresentation is for firms to provide employees who deal with clients or prospects a written list of the firm's available services and a description of the firm's qualifications. Employee qualifications should be accurately presented as well. To avoid plagiarism, maintain records of all materials used to generate reports or other firm products and properly cite sources (quotes and summaries) in work products. Information from recognized financial and statistical reporting services need not be cited.

Members should encourage their firms to establish procedures for verifying marketing claims of third parties whose information the firm provides to clients.

Application of Standard I(C) Misrepresentation

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Example 3:

Paul Ostrowski runs a 2-person investment management firm. Ostrowski's firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged by smaller firms for those firms' clients. Ostrowski's firm distributes these reports to clients as its own work.

Comment:

Ostrowski can rely on third-party research that has a reasonable and adequate basis, but he cannot imply that he is the author of the report. Otherwise, Ostrowski would misrepresent the extent of his work in a way that would mislead the firm's clients or prospective clients.

Example 4:

A member makes an error in preparing marketing materials and misstates the amount of assets his firm has under management.

Comment:

The member must attempt to stop distribution of the erroneous material as soon as the error is known. Simply making the error unintentionally is not a violation, but continuing to distribute material known to contain a significant misstatement of fact would be.

Example 5:

The marketing department states in sales literature that an analyst has received an MBA degree, but he has not. The analyst and other members of the firm have distributed this document for years.

Comment:

The analyst has violated the Standards, as he should have known of this misrepresentation after having distributed and used the materials over a period of years.

Example 6:

A member describes an interest-only collateralized mortgage obligation as guaranteed by the U.S. government because it is a claim against the cash flows of a pool of guaranteed mortgages, although the payment stream and the market value of the security are not guaranteed.

Comment:

This is a violation because of the misrepresentation.

Example 7:

A member describes a bank CD as "guaranteed."

Comment:

This is not a violation as long as the limits of the guarantee provided by the Federal Deposit Insurance Corporation are not exceeded and the nature of the guarantee is clearly explained to clients.

Example 8:

A member uses definitions he found online for such terms as variance and coefficient of variation in preparing marketing material.

Comment:

Even though these are standard terms, using the work of others word-for-word is plagiarism.

Example 9:

A candidate reads about a research paper in a financial publication and includes the information in a research report, citing the original research report but not the financial publication.

Comment:

To the extent that the candidate used information and interpretation from the financial publication without citing it, the candidate is in violation of the Standard. The candidate should either obtain the report and reference it directly or, if he relies solely on the financial publication, should cite both sources.

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

Guidance

CFA Institute discourages unethical behavior in all aspects of members' and candidates' lives. Do not abuse CFA Institute's Professional Conduct Program by seeking enforcement of this Standard to settle personal, political, or other disputes that are not related to professional ethics.

Recommended Procedures for Compliance

Firms are encouraged to adopt these policies and procedures:

- Develop and adopt a code of ethics and make clear that unethical behavior will not be tolerated.
- Give employees a list of potential violations and sanctions, including dismissal.
- Check references of potential employees.

Application of Standard I(D) Misconduct

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Example 3:

A member intentionally includes a receipt that is not in his expenses for a company trip.

Comment:

Because this act involves deceit and fraud and reflects on the member's integrity and honesty, it is a violation.

Example 4:

A member tells a client that he can get her a good deal on a car through his father-in-law, but instead gets her a poor deal and accepts part of the commission on the car purchase.

Comment:

The member has been dishonest and misrepresented the facts of the situation and has, therefore, violated the Standard.

II Integrity of Capital Markets

II(A) Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

Guidance

Information is "material" if its disclosure would impact the price of a security or if reasonable investors would want the information before making an investment decision. Ambiguous information, as far as its likely effect on price, may not be considered material. Information is "nonpublic" until it has been made available to the marketplace. An analyst conference call is not public disclosure. Selectively disclosing information by corporations creates the potential for insider-trading violations. The prohibition against acting on material nonpublic information extends to mutual funds containing the subject securities as well as related swaps and options contracts.

Some members and candidates may be involved in transactions during which they receive material nonpublic information provided by firms (e.g., investment banking transactions). Members and candidates may use the provided nonpublic information for its intended purpose, but must not use the information for any other purpose unless it becomes public information.

Guidance—Mosaic Theory

There is no violation when a perceptive analyst reaches an investment conclusion about a corporate action or event through an analysis of public information together with items of nonmaterial nonpublic information.

Guidance—Social Media

When gathering information from internet or social media sources, members and candidates need to be aware that not all of it is considered public information. Members and candidates should confirm that any material information they receive from these sources is also available from public sources, such as company press releases or regulatory filings.

Guidance—Industry Experts

Members and candidates may seek insight from individuals who have specialized expertise in an industry. However, they may not act or cause others to act on any material nonpublic information obtained from these experts until that information has been publicly disseminated.

Recommended Procedures for Compliance

Make reasonable efforts to achieve public dissemination of the information. Encourage firms to adopt procedures to prevent misuse of material nonpublic information. Use a "firewall" within the firm, with elements including:

- Substantial control of relevant interdepartmental communications, through a clearance area such as the compliance or legal department.
- Review employee trades—maintain "watch," "restricted," and "rumor" lists.
- Monitor and restrict proprietary trading while a firm is in possession of material nonpublic information.

Prohibition of all proprietary trading while a firm is in possession of material nonpublic information may be inappropriate because it may send a signal to the market. In these cases, firms should take the contra side of only unsolicited customer trades.

Application of Standard II(A) Material Nonpublic Information

Example 1:

Samuel Peter, an analyst with Scotland and Pierce, Inc., 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 employee personal accounts.

Comment:

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

Example 2:

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

Comment:

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

Example 3:

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

Comment:

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

Example 4:

A member's dentist, who is an active investor, tells the member that based on his research he believes that Acme, Inc., will be bought out in the near future by a larger firm in the industry. The member investigates and purchases shares of Acme.

Comment:

There is no violation here because the dentist had no inside information but has reached the conclusion on his own. The information here is not material because there is no reason to suspect that an investor would wish to know what the member's dentist thought before investing in shares of Acme.

Example 5:

A member received an advance copy of a stock recommendation that will appear in a widely read national newspaper column the next day and purchases the stock.

Comment:

A recommendation in a widely read newspaper column will likely cause the stock price to rise, so this is material nonpublic information. The member has violated the Standard.

Example 6:

A member trades based on information he gets by seeing an advance copy of an article that will be published in an influential magazine next week.

Comment:

This is a violation as this is nonpublic information until the article has been published.

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

Guidance

This Standard applies to transactions that deceive the market by distorting the price-setting mechanism of financial instruments or by securing a controlling position to manipulate the price of a related derivative and/or the asset itself. Spreading false rumors is also prohibited.

Application of Standard II(B) Market Manipulation

Example 1:

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

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

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

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

Comment:

Murphy violated Standard II(B) by trying to create artificial price volatility designed to have material impact on the price of an issuer's stock. Moreover, by lacking an adequate basis for the recommendation, Murphy also violated Standard V(A).

Example 2:

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

Comment:

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

Example 3:

A member is seeking to sell a large position in a fairly illiquid stock from a fund he manages. He buys and sells shares of the stock between that fund and another he also manages to create an appearance of activity and stock price appreciation, so that the sale of the whole position will have less market impact and he will realize a better return for the fund's shareholders.

Comment:

The trading activity is meant to mislead market participants and is, therefore, a violation of the Standard. The fact that his fund shareholders gain by this action does not change the fact that it is a violation.

Example 4:

A member posts false information about a firm on internet bulletin boards and stock chat facilities in an attempt to cause the firm's stock to increase in price.

Comment:

This is a violation of the Standard.

III Duties to Clients

III(A) Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

Guidance

Client interests always come first. Although this Standard does not impose a fiduciary duty on members or candidates where one did not already exist, it does require members and candidates to act in their clients' best interest and recommend products that are suitable given their clients' investment objectives and risk tolerances.

- Exercise the prudence, care, skill, and diligence under the circumstances that a person acting in a like capacity and familiar with such matters would use.
- Manage pools of client assets in accordance with the terms of the governing documents, such as trust documents or investment management agreements.
- Make investment decisions in the context of the total portfolio.
- Inform clients of any limitations in an advisory relationship (e.g., an advisor who may only recommend her own firm's products).
- Vote proxies in an informed and responsible manner. Due to cost benefit considerations, it may not be necessary to vote all proxies.
- Client brokerage, or "soft dollars" or "soft commissions" must be used to benefit the client.
- The "client" may be the investing public as a whole rather than a specific entity or person.

Recommended Procedures of Compliance

Submit to clients, at least quarterly, itemized statements showing all securities in custody and all debits, credits, and transactions.

Encourage firms to address these topics when drafting policies and procedures regarding fiduciary duty:

- Follow applicable rules and laws.
- Establish investment objectives of client. Consider suitability of portfolio relative to client's needs and circumstances, the investment's basic characteristics, or the basic characteristics of the total portfolio.
- Diversify.
- Deal fairly with all clients in regards to investment actions.
- Disclose conflicts.
- Disclose compensation arrangements.

- Vote proxies in the best interest of clients and ultimate beneficiaries.
- Maintain confidentiality.
- Seek best execution.
- Place client interests first.

Application of Standard III(A) Loyalty, Prudence, and Care

Example 1:

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

Comment:

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

Example 2:

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

Comment:

Rome is violating her duty of loyalty to the bank's trust accounts by using Gray for brokerage transactions simply because Gray trades Rome's personal account on favorable terms.

Example 3:

A member uses a broker for client-account trades that has relatively high prices and average research and execution. In return, the broker pays for the rent and other overhead expenses for the member's firm.

Comment:

This is a violation of the Standard because the member used client brokerage for services that do not benefit clients and failed to get the best price and execution for his clients.

Example 4:

In return for receiving account management business from Broker X, a member directs trades to Broker X on the accounts referred to her by Broker X, as well as on other accounts as an incentive to Broker X to send her more account business.

Comment:

This is a violation if Broker X does not offer the best price and execution or if the practice of directing trades to Broker X is not disclosed to clients. The obligation to seek best price and execution is always required unless clients provide a written statement that the member is not to seek best price and execution and that they are aware of the impact of this decision on their accounts.

Example 5:

A member does more trades in client accounts than are necessary to accomplish client goals because she desires to increase her commission income.

Comment:

The member is using client assets (brokerage fees) to benefit herself and has violated the Standard.

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

Guidance

Do not discriminate against any clients when disseminating recommendations or taking investment action. Fairly does not mean equally. In the normal course of business, there will be differences in the time e-mails, faxes, etc., are received by different clients. Different service levels are okay, but they must not negatively affect or disadvantage any clients. Disclose the different service levels to all clients and prospects, and make premium levels of service available to all who wish to pay for them.

Guidance—Investment Recommendations

Give all clients a fair opportunity to act upon every recommendation. Clients who are unaware of a change in a recommendation should be advised before the order is accepted.

Guidance—Investment Actions

Treat clients fairly in light of their investment objectives and circumstances. Treat both individual and institutional clients in a fair and impartial manner. Members and candidates should not take advantage of their position in the industry to disadvantage clients (e.g., in the context of IPOs).

Recommended Procedures for Compliance

Encourage firms to establish compliance procedures requiring proper dissemination of investment recommendations and fair treatment of all customers and clients. Consider these points when establishing fair dealing compliance procedures:

- Limit the number of people who are aware that a change in recommendation will be made.
- Shorten the time frame between decision and dissemination.
- Publish personnel guidelines for pre-dissemination—have in place guidelines prohibiting personnel who have prior knowledge of a recommendation from discussing it or taking action on the pending recommendation.
- Simultaneous dissemination of new or changed recommendations to all clients who have expressed an interest or for whom an investment is suitable.
- Maintain list of clients and holdings—use to ensure that all holders are treated fairly.
- Develop written trade allocation procedures—ensure fairness to clients, timely and efficient order execution, and accuracy of client positions.
- Disclose trade allocation procedures.
- Establish systematic account review—ensure that no client is given preferred treatment and that investment actions are consistent with the account's objectives.
- Disclose available levels of service.

Application of Standard III(B) Fair Dealing

Example 1:

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

Comment:

Ames violated Standard III(B) by disseminating the purchase recommendation to the clients with whom he had lunch a week before the recommendation was sent to all clients.

Example 2:

Spencer Rivers, president of XYZ Corporation, moves his company's growth-oriented pension fund to a particular bank primarily because of the excellent investment performance achieved by the bank's commingled fund for the prior 5-year period. A few years later, Rivers compares the results of his pension fund with those of the bank's commingled fund. He is startled to learn that, even though the two accounts have the same investment objectives and similar portfolios, his company's pension fund has significantly underperformed the bank's commingled fund. Questioning this result at his next meeting with the pension fund's manager, Rivers is told that, as a matter of policy, when a new security is placed on the recommended list, Morgan Jackson, the pension fund manager, first purchases the security for the commingled account and then purchases it on a pro rata basis for all other pension fund accounts. Similarly, when a sale is recommended, the security is sold first from the commingled account and then sold on a pro rata basis from all other accounts. Rivers also learns that if the bank cannot get enough shares (especially the hot issues) to be meaningful to all the accounts, its policy is to place the new issues only in the commingled account.

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

Comment:

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

Example 3:

A member gets options for his part in an IPO from the subject firm. The IPO is oversubscribed and the member fills his own and other individuals' orders but has to reduce allocations to his institutional clients.

Comment:

The member has violated the Standard. He must disclose to his employer and to his clients that he has accepted options for putting together the IPO. He should not take any shares of a hot IPO for himself and should have distributed his allocated shares of the IPO to all clients in proportion to their original order amounts.

Example 4:

A member is delayed in allocating some trades to client accounts. When she allocates the trades, she puts some positions that have appreciated in a preferred client's account and puts trades that have not done as well in other client accounts.

Comment:

This is a violation of the Standard. The member should have allocated the trades to specific accounts prior to the trades or should have allocated the trades proportionally to suitable accounts in a timely fashion.

Example 5:

Because of minimum lot size restrictions, a portfolio manager allocates the bonds she receives from an oversubscribed bond offering to her clients in a way that is not strictly proportional to their purchase requests.

Comment:

Since she has a reason (minimum lot size) to deviate from a strict pro rata allocation to her clients, there is no violation of Fair Dealing.

III(C) Suitability

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

   a. Make a reasonable inquiry into a client's or prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.

   b. Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.

   c. Judge the suitability of investments in the context of the client's total portfolio.

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

Guidance

In advisory relationships, be sure to gather client information at the beginning of the relationship, in the form of an investment policy statement (IPS). Consider clients' needs and circumstances and thus their risk tolerance. Consider whether or not the use of leverage is suitable for the client.

If a member is responsible for managing a fund to an index or other stated mandate, be sure investments are consistent with the stated mandate.

Guidance—Unsolicited Trade Requests

An investment manager might receive a client request to purchase a security that the manager knows is unsuitable, given the client's investment policy statement. The trade may or may not have a material effect on the risk characteristics of the client's total portfolio and the requirements are different for each case. In either case, however, the manager should not make the trade until he has discussed with the client the reasons (based on the IPS) that the trade is unsuitable for the client's account.

If the manager determines that the effect on the risk/return profile of the client's total portfolio is minimal, the manager, after discussing with the client how the trade does not fit the IPS goals and constraints, may follow his firm's policy with regard to unsuitable trades. Regardless of firm policy, the client must acknowledge the discussion and an understanding of why the trade is unsuitable.

If the trade would have a material impact on the risk/return profile of the client's total portfolio, one option is to update the IPS so that the client accepts a changed risk profile that would permit the trade. If the client will not accept a changed IPS, the manager may follow firm policy, which may allow the trade to be made in a separate client-directed account. In the absence of other options, the manager may need to reconsider whether to maintain the relationship with the client.

Recommended Procedures for Compliance

Members should:

- Put the needs and circumstances of each client and the client's investment objectives into a written IPS for each client.
- Consider the type of client and whether there are separate beneficiaries, investor objectives (return and risk), investor constraints (liquidity needs, expected cash flows, time, tax, and regulatory and legal circumstances), and performance measurement benchmarks.
- Review investor's objectives and constraints periodically to reflect any changes in client circumstances.

Application of Standard III(C) Suitability

Example 1:

Jessica McDowell, an investment advisor, suggests to Brian Crosby, a risk-averse client, that covered call options be used in his equity portfolio. The purpose would be to enhance Crosby's income and partially offset any untimely depreciation in value should the stock market or other circumstances affect his holdings unfavorably. McDowell educates Crosby about all possible outcomes, including the risk of incurring an added tax liability if a stock rises in price and is called away and, conversely, the risk of his holdings losing protection on the downside if prices drop sharply.

Comment:

When determining suitability of an investment, the primary focus should be on the characteristics of the client's entire portfolio, not on an issue-by-issue analysis. The basic characteristics of the entire portfolio will largely determine whether the investment recommendations are taking client factors into account. Therefore, the most important aspects of a particular investment will be those that will affect the characteristics of the total portfolio. In this case, McDowell properly considered the investment in the context of the entire portfolio and thoroughly explained the investment to the client.

Example 2:

Max Gubler, chief investment officer of a property/casualty insurance subsidiary of a large financial conglomerate, wants to better diversify the company's investment portfolio and increase its returns. The company's investment policy statement (IPS) provides for highly liquid investments, such as large caps, governments, and supra-nationals, as well as corporate bonds with a minimum credit rating of AA- and maturity of no more than five years. In a recent presentation, a venture capital group offered very attractive prospective returns on some of their private equity funds providing seed capital. An exit strategy is already contemplated but investors will first have to observe a minimum three-year lock-up period, with a subsequent laddered exit option for a maximum of one third of shares per year. Gubler does not want to miss this opportunity and after an extensive analysis and optimization of this asset class with the company's current portfolio, he invests 4% in this seed fund, leaving the portfolio's total equity exposure still well below its upper limit.

Comment:

Gubler violates Standard III(A) Loyalty, Prudence, and Care as well as Standard III(C). His new investment locks up part of the company's assets for at least three and for up to as many as five years and possibly beyond. Since the IPS requires investments in highly liquid investments and describes accepted asset classes, private equity investments with a lock-up period certainly do not qualify. Even without such lock-up periods an asset class with only an occasional, and thus implicitly illiquid, market may not be suitable. Although an IPS typically describes objectives and constraints in great detail, the manager must make every effort to understand the client's business and circumstances. Doing so should also enable the manager to recognize, understand, and discuss with the client other factors that may be or may become material in the investment management process.

Example 3:

A member gives a client account a significant allocation to non-dividend paying high-risk securities even though the client has low risk tolerance and modest return objectives.

Comment:

This is a violation of the Standard.

Example 4:

A member puts a security into a fund she manages that does not fit the mandate of the fund and is not a permitted investment according to the fund's disclosures.

Comment:

This, too, is a violation of the Standard.

Example 5:

A member starts his own money management business but puts all clients in his friend's hedge funds.

Comment:

He has violated the Standards with respect to suitability. He must match client needs and circumstances to the investments he recommends and cannot act like a sales agent for his friend's funds.

III(D) Performance Presentation. When communicating investment performance information, Members or Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

Guidance

Members must avoid misstating performance or misleading clients/prospects about investment performance of themselves or their firms, should not misrepresent past performance or reasonably expected performance, and should not state or imply the ability to achieve a rate of return similar to that achieved in the past. For brief presentations, members must make detailed information available on request and indicate that the presentation has offered limited information.

Recommended Procedures for Compliance

Encourage firms to adhere to Global Investment Performance Standards. Obligations under this Standard may also be met by:

- Considering the sophistication of the audience to whom a performance presentation is addressed.
- Presenting performance of weighted composite of similar portfolios rather than a single account.
- Including terminated accounts as part of historical performance and clearly stating when they were terminated.
- Including all appropriate disclosures to fully explain results (e.g., model results included, gross or net of fees, etc.).
- Maintaining data and records used to calculate the performance being presented.

Application of Standard III(D) Performance Presentation

Example 1:

Kyle Taylor of Taylor Trust Company, noting the performance of Taylor's common trust fund for the past two years, states in the brochure sent to his potential clients that "You can expect steady 25% annual compound growth of the value of your investments over the year." Taylor Trust's common trust fund did increase at the rate of 25% per annum for the past year which mirrored the increase of the entire market. The fund, however, never averaged that growth for more than one year, and the average rate of growth of all of its trust accounts for five years was 5% per annum.

Comment:

Taylor's brochure is in violation of Standard III(D). Taylor should have disclosed that the 25% growth occurred in only one year. Additionally, Taylor did not include client accounts other than those in the firm's common trust fund. A general claim of firm performance should take into account the performance of all categories of accounts. Finally, by stating that clients can expect a steady 25% annual compound growth rate, Taylor also violated Standard I(C), which prohibits statements of assurances or guarantees regarding an investment.

Example 2:

Aaron McCoy is vice president and managing partner of the equity investment group of Mastermind Financial Advisors, a new business. Mastermind recruited McCoy because he had a proven six-year track record with G&P Financial. In developing Mastermind's advertising and marketing campaign, McCoy prepared an advertisement that included the equity investment performance he achieved at G&P Financial. The advertisement for Mastermind did not identify the equity performance as being earned while at G&P. The advertisement was distributed to existing clients and prospective clients of Mastermind.

Comment:

McCoy violated Standard III(D) by distributing an advertisement that contained material misrepresentations regarding the historical performance of Mastermind. Standard III(D) requires that members and candidates make every reasonable effort to ensure that performance information is a fair, accurate, and complete representation of an individual or firm's performance. As a general matter, this standard does not prohibit showing past performance of funds managed at a prior firm as part of a performance track record so long as it is accompanied by appropriate disclosures detailing where the performance comes from and the person's specific role in achieving that performance. If McCoy chooses to use his past performance from G&P in Mastermind's advertising, he should make full disclosure as to the source of the historical performance.

Example 3:

A member puts simulated results of an investment strategy in a sales brochure without disclosing that the results are not actual performance numbers.

Comment:

The member has violated the Standard.

Example 4:

In materials for prospective clients, a member uses performance figures for a large-cap growth composite she has created by choosing accounts that have done relatively well and including some accounts with significant mid-cap exposure.

Comment:

This is a violation of the Standard as the member has attempted to mislead clients and has misrepresented her performance.

Example 5:

A member changes his firm's performance attribution method to one he believes is more consistent with the strategies used by the firm's investment managers.

Comment:

To avoid a violation of the Standard, the member must disclose this change to existing and new clients. He should explain the reasons for changing the method and report the managers' performance attribution using *both* the old and new methods so that clients may compare them.

III(E) Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

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

Guidance

If illegal activities by a client are involved, members may have an obligation to report the activities to authorities. The confidentiality Standard extends to former clients as well.

The requirements of this Standard are not intended to prevent Members and Candidates from cooperating with a CFA Institute Professional Conduct Program (PCP) investigation.

Recommended Procedures for Compliance

Members should avoid disclosing information received from a client except to authorized co-workers who are also working for the client. Members should follow firm procedures for storage of electronic data and recommend adoption of such procedures if they are not in place.

Application of Standard III(E) Preservation of Confidentiality

Example 1:

Sarah Connor, a financial analyst employed by Johnson Investment Counselors, Inc., provides investment advice to the trustees of City Medical Center. The trustees have given her a number of internal reports concerning City Medical's needs for physical plant renovation and expansion. They have asked Connor to recommend investments that would generate capital appreciation in endowment funds to meet projected capital expenditures. Connor is approached by a local business man, Thomas Kasey, who is considering a substantial contribution either to City Medical Center or to another local hospital. Kasey wants to find out the building plans of both institutions before making a decision, but he does not want to speak to the trustees.

Comment:

The trustees gave Connor the internal reports so she could advise them on how to manage their endowment funds. Because the information in the reports is clearly both confidential and within the scope of the confidential relationship, Standard III(E) requires that Connor refuse to divulge information to Kasey.

Example 2:

David Bradford manages money for a family-owned real estate development corporation. He also manages the individual portfolios of several of the family members and officers of the corporation, including the chief financial officer (CFO). Based on the financial records from the corporation, as well as some questionable practices of the CFO that he has observed, Bradford believes that the CFO is embezzling money from the corporation and putting it into his personal investment account.

Comment:

Bradford should check with his firm's compliance department as well as outside counsel to determine whether applicable securities regulations require reporting the CFO's financial records.

Example 3:

A member has learned from his client that one of his goals is to give more of his portfolio income to charity. The member tells this to a friend who is on the board of a worthy charity and suggests that he should contact the client about a donation.

Comment:

The member has violated the Standard by disclosing information he has learned from the client in the course of their business relationship.

Example 4:

A member learns that a pension account client is violating the law with respect to charges to the pension fund.

Comment:

The member must bring this to the attention of her supervisor and try to end the illegal activity. Failing this, the member should seek legal advice about any disclosure she should make to legal or regulatory authorities and dissociate herself from any continuing association with the pension account.

IV Duties to Employers

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

Guidance

Members must not engage in any activities which would injure the firm, deprive it of profit, or deprive it of the advantage of employees' skills and abilities. Members should always place client interests above interests of their employer but consider the effects of their actions on firm integrity and sustainability. There is no requirement that the employee put employer interests ahead of family and other personal obligations; it is expected that employers and employees will discuss such matters and balance these obligations with work obligations.

Guidance—Employer Responsibility

Members are encouraged to give their employer a copy of the Code and Standards. Employers should not have incentive and compensation systems that encourage unethical behavior.

Guidance—Independent Practice

Independent practice for compensation is allowed if a notification is provided to the employer fully describing all aspects of the services, including compensation, duration, and the nature of the activities *and* if the employer consents to all terms of the proposed independent practice before it begins.

Guidance—Leaving an Employer

Members must continue to act in their employer's best interests until resignation is effective. Activities which may constitute a violation include:

- Misappropriation of trade secrets.
- Misuse of confidential information.
- Soliciting employer's clients prior to leaving.
- Self-dealing.
- Misappropriation of client lists.

Employer records on any medium (e.g., home computer, PDA, cell phone) are the property of the firm.

Once an employee has left a firm, simple knowledge of names and existence of former clients is generally not confidential. There is also no prohibition on the use of experience or knowledge gained while with a former employer. If an agreement exists among employers (e.g, the U.S. "Protocol for Broker Recruiting") that permits brokers to take certain client information when leaving a firm, a member or candidate may act within the terms of the agreement without violating the Standard.

Guidance—Social Media

Members and candidates must adhere to their employers' policies concerning social media. When planning to leave an employer, members and candidates must ensure that their social media use complies with their employers' policies for notifying clients about employee separations. A best practice is to use separate social media accounts for personal and professional communications.

Guidance—Whistleblowing

There may be isolated cases where a duty to one's employer may be violated in order to protect clients or the integrity of the market, and not for personal gain.

Guidance—Nature of Employment

The applicability of this Standard is based on the nature of the employment—employee versus independent contractor. If Members and Candidates are independent contractors, they still have a duty to abide by the terms of the agreement.

Application of Standard IV(A) Loyalty

Example 1:

James Hightower has been employed by Jason Investment Management Corporation for 15 years. He began as an analyst but assumed increasing responsibilities and is now a senior portfolio manager and a member of the firm's investment policy committee. Hightower has decided to leave Jason Investment and start his own investment management business. He has been careful not to tell any of Jason's clients that he is leaving; he does not want to be accused of breaching his duty to Jason by soliciting Jason's clients before his departure. Hightower is planning to copy and take with him the following documents and information he developed or worked on while at Jason: (1) the client list, with addresses, telephone numbers, and other pertinent client information; (2) client account statements; (3) sample marketing presentations to prospective clients containing Jason's performance record; (4) Jason's recommended list of securities; (5) computer models to determine asset allocations for accounts with different objectives; (6) computer models for stock selection; and (7) personal computer spreadsheets for Hightower's major corporate recommendations which he developed when he was an analyst.

Comment:

Except with the consent of their employer, departing employees may not take employer property, which includes books, records, reports, and other materials, and may not interfere with their employer's business opportunities. Taking any employer records, even those the member or candidate prepared, violates Standard IV(A).

Example 2:

Dennis Elliot has hired Sam Chisolm who previously worked for a competing firm. Chisolm left his former firm after 18 years of employment. When Chisolm begins working for Elliot, he wants to contact his former clients because he knows them well and is certain that many will follow him to his new employer. Is Chisolm in violation of the Standard IV(A) if he contacts his former clients?

Comment:

Because client records are the property of the firm, contacting former clients for any reason through the use of client lists or other information taken from a former employer without permission would be a violation of Standard IV(A). In addition, the nature and extent of the contact with former clients may be governed by the terms of any non-compete agreement signed by the employee and the former employer that covers contact with former clients after employment.

But, simple knowledge of the name and existence of former clients is not confidential information, just as skills or experience that an employee obtains while employed is not "confidential" or "privileged" information. The Code and Standards do not impose a prohibition on the use of experience or knowledge gained at one employer from being used at another employer. The Code and Standards also do not prohibit former employees from contacting clients of their previous firm, absent a non-compete agreement. Members and candidates are free to use public information about their former firm after departing to contact former clients without violating Standard IV(A).

In the absence of a non-compete agreement, as long as Chisolm maintains his duty of loyalty to his employer before joining Elliot's firm, does not take steps to solicit clients until he has left his former firm, and does not make use of material from his former employer without its permission after he has left, he would not be in violation of the Code and Standards.

Example 3:

Several employees are planning to depart their current employer within a few weeks and have been careful to not engage in any activities that would conflict with their duty to their current employer. They have just learned that one of their employer's clients has undertaken a request for proposal (RFP) to review and possibly hire a new investment consultant. The RFP has been sent to the employer and all of its competitors. The group believes that the new entity to be formed would be qualified to respond to the RFP and eligible for the business. The RFP submission period is likely to conclude before the employees' resignations are effective. Is it permissible for the group of departing employees to respond to the RFP under their anticipated new firm?

Comment:

A group of employees responding to an RFP that their employer is also responding to would lead to direct competition between the employees and the employer. Such conduct would violate Standard IV(A) unless the group of employees received permission from their employer as well as the entity sending out the RFP.

Example 4:

A member solicits clients and prospects of his current employer to open accounts at the new firm he will be joining shortly.

Comment:

It is a violation of the Standard to solicit the firm's clients and prospects while he is still employed by the firm.

Example 5:

Two employees discuss joining with others in an employee-led buyout of their employer's emerging markets investment management business.

Comment:

There is no violation here. Their employer can decide how to respond to any buyout offer. If such a buyout takes place, clients should be informed of the nature of the changes in a timely manner.

Example 6:

A member is writing a research report on a company as a contract worker for Employer A (using Employer A's premises and materials) with the understanding that Employer A does not claim exclusive rights to the outcome of her research. As she is finishing the report, she is offered a full-time job by Employer B and sends Employer B a copy of a draft of her report for publication.

Comment:

She has violated the Standard by not giving Employer A the first rights to act on her research. She must also be careful not to take any materials used in preparing the report from Employer A's premises.

Example 7:

A member helps develop software for a firm while acting as an unpaid intern and takes the software, without permission, with her when she takes a full-time job at another firm.

Comment:

She is considered an employee of the firm and has violated the Standard by taking her employer's property without permission.

Example 8:

A member prepares to leave his employer and open his own firm by registering with the SEC, renting an office, and buying office equipment.

Comment:

As long as these preparations have not interfered with the performance of his current job, there has been no violation. The solicitation of firm clients and prospects prior to leaving his employer would, however, be a violation of the Standard.

Example 9:

A member is a full-time employee of an investment management firm and wants to accept a paid position as town mayor without asking his employer's permission.

Comment:

Because the member serving as mayor does not conflict with his employer's business interests, as long as the time commitment does not preclude performing his expected job functions well, there is no violation.

Example 10:

A member who has left one employer uses public sources to get the phone numbers of previous clients and solicits their business for her new employer.

Comment:

As long as there is no agreement in force between the member and his previous employer that prohibits such solicitation, there is no violation of the Standards.

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

Guidance

Compensation includes direct and indirect compensation from a client and other benefits received from third parties. Written consent from a member's employer includes e-mail communication. Members and candidates who are hired to work part time should discuss any arrangements that may compete with their employer's interest at the time they are hired, and abide by any limitations their employer identifies.

Recommended Procedures for Compliance

Make an immediate written report to employer detailing any proposed compensation and services, if additional to that provided by employer. Details including any performance incentives should be verified by the offering party.

Application of Standard IV(B) Additional Compensation Arrangements

Example 1:

Geoff Whitman, a portfolio analyst for Adams Trust Company, manages the account of Carol Cochran, a client. Whitman is paid a salary by his employer, and Cochran pays the trust company a standard fee based on the market value of assets in her portfolio. Cochran proposes to Whitman that "any year that my portfolio achieves at least a 15% return before taxes, you and your wife can fly to Monaco at my expense and use my condominium during the third week of January." Whitman does not inform his employer of the arrangement and vacations in Monaco the following January as Cochran's guest.

Comment:

Whitman violated Standard IV(B) by failing to inform his employer in writing of this supplemental, contingent compensation arrangement. The nature of the arrangement could have resulted in partiality to Cochran's account, which could have detracted from Whitman's performance with respect to other accounts he handles for Adams Trust. Whitman must obtain the consent of his employer to accept such a supplemental benefit.

Example 2:

A member is on the board of directors of a company whose shares he purchases for client accounts. As a member of the board, he receives the company's product at no charge.

Comment:

Because receiving the company's product constitutes compensation for his service, he is in violation of the Standard if he does not disclose this additional compensation to his employer.

IV(C) Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

Guidance

Members must make reasonable efforts to *prevent* employees from violating laws, rules, regulations, or the Code and Standards, as well as make reasonable efforts to *detect* violations.

Guidance—Compliance Procedures

Understand that an adequate compliance system must meet industry standards, regulatory requirements, and the requirements of the Code and Standards. Members with supervisory responsibilities have an obligation to bring an inadequate compliance system to the attention of firm's management and recommend corrective action. While investigating a possible breach of compliance procedures, it is appropriate to limit the suspected employee's activities.

A member or candidate faced with no compliance procedures or with procedures he believes are inadequate must decline supervisory responsibility in writing until adequate procedures are adopted by the firm.

Recommended Procedures for Compliance

A member should recommend that his employer adopt a code of ethics. Employers should not commingle compliance procedures with the firm's code of ethics—this can dilute the goal of reinforcing one's ethical obligations. Members should encourage employers to provide their code of ethics to clients.

Adequate compliance procedures should:

- Be clearly written.
- Be easy to understand.
- Designate a compliance officer with authority clearly defined.
- Have a system of checks and balances.
- Outline the scope of procedures.
- Outline what conduct is permitted.
- Contain procedures for reporting violations and sanctions.
- Structure incentives so that unethical behavior is not rewarded.

Once the compliance program is instituted, the supervisor should:

- Distribute it to the proper personnel.
- Update it as needed.
- Continually educate staff regarding procedures.
- Issue reminders as necessary.
- Require professional conduct evaluations.
- Review employee actions to monitor compliance and identify violations.

- Enforce procedures once a violation occurs.
- Review procedures and identify any changes needed to prevent violations in the future.

If there is a violation, respond promptly and conduct a thorough investigation while increasing supervision or placing limitations on the wrongdoer's activities.

Application of Standard IV(C) Responsibilities of Supervisors

Example 1:

Jane Mattock, senior vice president and head of the research department of H&V, Inc., a regional brokerage firm, has decided to change her recommendation for Timber Products from buy to sell. In line with H&V's procedures, she orally advises certain other H&V executives of her proposed actions before the report is prepared for publication. As a result of his conversation with Mattock, Dieter Frampton, one of the executives of H&V accountable to Mattock, immediately sells Timber's stock from his own account and from certain discretionary client accounts. In addition, other personnel inform certain institutional customers of the changed recommendation before it is printed and disseminated to all H&V customers who have received previous Timber reports.

Comment:

Mattock failed to supervise reasonably and adequately the actions of those accountable to her. She did not prevent or establish reasonable procedures designed to prevent dissemination of or trading on the information by those who knew of her changed recommendation. She must ensure that her firm has procedures for reviewing or recording trading in the stock of any corporation that has been the subject of an unpublished change in recommendation. Adequate procedures would have informed the subordinates of their duties and detected sales by Frampton and selected customers.

Example 2:

Deion Miller is the research director for Jamestown Investment Programs. The portfolio managers have become critical of Miller and his staff because the Jamestown portfolios do not include any stock that has been the subject of a merger or tender offer. Georgia Ginn, a member of Miller's staff, tells Miller that she has been studying a local company, Excelsior, Inc., and recommends its purchase. Ginn adds that the company has been widely rumored to be the subject of a merger study by a well-known conglomerate and discussions between them are under way. At Miller's request, Ginn prepares a memo recommending the stock. Miller passes along Ginn's memo to the portfolio managers prior to leaving for vacation, noting that he has not reviewed the memo. As a result of the memo, the portfolio managers buy Excelsior stock immediately. The day Miller returns to the office, Miller learns that Ginn's only sources for the report were her brother, who is an acquisitions analyst with Acme Industries and the "well-known conglomerate" and that the merger discussions were planned but not held.

Comment:

Miller violated Standard IV(C) by not exercising reasonable supervision when he disseminated the memo without checking to ensure that Ginn had a reasonable and adequate basis for her recommendations and that Ginn was not relying on material nonpublic information.

Example 3:

A member responsible for compliance by the firm's trading desk notices a high level of trading activity in a stock that is not on the firm's recommended list. Most of this trading is being done by a trainee, and the member does not investigate this trading.

Comment:

This is a violation of the member's responsibilities as supervisor. She must take steps to monitor the activities of traders in training, as well as investigate the reason for the heavy trading of the security by her firm's trading desk.

V Investment Analysis, Recommendations, and Actions

V(A) Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

Guidance

The application of this Standard depends on the investment philosophy adhered to, members' and candidates' roles in the investment decision-making process, and the resources and support provided by employers. These factors dictate the degree of diligence, thoroughness of research, and the proper level of investigation required.

Guidance—Reasonable Basis

The level of research required to satisfy the requirement for due diligence will differ depending on the product or service offered. A list of some things that should be considered prior to making a recommendation or taking investment action includes:

- Global and national economic conditions.
- A firm's financial results, operating history, and business cycle stage.
- Fees and historical results for a mutual fund.
- Limitations of any quantitative models used.
- A determination of whether peer group comparisons for valuation are appropriate.

Guidance—Using Secondary or Third-Party Research

Members should encourage their firms to adopt a policy for periodic review of the quality of third-party research, if they have not. Examples of criteria to use in judging quality are:

- Review assumptions used.
- Determine how rigorous the analysis was.
- Identify how timely how the research is.
- Evaluate objectivity and independence of the recommendations.

Guidance— Using Quantitative Research

Members must be able to explain the basic nature of the quantitative research and how it is used to make investment decisions. Members should consider scenarios outside those typically used to assess downside risk and the time horizon of the data used for model evaluation to ensure that both positive and negative cycle results have been considered.

Guidance—Developing Quantitative Techniques

The Standard requires greater diligence of members and candidates who create quantitative techniques than of those who use techniques developed by others. Members and candidates must understand the technical details of the products they offer to clients. A member or candidate who has created a quantitative strategy must test it thoroughly, including extreme scenarios with inputs that fall outside the range of historical data, before offering it to clients.

Guidance—External Advisers

Members should make sure their firms have procedures in place to review any external advisers they use or promote to ensure that, among other things, the advisers:

- Have adequate compliance and internal controls.
- Present returns information that is correct.
- Do not deviate from their stated strategies.

Guidance—Group Research and Decision Making

Even if a member does not agree with the independent and objective view of the group, he does not necessarily have to decline to be identified with the report, as long as there is a reasonable and adequate basis.

Recommended Procedures for Compliance

Members should encourage their firms to consider these policies and procedures supporting this Standard:

- Have a policy requiring that research reports and recommendations have a basis that can be substantiated as reasonable and adequate.
- Have detailed, written guidance for proper research and due diligence.
- Have measurable criteria for judging the quality of research, and base analyst compensation on such criteria.
- Have written procedures that provide a minimum acceptable level of scenario testing for computer-based models and include standards for the range of scenarios, model accuracy over time, and a measure of the sensitivity of cash flows to model assumptions and inputs.
- Have a policy for evaluating outside providers of information that addresses the reasonableness and accuracy of the information provided and establishes how often the evaluations should be repeated.
- Adopt a set of standards that provides criteria for evaluating external advisers and states how often a review of external advisers will be performed.

Application of Standard V(A) Diligence and Reasonable Basis

Example 1:

Helen Hawke manages the corporate finance department of Sarkozi Securities, Ltd. The firm is anticipating that the government will soon close a tax loophole that currently allows oil and gas exploration companies to pass on drilling expenses to holders of a certain class of shares. Because market demand for this tax-advantaged class of stock is currently high, Sarkozi convinces several companies to undertake new equity financings at once before the loophole closes. Time is of the essence, but Sarkozi lacks sufficient resources to conduct adequate research on all the prospective issuing companies. Hawke decides to estimate the IPO prices based on the relative size of each company and to justify the pricing later when her staff has time.

Comment:

Sarkozi should have taken on only the work that it could adequately handle. By categorizing the issuers as to general size, Hawke has bypassed researching all the other relevant aspects that should be considered when pricing new issues and thus has not performed sufficient due diligence. Such an omission can result in investors purchasing shares at prices that have no actual basis. Hawke has violated Standard V(A).

Example 2:

A member in the corporate finance department of a securities firm prices IPO shares without doing adequate research because she wants to get them to market quickly.

Comment:

This is a violation of Standard V(A).

Example 3:

A member screens a database of investment managers and sends a recommendation of five of them to a client. Subsequently, but before the client receives the report, one of the recommended firms loses its head of research and several key portfolio managers. The member does not update her report.

Comment:

This is a violation as the member should have notified the client of the change in key personnel at the management firm.

Example 4:

A member writes a report in which she estimates mortgage rates. After reviewing it, a majority of the investment committee vote to change the report to reflect a different interest rate forecast. Must the member dissociate herself from the report?

Comment:

The same facts may give rise to different opinions and as long as the committee has a reasonable and adequate basis for their (differing) opinion, the member is under no obligation to ask that her name be removed from the report or to disassociate from issuing the report.

Example 5:

A member makes a presentation for an offering his firm is underwriting, using maximum production levels as his estimate in order to justify the price of the shares he is recommending for purchase.

Comment:

Using the maximum possible production without acknowledging that this is not the expected level of production (or without presenting a range of possible outcomes and their relative probabilities) does not provide a reasonable basis for the purchase recommendation and is a violation of the Standard.

Example 6:

A member posts buy recommendations in an internet chat room based on “conventional wisdom” and what the public is currently buying.

Comment:

A recommendation that is not based on independent and diligent research into the subject company is a violation of the Standard.

Example 7:

A member is a principal in a small investment firm that bases its securities recommendations on third-party research that it purchases.

Comment:

This is not a violation as long as the member’s firm periodically checks the purchased research to determine that it has met, and still meets, the criteria of objectivity and reasonableness required by the Standard.

Example 8:

A member selects an outside advisor for international equities based solely on the fact that the selected firm has the lowest fees for managing the international equities accounts.

Comment:

This is a violation of Standard V(A). The member must consider performance and service, not just fees, in selecting an outside advisor for client accounts.

Example 9:

A member investigates the management, fees, track record, and investment strategy of a hedge fund and recommends it to a client who purchases it. The member accurately discloses the risks involved with the investment in the hedge fund. Soon afterward, the fund reports terrible losses and suspends operations.

Comment:

The bad outcome does not mean there has necessarily been a violation of Standard V(A). A member who has performed reasonable due diligence and disclosed investment risks adequately has complied with the requirements of Standard V(A), regardless of the subsequent outcome.

V(B) **Communication with Clients and Prospective Clients.** Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

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

3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

4. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

Guidance

Proper communication with clients is critical to provide quality financial services. Members must distinguish between opinions and facts and always include the basic characteristics of the security being analyzed in a research report.

Members must illustrate to clients and prospects the investment decision-making process utilized.

All means of communication are included here, not just research reports.

In preparing recommendations for structured securities, allocation strategies, or any other nontraditional investment, members should communicate those risk factors specific to such investments. In all cases, members should communicate the potential gains and losses on the investment clearly in terms of total returns. Members are required to communicate significant changes in the risk characteristics of an investment or strategy and to update clients regularly about changes in the investment process, including any risks and limitations that have been newly identified.

When using projections from quantitative models and analysis, members may violate the Standard by not explaining the limitations of the model and the assumptions it uses, which provides a context for judging the uncertainty regarding the estimated investment result.

Members and candidates must inform clients about limitations inherent to an investment. Two examples of such limitations are liquidity and capacity. *Liquidity* refers to the ability to exit an investment readily without experiencing a significant extra cost for doing so. *Capacity* refers to an investment vehicle's ability to absorb additional investment without reducing the returns it is able to achieve.

Recommended Procedures for Compliance

Selection of relevant factors in a report can be a judgment call, so be sure to maintain records indicating the nature of the research, and be able to supply additional information if it is requested by the client or other users of the report.

Application of Standard V(B) Communication with Clients and Prospective Clients

Example 1:

Sarah Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technician's income and diversifying its product base. Williamson plans to build on Country Technician's reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technician's investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio-construction rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top-five buy and sell recommendations and to leave out details of the valuation models and the portfolio-structuring scheme.

Comment:

Williamson's plans for the newsletter violate Standard V(B) because she does not intend to include all the relevant factors behind the investment advice. Williamson need not describe the investment system in detail in order to implement the advice effectively, but clients must be informed of Country Technician's basic process and logic. Without understanding the basis for a recommendation, clients cannot possibly understand its limitations or its inherent risks.

Example 2:

Richard Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation based on the core samples from the company's latest drilling. According to Dox's calculations, the company has in excess of 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong BUY."

Comment:

If Dox issues the report as written, he will violate Standard V(B). His calculation of the total gold reserves for the property is an opinion, not a fact. Opinion must be distinguished from fact in research reports.

Example 3:

May & Associates is an aggressive growth manager that has represented itself since its inception as a specialist at investing in small-capitalization domestic stocks. One of May's selection criteria is a maximum capitalization of $250 million for any given company. After a string of successful years of superior relative performance, May expanded its client base significantly, to the point at which assets under management now exceed $3 billion. For liquidity purposes, May's chief investment officer (CIO) decides to lift the maximum permissible market-cap ceiling to $500 million and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

Comment:

Although May's CIO is correct about informing potentially interested parties as to the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap and large-cap specialists in a multiple-manager approach. Such clients could regard May's change of criteria as a style change that could distort their overall asset allocations.

Example 4:

Rather than lifting the ceiling for its universe from $250 million to $500 million, May & Associates extends its small-cap universe to include a number of non-U.S. companies.

Comment:

Standard V(B) requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in domestic small-cap stocks. Other variations requiring client notification include introducing derivatives to emulate a certain market sector or relaxing various other constraints, such as portfolio beta. In all such cases, members and candidates must disclose changes to all interested parties.

Example 5:

A member sends a report to his investment management firm's clients describing a strategy his firm offers in terms of the high returns it will generate in the event interest rate volatility decreases. The report does not provide details of the strategy because they are deemed proprietary. The report does not consider the possible returns if interest rate volatility actually increases.

Comment:

This is a violation on two counts. The basic nature of the strategy must be disclosed, including the extent to which leverage is used to generate the high returns when volatility falls. Further, the report must include how the strategy will perform if volatility rises, as well as if it falls.

Example 6:

A member's firm changes from its old equity selection model, which is based on price-sales ratios, to a new model based on several factors, including future earnings growth rates, but does not inform clients of this change.

Comment:

This is a violation because members must inform their clients of any significant change in their investment process. Here, the introduction of forecast data on earnings growth can be viewed as a significant change because the old single-variable model was based on reported rather than forecast data.

Example 7:

A member's firm, in response to poor results relative to its stated benchmark, decides to structure portfolios to passively track the benchmark and does not inform clients.

Comment:

This is a significant change in the investment process and must be communicated to clients.

Example 8:

At a firm where individual portfolio managers have been responsible for security selection, a new policy is implemented whereby only stocks on an approved list constructed by the firm's senior managers may be purchased in client accounts. A member who is a portfolio manager does not inform his clients.

Comment:

This is a violation of the Standard because it represents a significant change in the investment process.

Example 9:

A member changes his firm's outside manager of real estate investments and provides information of this change only in the firm's annual report where outside advisers are listed.

Comment:

This is a violation of the Standard. The member should notify clients immediately of such a change in the firm's investment process.

Example 10:

A member discovers that an error in one of his firm's quantitative models led to a number of trades in one portfolio that should not have been made. The member corrects the error in the model and rebalances the portfolio to reverse the erroneous trades, but does not report the issue.

Comment:

The member violated the Standard by failing to disclose both the error and the corrective action to clients.

Professor's Note: Remember, the argument that clients "won't care" about a process change can be turned around to "there's no reason not to disclose the change."

V(C) Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analysis, recommendations, actions, and other investment-related communications with clients and prospective clients.

Guidance

Members must maintain research records that support the reasons for the analyst's conclusions and any investment actions taken. Such records are the property of the firm. If no other regulatory standards or firm policies are in place, the Standard recommends a 7-year minimum holding period. All communications with clients through any medium, including emails and text messages, are records that must be retained.

A member who changes firms must recreate the analysis documentation supporting her recommendation using publicly available information or information obtained from the company and must not rely on memory or materials created at her previous firm.

Recommended Procedures for Compliance

This record-keeping requirement generally is the firm's responsibility.

Application of Standard V(C) Record Retention

Example 1:

One of Nikolas Lindstrom's clients is upset by the negative investment returns in his equity portfolio. The investment policy statement for the client requires that the portfolio manager follow a benchmark-oriented approach. The benchmark for the client included a 35% investment allocation in the technology sector, which the client acknowledged was appropriate. Over the past three years, the portion put into the segment of technology stocks suffered severe losses. The client complains to the investment manager that so much money was allocated to this sector.

Comment:

For Lindstrom, it is important to have appropriate records to show that over the past three years the percentage of technology stocks in the benchmark index was 35%. Therefore, the amount of money invested in the technology sector was appropriate according to the investment policy statement. Lindstrom should also have the investment policy statement for the client stating that the benchmark was appropriate for the client's investment objectives. He should also have records indicating that the investment had been explained appropriately to the client and that the investment policy statement was updated on a regular basis.

Example 2:

A member bases his research reports on interviews, his own analysis, and industry reports from third parties on his industry and related industries.

Comment:

The member must keep records of all the information that went into the research on which his reports and recommendations are based.

Example 3:

When a member leaves a firm at which he has developed a complex trading model, he takes documentation of the model assumptions and how they were derived over time with him because he will use the model at his new firm.

Comment:

Taking these materials without permission from his previous employer is a violation of his duties to his (previous) employer. While he may use knowledge of the model at the new firm, the member must recreate the supporting documents. The originals are the property of the firm where he worked on developing the model.

VI Conflicts of Interest

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

Guidance

Members must fully disclose to clients, prospects, and their employers all actual and potential conflicts of interest in order to protect investors and employers. These disclosures must be clearly stated.

Guidance—Disclosure to Clients

The requirement that all potential areas of conflict be disclosed allows clients and prospects to judge motives and potential biases for themselves. Disclosure of broker/dealer market-making activities would be included here. Board service is another area of potential conflict.

The most common conflict which requires disclosure is actual ownership of stock in companies that the member recommends or that clients hold.

Another common source of conflicts of interest is a member's compensation/bonus structure, which can potentially create incentives to take actions that produce immediate gains for the member with little or no concern for longer-term returns for the client. Such conflicts must be disclosed when the member is acting in an advisory capacity and must be updated in the case of significant change in compensation structure.

Guidance—Disclosure of Conflicts to Employers

Members must give the employer enough information to judge the impact of the conflict. Take reasonable steps to avoid conflicts, and report them promptly if they occur.

Recommended Procedures of Compliance

Any special compensation arrangements, bonus programs, commissions, and incentives should be disclosed.

Application of Standard VI(A) Disclosure of Conflicts

Example 1:

Hunter Weiss is a research analyst with Farmington Company, a broker and investment banking firm. Farmington's merger and acquisition department has represented Vimco, a conglomerate, in all of its acquisitions for 20 years. From time to time, Farmington officers sit on the boards of directors of various Vimco subsidiaries. Weiss is writing a research report on Vimco.

Comment:

Weiss must disclose in his research report Farmington's special relationship with Vimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company presents a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report and must be disclosed.

Example 2:

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing defined-benefit pension plan accounts, all of which are in the accumulative phase and have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and certain benchmark indexes. Snead changes her investment strategy and purchases several high-beta stocks for client portfolios in an attempt to improve short-term performance. These purchases are seemingly contrary to the client investment policy statement. Now, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

Comment:

Snead violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her employer that created a conflict of interest. Firms may pay employees on the basis of performance, but pressure by Thomas Investment Counsel to achieve short-term performance goals is in basic conflict with the objectives of Snead's accounts.

Example 3:

Bruce Smith covers East European equities for Marlborough investments, an investment management firm with a strong presence in emerging markets. While on a business trip to Russia, Smith learns that investing in Russian equity directly is difficult but that equity-linked notes that replicate the performance of the underlying Russian equity can be purchased from a New York-based investment bank. Believing that his firm would not be interested in such a security, Smith purchases a note linked to a Russian telecommunications company for his own account without informing Marlborough. A month later, Smith decides that the firm should consider investing in Russian equities using equity-linked notes, and he prepares a write-up on the market that concludes with a recommendation to purchase several of the notes. One note recommended is linked to the same Russian telecom company that Smith holds in his personal account.

Comment:

Smith violated Standard VI(A) by failing to disclose his ownership of the note linked to the Russian telecom company. Smith is required by the standard to disclose the investment opportunity to his employer and look to his company's policies on personal trading to determine whether it was proper for him to purchase the note for his own account. By purchasing the note, Smith may or may not have impaired his ability to make an unbiased and objective assessment of the appropriateness of the derivative instrument for his firm, but Smith's failure to disclose the purchase to his employer impaired his employer's ability to render an opinion regarding whether the ownership of a security constituted a conflict of interest that might have affected future recommendations. Once he recommended the notes to his firm, Smith compounded his problems by not disclosing that he owned the notes in his personal account—a clear conflict of interest.

Example 4:

An investment management partnership sells a significant stake to a firm that is publicly traded. The partnership has added the firm's stock to its recommended list and approved its commercial paper for cash management accounts.

Comment:

Members are required to disclose such a change in firm ownership to all clients. Further, any transactions in client accounts involving the securities of the public firm, and any recommendations concerning the public firm's securities, must include a disclosure of the business relation between it and the partnership.

Example 5:

A member provides clients with research about a company's stock, and his wife inherits a significant amount of stock in the company.

Comment:

The member must disclose this potential conflict to his employer and in any subsequent reports or recommendations he authors. His employer may prudently choose to reassign the stock.

Example 6:

A member's investment banking firm receives a significant number of options as partial compensation for bringing a firm public. The member will profit personally from a portion of these options as well.

Comment:

In any research report on the public firm's securities, the member must disclose the fact that these options exist and include their number and the expiration date(s). Because he will profit personally from these, he must also disclose the extent of his participation in these options.

Example 7:

A member accepts an offer from a stock promoter who will provide additional compensation when the member sells Acme stock to his clients. He does not inform his clients or his employer.

Comment:

The member is in violation of the Standard because he must disclose this additional compensation to those clients to whom he recommends the stock and to his employer. Both have a right to determine for themselves the extent to which this additional compensation might affect the member's objectivity.

Example 8:

A member who is a portfolio manager for a small investment management firm serving individuals accepts a job as a trustee of an endowment fund that has over €1.5 billion in assets and does not disclose this to her employer.

Comment:

This is a significant position that may require a substantial portion of the member's time and may involve decisions on security selection and trading. The member is in violation of the Standard by not disclosing this involvement to her employer and by not discussing it with her employer before accepting the position.

Example 9:

A member replaces his firm's external manager, which has had average results, with a friend's firm.

Comment:

Taking such action without disclosing to his firm that the new manager is a personal friend is a violation of the Standards.

Example 10:

A member who is a portfolio manager participates in her employer's defined contribution pension plan through automatic contributions each pay period. The investment choices in the plan are large, diversified mutual funds, including one fund that is managed by her employer.

Comment:

The Standard does not require the member to disclose her personal investments in diversified funds unless this is her firm's policy, nor does it require preclearence for her automatic payroll deductions. The member should follow her firm's policies with regard to preclearing and disclosing her investments in firm-managed funds.

VI(B) Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

Guidance

Client transactions take priority over personal transactions and over transactions made on behalf of the member's firm. Personal transactions include situations where the member is a "beneficial owner." Personal transactions may be undertaken only after clients and the member's employer have had an adequate opportunity to act on a recommendation. Note that family member accounts that are client accounts should be treated just like any client account; they should not be disadvantaged.

Information about pending trades should not be acted on for personal gain. The overriding considerations with respect to personal trades are that they do not disadvantage any clients.

Recommended Procedures for Compliance

All firms should have in place basic procedures that address conflicts created by personal investing. The following areas should be included:

- Limited participation in equity IPOs. Members can avoid these conflicts by not participating in IPOs.
- Restrictions on private placements. Strict limits should be placed on employee acquisition of these securities and proper supervisory procedures should be in place. Participation in these investments raises conflict of interest issues, similar to IPOs.
- Establish blackout/restricted periods. Employees involved in investment decision-making should have blackout periods prior to trading for clients—no "front running" (i.e., purchase or sale of securities in advance of anticipated client or employer purchases and sales). The size of the firm and the type of security should help dictate how severe the blackout requirement should be.
- Reporting requirements. Supervisors should establish reporting procedures, including duplicate trade confirmations, disclosure of personal holdings/beneficial ownership positions, and preclearance procedures.
- Disclosure of policies. When requested, members must fully disclose to investors their firm's personal trading policies.

Members should encourage their firms to adopt such procedures if they have not.

Application of Standard VI(B) Priority of Transactions

Example 1:

Erin Toffler, a portfolio manager at Esposito Investments, manages the retirement account established with the firm by her parents. Whenever IPOs become available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place any remaining portion in her parents' account, if the issue is appropriate for them. She has adopted this procedure so that no one can accuse her of favoring her parents.

Comment:

Toffler has breached her duty to her parents by treating them differently from her other accounts simply because of the family relationship. As fee-paying clients of Esposito Investments, Toffler's parents are entitled to the same treatment as any other client of the firm. If Toffler has beneficial ownership in the account, however, and Esposito Investments has preclearance and reporting requirements for personal transactions, she may have to preclear the trades and report the transactions to Esposito.

Example 2:

A brokerage's insurance analyst, Denise Wilson, makes a closed-circuit report to her firm's branches around the country. During the broadcast, she includes negative comments about a major company within the industry. The following day, Wilson's report is printed and distributed to the sales force and public customers. The report recommends that both short-term traders and intermediate investors take profits by selling that company's stocks. Several minutes after the broadcast, Ellen Riley, head of the firm's trading department, closes out a long call position in the stock. Shortly thereafter, Riley establishes a sizable "put" position in the stock. Riley claims she took this action to facilitate anticipated sales by institutional clients.

Comment:

Riley expected that both the stock and option markets would respond to the "sell" recommendation, but she did not give customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Riley's firm could have depressed the price of the "calls" and increased the price of the "puts." The firm could have avoided a conflict of interest if it had waited to trade for its own account until its clients had an opportunity to receive and assimilate Wilson's recommendations. As it is, Riley's actions violated Standard VI(B).

Example 3:

A member who is a research analyst does not recommend a stock to his employer because he wants to purchase it quickly for his personal account.

Comment:

He has violated the priority of transactions by withholding this information from his employer and seeking to profit personally at his employer's expense. The member has likely violated his duty to his employer under Standard IV(A) Loyalty as well.

Example 4:

A member who manages a fund gets hot IPO shares for her husband's account from syndicate firms, even when the fund is unable to get shares.

Comment:

The member has violated the Standard by this action. She must act in the interest of the shareholders of the fund and place allocated shares there first. She must also inform her employer of her participation in these offerings through her beneficial interest in her husband's account(s).

Example 5:

A member allows an employee to continue his duties without having signed a required report of his personal trading activity over the last three months. The employee, a CFA candidate, has been purchasing securities for his own account just before firm buy recommendations have been released.

Comment:

The employee has violated the Standard. The member has also violated Standard IV(C) Responsibilities of Supervisors by allowing the employee to continue in his regular duties.

Example 6:

A member reveals a sell rating on some securities in a broadcast to all of her firm's brokers. The changed rating is sent to clients the next day. Shortly after revealing the change to her firm's brokers and prior to dissemination to clients, she buys puts on the stock for her firm's account.

Comment:

The member did not give clients adequate opportunity to act on the change in recommendation before buying the puts for her firm's account.

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

Guidance

Members must inform employers, clients, and prospects of any benefit received for referrals of customers and clients, allowing them to evaluate the full cost of the service as well as any potential partiality. All types of consideration must be disclosed.

Recommended Procedures for Compliance

Members should encourage their firms to adopt clear procedures regarding compensation for referrals. Firms that do not prohibit such fees should have clear procedures for approval, and members should provide their employers with updates at least quarterly regarding the nature and value of referral compensation received.

Application of Standard VI(C) Referral Fees

Example 1:

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment counseling firm. In this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral accounts to Brady Securities.

Willard White, a partner in Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities are US$20,000 annually.

Referrals from Brady Securities last year resulted in fee income of US$200,000 for Lewis Brothers, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of US$10,000.

Diane Branch, the chief financial officer of Maxwell Inc., contacts White and says that she is seeking an investment manager for Maxwell's profit-sharing plan. She adds, "My friend Harold Hill at Brady Securities recommended your firm without qualification, and that's good enough for me. Do we have a deal?" White accepts the new account but does not disclose his firm's referral arrangement with Brady Securities.

Comment:

White has violated Standard VI(C) by failing to inform the prospective customer of the referral fee payable in services and commissions for an indefinite period to Brady

Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

Example 2:

James Handley works for the Trust Department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement within Central trust to his clients.

Comment:

Handley has violated Standard VI(C) by not disclosing the referral arrangement at Central Trust Bank to his clients. The Standard does not distinguish between referral fees paid by a third party for referring clients to the third party and internal compensation arrangements paid within the firm to attract new business to a subsidiary. Members and candidates must disclose all such referral fees. Therefore, Handley would be required to disclose, at the time of referral, any referral fee agreement in place between Central Trust Bank's departments. The disclosure should include the nature and the value of the benefit and should be made in writing.

Example 3:

An investment consultant conducts an independent and objective analysis of investment managers for a pension fund and selects the best one. Subsequently, the selected advisor makes a payment to the consultant.

Comment:

This is a violation of the Standard. The potential for a payment should have been disclosed to the pension fund. There are very likely regulatory or legal considerations with regard to such payment as well.

VII Responsibilities as a CFA Institute Member or CFA Candidate

VII(A) Conduct as Participants in CFA Institute Programs. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

Professor's Note: The Standard is intended to cover conduct such as cheating on the CFA exam or otherwise violating rules of CFA Institute or the CFA program. It is not intended to prevent anyone from expressing any opinions or beliefs concerning CFA Institute or the CFA program.

Members must not engage in any activity that undermines the integrity of the CFA charter. This Standard applies to conduct which includes:

- Cheating on the CFA exam or any exam.
- Revealing anything about either broad or specific topics tested, content of exam questions, or formulas required or not required on the exam.

- Not following rules and policies of the CFA program.
- Giving confidential information on the CFA program to candidates or the public.
- Improperly using the designation to further personal and professional goals.
- Misrepresenting information on the Professional Conduct Statement (PCS) or the CFA Institute Professional Development Program.

Members and candidates are not precluded from expressing their opinions regarding the exam program or CFA Institute but must not reveal confidential information about the CFA program.

Candidates who violate any of the CFA exam policies (calculator, personal belongings, Candidate Pledge) have violated Standard VII(A).

Members who volunteer in the CFA program may not solicit or reveal information about questions considered for or included on a CFA exam, about the grading process, or about scoring of questions.

Application of Standard VII(A) Conduct as Participants in CFA Institute Programs

Example 1:

Jose Ramirez is an investment-relations consultant for several small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute society in the city where he works. To the exclusion of other companies, Ramirez only schedules companies that are his clients to make presentations to the society.

Comment:

Ramirez, by using his volunteer position at CFA Institute to benefit himself and his clients, compromises the reputation and integrity of CFA Institute and, thus, violates Standard VII(A).

Example 2:

A member who is an exam grader discusses with friends the guideline answer for and relative candidate performance on a specific question he graded on the CFA exam.

Comment:

He has violated his Grader's Agreement and also the Standard by compromising the integrity of the CFA exam.

Example 3:

A candidate does not stop writing when asked to by the proctor at the CFA exam.

Comment:

By taking additional time compared to other candidates, this candidate has violated the Standard, compromising the integrity of the exam process.

Example 4:

A member who is a volunteer on a CFA Institute committee tells her clients that what she learns through her committee work will allow her to better serve their interests.

Comment:

She has violated the Standard by using her CFA committee position to benefit herself personally and to any extent her 'inside' knowledge has benefited her clients.

Example 5:

A candidate tells another candidate, "I'm sure glad that Bayes' formula was not on the Level I test this year."

Comment:

This is a violation of Standard VII(A). Candidates are not permitted to reveal any formulas required or not required on a CFA exam.

Example 6:

A candidate tells his beloved CFA instructor, "I really appreciate the emphasis that you put on Financial Reporting and Analysis because that was a huge part of the test this year."

Comment:

This is a violation of Standard VII(A). Candidates are not permitted to disclose the relative weighting of topics on the exam.

Example 7:

A candidate tells his mother, "There was an item set on the CFA exam on the Residual Income Model that just kicked my butt."

Comment:

This is a violation of Standard VII(A). Candidates are not permitted to disclose specific topics tested on the exam.

VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program.

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

Guidance

Members must not make promotional promises or guarantees tied to the CFA designation. Do not:

- Over-promise individual competence.
- Over-promise investment results in the future (i.e., higher performance, less risk, etc.).

Guidance—CFA Institute Membership

Members must satisfy these requirements to maintain membership:

- Sign PCS annually.
- Pay CFA Institute membership dues annually.

If they fail to do this, they are no longer active members.

Guidance—Using the CFA Designation

Do not misrepresent or exaggerate the meaning of the designation.

Guidance—Referencing Candidacy in the CFA Program

There is no partial designation. It is acceptable to state that a candidate successfully completed the program in three years, if in fact he did, but claiming superior ability because of this is not permitted.

Guidance—Proper Usage of the CFA Marks

The Chartered Financial Analyst and CFA marks must always be used either after a charterholder's name or as adjectives, but not as nouns, in written and oral communications. The CFA designation should not be used in pseudonyms, such as online profile names, because CFA Institute must be able to verify that an individual has earned the right to use the CFA designation.

Recommended Procedures for Compliance

Make sure that members' and candidates' firms are aware of the proper references to a member's CFA designation or candidacy, as this is a common error.

Application of Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

Example 1:

An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.

Comment:

AZ may state that all principals passed the three examinations on the first try as long as this statement is true and is not linked to performance or does not imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try may be more successful than those who do not violates Standard VII(B).

Example 2:

Five years after receiving his CFA charter, Louis Vasseur resigns his position as an investment analyst and spends the next two years traveling abroad. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. At the conclusion of his travels, Vasseur becomes a self-employed analyst, accepting assignments as an independent contractor. Without reinstating his CFA Institute membership by filing his Professional Conduct Statement and paying his dues, he prints business cards that display "CFA" after his name.

Comment:

Vasseur has violated Standard VII(B) because Vasseur's right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues. Therefore, he no longer is able to state or imply that he is an active CFA charterholder. When Vasseur files his Professional Conduct Statement and resumes paying CFA Institute dues to activate his membership, he will be eligible to use the CFA designation upon satisfactory completion of CFA Institute reinstatement procedures.

Example 3:

A member still uses the initials CFA after his name even though his membership has been suspended for not paying dues and for not submitting a personal conduct statement as required.

Comment:

This is a violation of the Standard.

Example 4:

A member puts the CFA logo on his letterhead, his business cards, and the company letterhead.

Comment:

By putting the logo on the company letterhead (rather than the letterhead or business card of an individual who is a CFA charterholder), the member has violated the Standard.

Example 5:

A member maintains an online account on a popular internet forum using the name "Old_CFA_Charterholder." The member is not otherwise identified in the forum.

Comment:

This use of the designation violates the Standard because the name hides the member's identity.

CONCEPT CHECKERS

1. In situations where the laws of a member or candidate's country of residence, the local laws of regions where the member or candidate does business, and the Code and Standards specify different requirements, the member or candidate must abide by:
   A. local law or the Code and Standards, whichever is stricter.
   B. the Code and Standards or his country's laws, whichever are stricter.
   C. the strictest of local law, his country's laws, or the Code and Standards.

2. According to the Standard on independence and objectivity, members and candidates:
   A. may accept gifts or bonuses from clients.
   B. may not accept compensation from an issuer of securities in return for producing research on those securities.
   C. should consider credit ratings issued by recognized agencies to be objective measures of credit quality.

3. Bill Cooper finds a table of historical bond yields on the website of the U.S. Treasury that supports the work he has done in his analysis and includes the table as part of his report without citing the source. Has Cooper violated the Code and Standards?
   A. Yes, because he did not cite the source of the table.
   B. Yes, because he did not verify the accuracy of the information.
   C. No, because the table is from a recognized source of financial or statistical data.

4. Which of the following statements about the Standard on misconduct is *most accurate*?
   A. Misconduct applies only to a member or candidate's professional activities.
   B. Neglecting to perform due diligence when required is an example of misconduct.
   C. A member or candidate commits misconduct by engaging in any illegal activity.

5. Ed Ingus, CFA, visits the headquarters and main plant of Bullitt Company and observes that inventories of unsold goods appear unusually large. From the CFO, he learns that a recent increase in returned items may result in earnings for the current quarter that are below analysts' estimates. Based on his visit, Ingus changes his recommendation on Bullitt to "Sell." Has Ingus violated the Standard concerning material nonpublic information?
   A. Yes.
   B. No, because the information he used is not material.
   C. No, because his actions are consistent with the mosaic theory.

6. Green Brothers, an emerging market fund manager, has two of its subsidiaries simultaneously buy and sell emerging market stocks. In its marketing literature, Green Brothers cites the overall emerging market volume as evidence of the market's liquidity. As a result of its actions, more investors participate in the emerging markets fund. Green Brothers *most likely*:
   A. did not violate the Code and Standards.
   B. violated the Standard regarding market manipulation.
   C. violated the Standard regarding performance presentation.

7. Cobb, Inc., has hired Jude Kasten, CFA, to manage its pension fund. The client(s) to whom Kasten owes a duty of loyalty are:
   A. Cobb's management.
   B. the shareholders of Cobb, Inc.
   C. the beneficiaries of the pension fund.

8. Which of the following actions is *most likely* a violation of the Standard on fair dealing?
   A. A portfolio manager allocates IPO shares to all client accounts, including her brother's fee-based retirement account.
   B. An investment firm routinely begins trading for its own account immediately after announcing recommendation changes to clients.
   C. After releasing a general recommendation to all clients, an analyst calls the firm's largest institutional clients to discuss the recommendation in more detail.

9. The Standard regarding suitability *most likely* requires that:
   A. an advisor must analyze an investment's suitability for the client prior to recommending or acting on the investment.
   B. a member or candidate must decline to carry out an unsolicited transaction that she believes is unsuitable for the client.
   C. when managing a fund to an index, a manager who is evaluating potential investments must consider their suitability for the fund's shareholders.

10. Which of the following is *most likely* a recommended procedure for complying with the Standard on performance presentation?
   A. Exclude terminated accounts from past performance history.
   B. Present the performance of a representative account to show how a composite has performed.
   C. Consider the level of financial knowledge of the audience to whom the performance is presented.

11. The CFA Institute Professional Conduct Program (PCP) has begun an investigation into Chris Jones, a Level II CFA candidate, and a number of his CFA Charterholder colleagues. Jones has access to confidential client records that could be useful in clearing his name and wishes to share this information with the PCP. Which of the following *most accurately* describes Jones's duties with regard to preservation of confidentiality?
    A. Sharing the confidential information with the PCP would violate the Standards.
    B. The Standards encourage, but do not require, that Jones support the PCP investigation into his colleagues.
    C. Jones may share confidential information about former clients with the PCP but may not share confidential information about current clients.

12. Connie Fletcher, CFA, works for a small money management firm that specializes in pension accounts. Recently, a friend asked her to act as an unpaid volunteer manager for the city's street sweep pension fund. As part of the position, the city would grant Fletcher a free parking space in front of her downtown office. Before Fletcher accepts, she should *most appropriately*:
    A. do nothing because this is a volunteer position.
    B. inform her current clients in writing and discuss the offer with her employer.
    C. disclose the details of the volunteer position to her employer and obtain written permission from her employer.

13. Sarah Johnson, a portfolio manager, is offered a bonus directly by a client if Johnson meets certain performance goals. To comply with the Standard that governs additional compensation arrangements, Johnson should:
    A. decline to accept a bonus outside of her compensation from her employer.
    B. disclose this arrangement to her employer in writing and obtain her employer's permission.
    C. disclose this arrangement to her employer only if she actually meets the performance goals and receives the bonus.

14. A member or candidate who has supervisory responsibility:
    A. should place particular emphasis on enforcing investment-related compliance policies.
    B. is responsible for instructing those to whom he has delegated authority about methods to detect and prevent violations of the law and the Code and Standards.
    C. has complied with the Standards if she reports employee violations to upper management and provides a written warning to the employee to cease such activities.

15. Which of the following actions is a *required*, rather than *recommended*, action under the Standard regarding diligence and a reasonable basis for a firm's research recommendations?
    A. Compensate analysts based on a measure of the quality of their research.
    B. Review the assumptions used and evaluate the objectivity of third-party research reports.
    C. Have a policy requiring that research reports and recommendations have a basis that can be substantiated as reasonable and adequate.

16. Claire Marlin, CFA, manages an investment fund specializing in foreign currency trading. Marlin writes a report to investors that describes the basic characteristics of her strategy, which is based on an expected appreciation of the euro relative to other major currencies. Marlin shows the projected returns from the strategy if the euro appreciates less than 5%, between 5% and 10%, or more than 10%, while clearly stating that these forecasts are her opinion. Has Marlin violated the Standard related to communication with clients?
    A. Yes.
    B. No, because she disclosed the basic characteristics of the investment.
    C. No, because she distinguished fact from opinion and discussed how the strategy may perform under a range of scenarios.

17. If regulations do not specify how long to retain the documents that support an analyst's conclusions, the Code and Standards recommend a period of at least:
    A. five years.
    B. seven years.
    C. ten years.

18. Daniel Lyons, CFA, is an analyst who covers several stocks including Horizon Company. Lyons's aunt owns 30,000 shares of Horizon. She informs Lyons that she has created a trust in his name into which she has placed 2,000 shares of Horizon. The trust is structured so that Lyons will not be able to sell the shares until his aunt dies, but may vote the shares. Lyons is due to update his research coverage of Horizon next week. Lyons should *most appropriately*:
    A. update the report as usual because he is not a beneficial owner of the stock.
    B. advise his superiors that he is no longer able to issue research recommendations on Horizon.
    C. disclose the situation to his employer and, if then asked to prepare a report, also disclose his beneficial ownership of the shares in his report.

19. Kate Wilson, CFA, is an equity analyst. Wilson enters two transactions for her personal account. Wilson sells 500 shares of Tibon, Inc., a stock on which her firm currently has a "Buy" recommendation. Wilson buys 200 shares of Hayfield Co. and the following day issues a research report on Hayfield with a "Buy" recommendation. Has Wilson violated the Code and Standards?
    A. No.
    B. Yes, both of her actions violate the Code and Standards.
    C. Yes, but only one of her actions violates the Code and Standards.

20. Hern Investments provides monthly emerging market research to Baker Brokerage in exchange for prospective client referrals and European equity research from Baker. Clients and prospects of Hern are not made aware of the agreement, but clients unanimously rave about the high quality of the research provided by Baker. As a result of the research, many clients with non-discretionary accounts have earned substantial returns on their portfolios. Managers at Hern have also used the research to earn outstanding returns for the firm's discretionary accounts. Hern has *most likely*:
    A. not violated the Code and Standards.
    B. violated the Code and Standards by using third-party research in discretionary accounts.
    C. violated the Code and Standards by failing to disclose the referral agreement with Baker.

21. After writing the CFA Level I exam, Cynthia White goes to internet discussion site *CFA Haven* to express her frustration. White writes, "CFA Institute is not doing a competent job of evaluating candidates because none of the questions in the June exam touched on Alternative Investments." White *most likely* violated the Standard related to conduct as a candidate in the CFA program by:
    A. publicly disputing CFA Institute policies and procedures.
    B. disclosing subject matter covered or not covered on a CFA exam.
    C. participating in an internet forum that is directed toward CFA Program participants.

22. After passing all three levels of the CFA exams on her first attempts and being awarded her CFA Charter, Paula Osgood is promoting her new money management firm by issuing an advertisement. Which of these statements would *most likely* violate the Standard related to use of the CFA designation?
    A. "To earn the right to use the CFA designation, Paula passed three exams covering ethics, financial statement analysis, asset valuation, and portfolio management."
    B. "Paula passed three 6-hour exams on her first attempts and is a member of her local investment analyst society."
    C. "Because of her extensive training, Paula will be able to achieve better investment results than managers who have not been awarded the CFA designation."

Answers – Concept Checkers

1. **C** To comply with Standard I(A) Knowledge of the Law, a member must always abide by the strictest applicable law, regulation, or standard.

2. **A** Gifts from clients are acceptable under Standard I(B) Independence and Objectivity, but the Standard requires members and candidates to disclose such gifts to their employers. Standard I(B) allows issuer-paid research as long as the analysis is thorough, independent, unbiased, and has a reasonable and adequate basis for its conclusions, and the compensation from the issuer is disclosed. Members and candidates should consider the potential for conflicts of interest inherent in credit ratings and may need to do independent research to evaluate the soundness of these ratings.

3. **C** According to Standard I(C) Misrepresentation, members and candidates must cite the sources of the information they use in their analysis, unless the information is factual data (as opposed to analysis or opinion) from a recognized financial or statistical reporting service. The U.S. Treasury is one example of a recognized source of factual data.

4. **B** Failing to act when required by one's professional obligations, such as neglecting to perform due diligence related to an investment recommendation, violates Standard I(D) Misconduct. Acts a member commits outside his professional capacity are misconduct if they reflect poorly on the member or candidate's honesty, integrity, or competence (e.g., theft or fraud).Violations of the law that do not reflect on the member or candidate's honesty, integrity, or competence (e.g., an act related to civil disobedience) are not necessarily regarded as misconduct.

5. **A** The statement from the CFO about the current quarter's earnings is material nonpublic information. Ingus violated Standard II(A) Material Nonpublic Information by acting or causing others to act on it.

6. **B** The intent of Green Brothers' actions is to manipulate the appearance of market liquidity in order to attract investment to its own funds. The increased trading activity was not based on market fundamentals or an actual trading strategy to benefit investors. It was merely an attempt to mislead market participants in order to increase assets under Green Brothers' management. The action violates Standard II(B) Market Manipulation.

7. **C** Standard III(A) Loyalty, Prudence, and Care specifies that for the manager of a pension or trust, the duty of loyalty is owed to the beneficiaries, not to the individuals who hired the manager.

8. **B** The firm must give its clients an opportunity to act on recommendation changes. Firms can offer different levels of service to clients as long as this is disclosed to all clients. The largest institutional clients would likely be paying higher fees for a greater level of service. The portfolio manager's brother's account should be treated the same as any other client account.

9. **A** According to Standard III(C) Suitability, a member or candidate who is in an advisory relationship with a client is responsible for analyzing the suitability of an investment for the client before taking investment action or making a recommendation. If a member or candidate believes an unsolicited trade is unsuitable for a client, the appropriate action is to discuss the trade with the client. The advisor may follow her firm's policies for obtaining client approval if the requested trade would not affect the risk and return of the client's portfolio materially. If the trade would have a material effect, the advisor should discuss with the client whether the IPS needs to be updated. When managing a fund to an index or stated mandate, the manager is responsible for ensuring that potential investments are consistent with the fund's mandate. Suitability for individuals would be a concern for an advisor who recommends the fund to clients, but not for the manager of the fund.

10. **C** Recommendations stated in Standard III(D) Performance Presentation include considering the sophistication and knowledge of the audience when presenting performance data. Other recommendations are to include terminated accounts in past performance history; to present the performance of a composite as a weighted average of the performance of similar portfolios, rather than using a single representative account; and to maintain the records and data that were used to calculate performance.

11. **B** Members and candidates are required to cooperate with PCP investigations into their own conduct and encouraged to cooperate with PCP investigations into the conduct of others. Sharing confidential information with the PCP is not a violation of Standard III(E) Preservation of Confidentiality. Any client information shared with the PCP will be kept in strict confidence. Standard III(E) states that members and candidates are required to maintain confidentiality of client records even after the end of the client relationship.

12. **C** According to Standard IV(A) Loyalty, members and candidates are expected to act for the benefit of their employer and not deprive the employer of their skills. Fletcher is performing work similar to the services that her employer provides. Although the position is a volunteer position, Fletcher will receive compensation in the form of a free parking space. In light of the circumstances, Fletcher must disclose the details of the position to her employer and get written permission before accepting the volunteer position.

13. **B** Johnson should disclose her additional compensation arrangement in writing to her employer and obtain her employer's written consent before accepting this offer, in accordance with Standard IV(B) Additional Compensation Arrangements.

14. **B** Members or candidates may delegate supervisory duties to subordinates but remain responsible for instructing them about how to detect and prevent violations. Reporting the violation and warning the employee are not sufficient to comply with Standard IV(C) Responsibilities of Supervisors. The supervisor must also take steps to prevent further violations while she conducts an investigation, such as limiting the employee's activity or increasing her monitoring of the employee. Supervisors should enforce investment-related and non-investment related policies equally.

15. **B** Standard V(A) Diligence and Reasonable Basis requires analysts who use third-party research to review its assumptions and evaluate the independence and objectivity of the research. The other choices are recommended procedures for compliance with the Standard.

16. **A** Standard V(B) Communication with Clients and Prospective Clients requires that members and candidates communicate the risk associated with the investment strategy used and how the strategy is expected to perform in a range of scenarios. These scenarios should include those different from the current trend. Marlin should have discussed how her strategy would perform if the euro depreciates instead of appreciating as she expects.

17. **B** When no other regulatory guidance applies, Standard V(C) Record Retention recommends that records be maintained for a minimum of seven years.

18. **C** Even though the shares are held in trust, Lyons is considered a beneficial owner under Standard VI(A) Disclosure of Conflicts because he has a pecuniary interest in the shares and because has the power to vote the shares. Lyons is obligated to inform his employer of the potential conflict. If Lyons's employer permits him to continue issuing investment recommendations on the company, Lyons must disclose the existence of a potential conflict in his reports.

19. **C** Only one of these transactions is a violation. Standard VI(B) Priority of Transactions requires members and candidates to give clients an adequate opportunity to act on a recommendation before trading for accounts in which the member or candidate has a beneficial ownership interest. Members and candidates may trade for their own accounts as long as they do not disadvantage clients, benefit personally from client trades, or violate any regulations that apply. The Standard does not prohibit members and candidates from entering personal transactions that are contrary to what their firms are recommending for clients, as long as the transaction does not violate any of these criteria.

20. **C** According to Standard VI(C) Referral Fees, Hern must disclose the referral arrangement between itself and Baker so that potential clients can judge the true cost of Hern's services and assess whether there is any partiality inherent in the recommendation of services.

21. **B** Standard VII(A) Conduct as Participants in CFA Institute Programs prohibits candidates from revealing which portions of the Candidate Body of Knowledge were or were not covered on an exam. Members and candidates are free to disagree with the policies, procedures, or positions taken by the CFA Institute. The Standard does not prohibit participating in CFA Program-related internet blogs, forums, or social networks.

22. **C** Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program prohibits members and candidates from implying superior performance as a result of being a CFA charterholder. Concise factual descriptions of the requirements to obtain the CFA Charter are acceptable. Osgood's statement that she passed the exams on her first attempts is acceptable because it states a fact.

The following is a review of the Ethical and Professional Standards principles designed to address the learning outcome statements set forth by CFA Institute. This topic is also covered in:

Introduction to the Global Investment Performance Standards (GIPS®)

Study Session 1

Exam Focus

The following two topic reviews cover the key features of the Global Investment Performance Standards (GIPS®) as adopted by CFA Institute in 1999 and subsequently updated. Compliance with GIPS is voluntary. For the Level I exam, you are responsible for only the "Introduction to the Global Investment Performance Standards (GIPS®)" and the Preface, Section I, and Section II (through II.0: Fundamentals of Compliance) of the GIPS document. The GIPS document is included in the book of candidate readings for Level I and is also available on the CFA Institute Web site. A helpful glossary of terms is included in the document. Candidates should not underestimate the importance of this material for the exam.

LOS 3.a: Explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is served by the standards.

CFA® Program Curriculum, Volume 1, page 195

In the past, a variety of reporting procedures were misleading at best. Some of these misleading practices included:

- *Representative accounts*—showing a top-performing portfolio as representative of a firm's results.
- *Survivorship bias*—excluding "weak performance" accounts that have been terminated.
- *Varying time periods*—showing performance for selected time periods with outstanding returns.

GIPS are a set of ethical principles based on a standardized, industry-wide approach. Investment firms can *voluntarily* follow GIPS in their presentation of historical investment results to prospective clients. These standards seek to avoid misrepresentations of performance.

GIPS apply to investment management firms and are intended to serve prospective and existing clients of investment firms. GIPS allow clients to more easily compare investment performance among investment firms and have more confidence in reported performance.

LOS 3.b: Explain the construction and purpose of composites in performance reporting.

CFA® Program Curriculum, Volume 1, page 197

A composite is a grouping of individual discretionary portfolios representing a similar investment strategy, objective, or mandate. Examples of possible composites are "Large Capitalization Growth Stocks" and "Investment Grade Domestic Bonds." Reporting on the performance of composites gives clients and prospects information about the firm's success in managing various types of securities or results for various investment styles.

A composite, such as International Equities, must include all fee-paying, discretionary portfolios (current and past) that the firm has managed in accordance with this particular strategy. The firm should identify which composite each managed portfolio is to be included in before the portfolio's performance is known. This prevents firms from choosing portfolios to include in a composite in order to create composites with superior returns.

LOS 3.c: Explain the requirements for verification.

CFA® Program Curriculum, Volume 1, page 197

Verification—requirements:

Verification is performed by a third party, not by the firm itself, on a firm-wide basis. This third party verifier must attest that (1) the firm has complied with all GIPS requirements for composite construction on a firm-wide basis and (2) the firm's processes and procedures are established to present performance in accordance with the calculation methodology required by GIPS, the data requirements of GIPS, and in the format required by GIPS.

Verification—recommendations:

- Firms are encouraged to pursue independent verification. Verification applies to the entire firm's performance measurement practices and methods, not a selected composite.
- Verified firms should include the following disclosure language:

  "[Insert name of firm] has been verified for the periods [insert dates] by [name of verifier]. A copy of the verification report is available upon request."

The following is a review of the Ethical and Professional Standards principles designed to address the learning outcome statements set forth by CFA Institute. This topic is also covered in:

The GIPS Standards

Study Session 1

LOS 4.a: Describe the key features of the GIPS standards and the fundamentals of compliance.

CFA® Program Curriculum, Volume 1, page 202

GIPS Objectives

- To obtain global acceptance of calculation and presentation standards in a fair, comparable format with full disclosure.
- To ensure consistent, accurate investment performance data in areas of reporting, records, marketing, and presentations.
- To promote fair competition among investment management firms in all markets without unnecessary entry barriers for new firms.
- To promote global "self regulation."

Key Characteristics of GIPS

- To claim compliance, an investment management firm must define its "firm." This definition should reflect the "distinct business entity" that is held out to clients and prospects as the investment firm.
- GIPS are ethical standards for performance presentation which ensure fair representation of results and full disclosure.
- Include all actual fee-paying, discretionary portfolios in composites for a minimum of five years or since firm or composite inception. After presenting five years of compliant data, the firm must add annual performance each year going forward up to a minimum of ten years.
- Firms are required to use certain calculation and presentation standards and make specific disclosures.
- Input data must be accurate.
- GIPS contain both *required* and *recommended* provisions—firms are *encouraged* to adopt the *recommended* provisions.
- Firms are encouraged to present all pertinent additional and supplemental information.
- There will be no partial compliance and only full compliance can be claimed.
- Follow the local laws for cases in which a local or country-specific law or regulation conflicts with GIPS, but disclose the conflict.
- Certain recommendations may become requirements in the future.
- Supplemental private equity and real estate provisions contained in GIPS are to be applied to those asset classes.

Fundamentals of compliance contain both requirements and recommendations:

Definition of the firm—requirements:

- Apply GIPS on a firm-wide basis.
- Firm must be defined as a distinct business unit.
- Total firm assets include total market value of discretionary and non-discretionary assets, including fee-paying and non-fee-paying accounts.
- Include asset performance of sub-advisors, as long as the firm has discretion over sub-advisor selection.
- If a firm changes its organization, historical composite results cannot be changed.

Definition of the firm—recommendations:

- Include the broadest definition of the firm, including all geographical offices marketed under the same brand name.

Document policies and procedures—requirements:

- Document, in writing, policies and procedures the firm uses to comply with GIPS.

Claim of compliance—requirements:

- Once GIPS requirements have been met, the following compliance statement must be used:

  "[Insert name of firm] has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®)."

- There is no such thing as partial compliance.
- There are to be no statements referring to calculation methodologies used in a composite presentation as being "in accordance with GIPS" or the like.
- Similarly, there should be no such statements referring to the performance of an individual, existing client as being "calculated in accordance with GIPS" or the like, unless a compliant firm is reporting results directly to the client.

Firm fundamental responsibilities—requirements:

- Firms must provide a compliant presentation to *all* prospects (prospect must have received a presentation within the previous 12 months).
- Provide a composite list and composite description to all prospects that make a request. List discontinued composites for at least five years.
- Provide, to clients requesting it, a compliant presentation and a composite description for any composite included on the firm's list.
- When jointly marketing with other firms, if one of the firms claims GIPS compliance, be sure it is clearly defined as separate from noncompliant firms.
- Firms are encouraged to comply with recommendations and must comply with all requirements. Be aware of updates, guidance statements, and the like.

LOS 4.b: Describe the scope of the GIPS standards with respect to an investment firm's definition and historical performance record.

CFA® Program Curriculum, Volume 1, page 202

The definition of the firm, for purposes of GIPS compliance, must be the corporation, subsidiary, or division that is held out to clients as a business entity. If a firm has different geographic locations (e.g., all doing business under the name of Bluestone Advisers), then the definition of the firm should include all the various geographic locations and their clients. Firms based in any country may present GIPS compliant performance histories.

A firm must initially present a minimum of five years of compliant performance presentation for the firm and each composite unless the firm or composite has been in existence less than five years. For firms or composites in existence less than five years, compliant performance since inception must be presented in order to claim compliance. After the initial compliant performance presentation, one year of compliant performance must be added each year to a required (minimum) performance history of ten years.

Firms may present periods of noncompliant performance immediately prior to the compliant performance history as long as no noncompliant performance is presented for any periods after January 1, 2000. Firms must specify which performance results are noncompliant and the ways in which such (noncompliant) performance does not comply with GIPS.

LOS 4.c: Explain how the GIPS standards are implemented in countries with existing standards for performance reporting and describe the appropriate response when the GIPS standards and local regulations conflict.

CFA® Program Curriculum, Volume 1, page 203

Firms that previously presented performance in compliance with a particular Country Version of GIPS (CVG) may claim GIPS compliance for any CVG-compliant results prior to January 1, 2006. Firms that report such CVG-compliant performance data must continue to include that performance data in subsequent GIPS-compliant presentations until a minimum of ten years of compliant performance is presented.

In any cases where country-specific regulations conflict with GIPS, firms must follow the applicable country-specific regulations but must also disclose the nature of the conflict with GIPS.

LOS 4.d: Describe the nine major sections of the GIPS standards.

CFA® Program Curriculum, Volume 1, page 205

0. *Fundamentals of compliance*. The fundamental issues involved in complying with GIPS are (a) definition of the firm, (b) documentation of firm policies and procedures with respect to GIPS compliance, (c) complying with GIPS updates, (d) claiming compliance

in the appropriate manner, and (e) appropriate verification statement when a third-party verifier is employed.

To claim GIPS compliance, a firm *must*:

- Comply with all GIPS requirements, guidance, and updates.
- Comply with all applicable laws and regulations concerning performance presentation.
- Apply GIPS on a firmwide basis.
- Document their policies for maintaining GIPS compliance.
- Make reasonable efforts to provide all prospective clients a GIPS-compliant presentation.
- Provide a complete list of composites and their descriptions to any prospective client who requests one. The list must include all current composites and any that were terminated within the last five years.
- Provide a GIPS-compliant performance presentation for any composite to any prospective client who requests one.
- Define the firm as the distinct business entity that is held out to clients or prospective clients.
- Calculate total firm assets as the fair value of all assets managed by the firm, including discretionary, nondiscretionary, fee-paying, and non-fee-paying accounts.
- Clearly define the firm that is claiming GIPS compliance, when marketing jointly with other firms.

In addition, a GIPS-compliant firm *must not*:

- Present false or misleading performance information.
- Claim any kind of partial GIPS compliance.
- State that a specific calculation is in compliance with GIPS.
- State that an individual portfolio's performance has been calculated in compliance with GIPS, except when reporting a single client's portfolio performance to that client.
- Choose which prospective clients will receive a GIPS-compliant presentation.
- Alter historical performance of composites based on a change in the firm's organization.

1. *Input data*. Input data should be consistent in order to establish full, fair, and comparable investment performance presentations.

2. *Calculation methodology.* Certain methodologies are required for portfolio return calculations and certain other methodologies are required for composite return calculations. Uniformity in methods across firms is required so that their results are comparable.

3. *Composite construction*. Creation of meaningful, asset-weighted composites is important to achieve a fair presentation. Composite performance is based on the performance of one or more portfolios that have the same investment strategy or investment objective. Composite returns are the asset-weighted average (not a simple average) of the returns on the portfolios that are included in each composite.

4. *Disclosures*. The firm must disclose information about the presentation and the policies adopted by the firm so that the raw numbers presented in the report are

understandable to the user. There are some disclosures that all firms must make, but some disclosures may not apply to all firms. If a disclosure is not applicable to a specific firm, the firm is not required to include any statement regarding it.

5. *Presentation and reporting*. Investment performance must be presented according to GIPS requirements. Other firm-specific information not specifically required by GIPS should be included when appropriate.

6. *Real estate*. Certain provisions apply to all real estate investments (land, buildings, etc.) regardless of the level of control the firm has over management of the investment. These provisions apply regardless of whether the asset is producing revenue or there is leverage involved in the investment.

7. *Private equity*. Private equity investments must be valued according to the GIPS Private Equity Valuation Principles, which are contained in Appendix D, unless the investment is an open-end or evergreen fund (which must follow regular GIPS). Private equity investments include all investment in companies that are not publicly traded, regardless of their stage of business development. This would include venture capital investments, ownership of a previously public company that has been purchased (taken private), and mezzanine financing, as well as limited partnership shares in such investments and fund-of-funds investments.

8. *Wrap fee/Separately Managed Account (SMA) portfolios.* For these portfolios, some of the requirements and recommendations in Sections 0 through 5 are supplemented or replaced by the requirements specified in this section.

Concept Checkers

1. Which of the following statements *most accurately* describes the parties that GIPS are intended to apply to and serve? GIPS apply to:
   A. consultants who serve their existing and prospective clients.
   B. firms that issue securities and serve investment management firms.
   C. investment management firms and serve their existing and prospective clients.

2. For a composite to be constructed in compliance with GIPS, the portfolios included in the composite must:
   A. have been managed by the firm for the full performance reporting period.
   B. be selected immediately after the last business day of the period for which the composite's performance will be presented.
   C. include all fee-paying, discretionary portfolios that are managed according to the same strategy, mandate, or investment objective.

3. Verification of compliance with GIPS:
   A. may be performed on single composites.
   B. is required for a firm to claim GIPS compliance.
   C. requires the verification report to be issued for the entire firm.

4. Firms that claim to present investment performance in compliance with GIPS are required to:
   A. document the procedures and policies they use to ensure GIPS compliance.
   B. clearly disclose any calculations or other aspects of a presentation that are non-compliant with GIPS.
   C. calculate total firm assets as the fair value of all fee-paying discretionary portfolios managed by the firm.

5. Which of the following definitions of a firm would violate GIPS?
   A. Investment firm that has been in existence for less than five years.
   B. Regional branch of an investment management firm marketed under the name of its parent.
   C. Entity registered with the national regulator that oversees its investment management activities.

6. If a country has regulations in place that conflict with GIPS, firms that wish to claim GIPS compliance:
   A. may not do so because GIPS do not permit exceptions or partial compliance.
   B. must establish a subsidiary in a location where local law does not conflict with GIPS.
   C. must comply with local regulations and disclose the nature of the conflict in the presentation.

7. Which of the following includes only sections of the Global Investment Performance Standards?
   A. Disclosure, Public Equity, Presentation and Reporting.
   B. Real Estate, Calculation Methodology, Fundamentals of Compliance.
   C. Input Data, Composite Construction, Wrap Fee/Speculative Margin Account (SMA) Portfolios.

Answers – Concept Checkers

1. **C** GIPS apply to investment management firms. They are intended to serve prospective and existing clients of investment firms and consultants who advise these clients.

2. **C** To comply with GIPS, a composite must include all fee-paying, discretionary portfolios managed according to the same investment objective, strategy, or mandate. The composite or composites in which a portfolio will be included must be determined on an ex-ante basis (i.e., before the period for which the composite's performance will be calculated). A GIPS-compliant composite must include terminated accounts.

3. **C** Verification of GIPS compliance is optional, but if a firm chooses to seek third-party verification, the report must be issued with respect to the whole firm. GIPS verification cannot be carried out for a single composite.

4. **A** GIPS Section 0, "Fundamentals of Compliance," states that firms must document their procedures for remaining in compliance with GIPS. Firms which state that they are in compliance with GIPS must comply fully and may not claim partial compliance. GIPS defines total firm assets as the fair value of all portfolios managed by the firm, including discretionary and non-discretionary, fee-paying and non-fee-paying portfolios.

5. **B** The definition of a firm for GIPS-compliant performance presentation should include all geographical offices marketed under the same name brand.

6. **C** Firms must always comply with the laws and regulations of the country in which they reside. In cases where local regulations conflict with GIPS, a firm can still claim GIPS compliance if they disclose the conflict fully in an otherwise compliant presentation.

7. **B** The nine major sections of GIPS are (0) Fundamentals of Compliance; (1) Input Data; (2) Calculation Methodology; (3) Composite Construction; (4) Disclosure; (5) Presentation and Reporting; (6) Real Estate; (7) Private Equity; and (8) Wrap Fee/Separately Managed Account (SMA) Portfolios.

   The incorrect choices misstate at least one of these sections. Neither "Public Equity" nor "Speculative Margin Account" is a section of GIPS.

SELF-TEST: ETHICS AND PROFESSIONAL STANDARDS

18 questions: 27 minutes

1. Karen Jones, CFA, is an outside director for Valley Manufacturing. At a director's meeting, Jones finds out that Valley Corp. has made several contributions to foreign politicians that she suspects were illegal. Jones checks with her firm's legal counsel and determines that the contributions were indeed illegal. At the next board meeting, Jones urges the board to disclose the contributions. The board, however, votes not to make a disclosure. Jones's *most appropriate* action would be to:
   A. protest the board's actions in writing to the executive officer of Valley.
   B. resign from the board and seek legal counsel as to her legal disclosure requirements.
   C. inform her supervisor of her discovery and cease attending meetings until the matter is resolved.

2. Over the past two days, Lorraine Quigley, CFA, manager of a hedge fund, has been purchasing large quantities of Craeger Industrial Products' common stock while at the same time shorting put options on the same stock. Quigley did not notify her clients of the trades although they are aware of the fund's general strategy to generate returns. Which of the following statements is *most likely* correct? Quigley:
   A. did not violate the Code and Standards.
   B. violated the Code and Standards by manipulating the prices of publicly traded securities.
   C. violated the Code and Standards by failing to disclose the transactions to clients before they occurred.

3. Melvin Byrne, CFA, manages a portfolio for James Martin, a wealthy client. Martin's portfolio is well diversified with a slight tilt toward capital appreciation. Martin requires very little income from the portfolio. Recently, Martin's brother, Cliff, has become a client of Byrne. Byrne proceeds to invest Cliff's portfolio in a similar manner to James's portfolio based on the fact that both brothers have a similar lifestyle and are only two years apart in age. Which of the following statements is *most likely* correct? Byrne:
   A. violated the Code and Standards by knowingly creating a conflict of interest between James's and Cliff's portfolios.
   B. violated the Code and Standards by failing to determine Cliff's objectives and constraints prior to investing his portfolio.
   C. did not violate the Code and Standards.

4. Robert Blair, CFA, Director of Research, has had an ongoing battle with his firm's management about the adequacy of its compliance system. Blair believes the firm's compliance procedures are inadequate in that they are not being monitored or carefully followed. Blair should *most appropriately*:
   A. resign from the firm unless the compliance system is strengthened and followed.
   B. send his superior a memo outlining the problem.
   C. decline in writing to continue to accept supervisory responsibility until reasonable compliance procedures are adopted.

5. Beth Anderson, CFA, is a portfolio manager for several wealthy clients including Reuben Carlyle. Anderson manages Carlyle's personal portfolio of stock and bond investments. Carlyle recently told Anderson that he is under investigation by the IRS for tax evasion related to his business, Carlyle Concrete. After learning about the investigation, Anderson informs a friend at a local investment bank so that they may withdraw their proposal to take Carlyle Concrete public. Anderson has *most likely*:
   A. violated the Code and Standards by failing to maintain the confidentiality of her client's information.
   B. violated the Code and Standards by failing to detect and report the tax evasion to the proper authorities.
   C. not violated the Code and Standards since the information she conveyed pertained to illegal activities on the part of her client.

6. A research report states: "Based on the fact that the South American utilities sector has seen rapid growth in new service orders, we expect that most companies in the sector will be able to convert the revenue increases into significant profits. We also believe the trend will continue for the next three to five years." The report goes on to describe the major risks of investing in this market. The author of this report:
   A. has not violated the Code and Standards.
   B. violated the Code and Standards by failing to properly distinguish factual information from opinions.
   C. violated the Code and Standards by failing to properly identify details related to the operations of South American utilities.

7. Frist Investments, Inc. has just hired Michael Pulin to manage institutional portfolios, most of which are pension related. Pulin has just taken the Level III CFA exam and is awaiting his results. Pulin has more than 15 years of investment management experience with individual clients but has never managed an institutional portfolio. Pulin joined the CFA Institute as an affiliate member two years ago and is in good standing with the organization. Which of the following statements would be *most appropriate* for Frist to use in advertising Pulin as a new member of the firm? Pulin:
   A. has many years of investment experience which, along with his participation in the CFA program, will allow him to deliver superior investment performance relative to other managers.
   B. is a CFA Level III and passed the first two exams on the first attempt. He is an affiliate member of the CFA Institute. We expect him to become a regular member if he passes the Level III examination.
   C. is a Level III CFA candidate and has many years of excellent performance in the investment management industry. Pulin is an affiliate member of the CFA Institute and will be eligible to become a CFA charterholder and regular member if he passes the Level III CFA Exam.

8. Zanuatu, an island nation, does not have any regulations precluding the use of nonpublic information. Alfredo Romero has a friend and fellow CFA charterholder there, Donna Gordon, with whom he has shared nonpublic information regarding firms outside his industry. The information concerns several firms' internal earnings and cash flow projections. Gordon may:
   A. trade on the information under the laws of Zanuatu, which govern her behavior.
   B. not trade on the information under CFA Institute Standards, which govern her behavior.
   C. trade on the information under CFA Institute Standards since the firms concerned are outside Romero's industry.

9. Samantha Donovan, CFA, is an exam proctor for the Level II CFA exam. The day before the exam is to be administered, Donovan faxes a copy of one of the questions to two friends, James Smythe and Lynn Yeats, who are Level II candidates in the CFA program. Donovan, Smythe, and Yeats had planned the distribution of an exam question months in advance. Smythe used the fax to prepare for the exam. Yeats, however, had second thoughts and threw the fax away without looking at its contents. Which of the following statements is *most likely* correct?
   A. Smythe violated the Code and Standards, but Yeats did not.
   B. Donovan violated the Code and Standards, but Smythe did not.
   C. Donovan and Yeats both violated the Code and Standards.

10. Sally Albright, CFA, works full time for Frank & Company, an investment management firm, as a fixed income security analyst. Albright has been asked by a business contact at KDG Enterprises to accept some analytical work from KDG on a consulting basis. The work would entail investigating potential distressed debt securities in the small-cap market. Albright should *most appropriately*:
   A. accept the work as long as she obtains consent to all the terms of the engagement from Frank & Company.
   B. not accept the work as it violates the Code and Standards by creating a conflict of interest.
   C. accept the work as long as she obtains written consent from KDG and does it on her own time.

11. Josef Karloff, CFA, acts as liaison between Pinnacle Financial (an investment management firm) and Summit Inc. (an investment banking boutique specializing in penny stocks). When Summit underwrites an IPO, Karloff routinely has Pinnacle issue vague statements implying that the firm has cash flows, financial resources, and growth prospects that are better than is the case in reality. This action is *most likely* a violation of the section of the Standards concerning:
   A. fair dealing.
   B. nonpublic information.
   C. misconduct.

12. Steve Matthews, CFA, is a principal at Carlson Brothers, a leading regional investment bank specializing in initial public offerings of small to mid-sized biotech firms. Just before many of the IPOs are offered to the general public, Matthews arranges for 10% of the shares to be distributed to management of the firm going public. This action is a violation of the Standard concerning:
    A. additional compensation.
    B. disclosure of conflicts of interest.
    C. fair dealing.

13. Will Hunter, CFA, is a portfolio manager at NV Asset Managers. An investment banker asks Hunter to purchase shares in a new IPO to support the price long enough for insiders to liquidate their holdings. Hunter realizes that the price of the shares will almost certainly fall dramatically after his buying support ceases. NV management "strongly suggests" that Hunter honor the investment banker's request since NV has had a longstanding relationship with the investment bank. If Hunter agrees to make the purchases, he will:
    A. not violate the Code and Standards.
    B. violate the Standard concerning market manipulation.
    C. violate the Standard concerning priority of transactions.

14. Neiman Investment Co. receives brokerage business from Pick Asset Management in exchange for referring prospective clients to Pick. Pick advises clients—in writing, before the relationship is established—of the nature of its arrangement with Neiman. With regard to this practice, Pick has:
    A. complied with the Code and Standards.
    B. violated the Code and Standards by failing to preserve the confidentiality of the agreement with Neiman.
    C. violated the Code and Standards by participating in an agreement that creates a conflict of interest.

15. Ralph Salley, a Level I candidate in the CFA Program, is explaining Standard VI(B) Priority of Transactions, to his supervisor. Salley states, "The Standard recommends, but does not require, that members and candidates should not participate in initial public offerings. The Standard also recommends that trades for accounts of family members be made after those for other clients, but before those for the account of the members and candidates responsible for executing the transactions." Salley's explanation of the Standard is:
    A. correct.
    B. incorrect, because the Standard does not recommend that trades for family members be made after those for other clients.
    C. incorrect, because the Standard requires that members and candidates not participate in initial public offerings.

16. Which of the following policies is required to comply with GIPS?
    A. Compliance with GIPS must be verified by an independent third party.
    B. Restructuring of the firm's organization cannot be used as a basis to change the historical performance results of a composite.
    C. The definition of the firm must include the firm's offices in all countries and regions.

17. Mason Smith is trying to decide which of the following composite definitions, submitted by his junior analysts, would be considered an acceptable composite according to GIPS. An acceptable composite can include all:
    A. accounts that are managed directly from the firm's Hong Kong office.
    B. actively managed portfolios, but exclude passively managed portfolios.
    C. portfolios that are managed to provide a return approximately equal to that of the S&P 500 Index.

18. An investment management firm, Investco, Inc., was recently audited by the United States Securities and Exchange Commission (SEC). Investco included the following statement in its performance presentation report: "This report has been verified as GIPS compliant by Investco's Compliance Department and the United States Securities and Exchange Commission." Does this constitute acceptable verification under GIPS?
    A. No, only one party may perform GIPS verification.
    B. No, neither party involved in the audit constitutes an acceptable GIPS verification.
    C. Yes, because an audit was performed implicitly by the SEC and explicitly by the firm's audit team.

Self-Test Answers: Ethics and Professional Standards

1. **B** According to Standard I(A) Knowledge of the Law, since she has taken steps to stop the illegal activities and the board has ignored her, Jones must dissociate from the board and seek legal advice as to what other actions would be appropriate in this instance. She may need to inform legal or regulatory authorities of the illegal activities.

2. **A** Quigley's trades are most likely an attempt to take advantage of an arbitrage opportunity that exists between Craeger's common stock and its put options. She is not manipulating the prices of securities in an attempt to mislead market participants, which would violate Standard II(B) Market Manipulation. She is pursuing a legitimate investment strategy. Participants in her hedge fund are aware of the fund's investment strategy, and thus Quigley did not violate the Code and Standards by not disclosing this specific set of trades in advance of trading.

3. **B** Standard III(C) Suitability requires that before taking investment action, members and candidates must make a reasonable inquiry into a client's or prospect's investment objectives and constraints as well as their prior investment experience. Byrne cannot assume that because the brothers have similar lifestyles and are close in age that they should have similarly managed portfolios. Byrne should have interviewed Cliff directly before investing his portfolio.

4. **C** According to Standard IV(C) Responsibilities of Supervisors, because he is aware that the firm's compliance procedures are not being monitored and followed and because he has repeatedly tried to get company management to correct the situation, Blair should decline supervisory responsibility until adequate procedures to detect and prevent violations of laws, regulations, and the Code and Standards are adopted and followed. If he does not do so, he will be in violation of the Code and Standards.

5. **A** Anderson must maintain the confidentiality of client information according to Standard III(E) Preservation of Confidentiality. Confidentiality may be broken in instances involving illegal activities on the part of the client, but the client's information may only be relayed to proper authorities. Anderson did not have the right to inform the investment bank of her client's investigation.

6. **A** Historical growth can be cited as a fact. The report states that the firm *expects* further growth and profitability, which phrases the statement as an opinion. Under Standard V(B) Communication with Clients and Prospective Clients, it is not necessary to include every detail about a potential investment in a report. Members and candidates are expected to use their judgment and identify the most important factors to include.

7. **C** Standard VII(B) governs acceptable methods of referencing the CFA Institute, CFA designation, and CFA Program. Candidates may reference their candidacy if they are enrolled for, or waiting for the results of, a CFA exam. Pulin may also reference his membership status with the CFA Institute as well as his remaining eligibility requirements to become a CFA charterholder.

8. **B** Even though the laws of Zanuatu would not preclude trading on the information, as a CFA Charterholder, Gordon is bound by the CFA Institute Code and Standards. Standard II(A) prohibits the use of material nonpublic information, and Gordon may not trade the stocks about which she has such information under any circumstances.

9. **C** In this situation, Donovan, Smythe, and Yeats all violated Standard VII(A) Conduct as Participants in CFA Institute Programs. The Standard prohibits conduct that compromises the integrity, validity, or security of the CFA exams. Donovan clearly breached the exam security. Smythe and Yeats both compromised the integrity of the exams by planning to use the actual exam question to gain an advantage over other candidates. Even though Yeats did not ultimately use the information to study for the exam, she participated in a scheme to cheat on the CFA exam.

10. **A** Albright may accept work for which she receives outside compensation and which may compete with her employer only if she obtains her employer's consent. Under Standard IV(A) Loyalty, such consent must be obtained from her employer prior to beginning the work.

11. **C** Since the statements are vague, we have no direct evidence that a violation of securities law has occurred. However, under Standard I(D) Misconduct, members and candidates are prohibited from engaging in activities involving deceit. Karloff's action is a clear attempt to mislead the investing public regarding the value of Summit IPOs.

12. **C** Standard III(B) Fair Dealing requires that members not use their position to disadvantage clients, specifically in the case of IPOs.

13. **B** NV management is asking Hunter to violate Standard II(B) Market Manipulation, which prohibits actions that are designed to distort prices or artificially increase trading volume. The intent is to mislead market participants and allow corporate insiders to take advantage of artificially high prices.

14. **A** Pick has not violated the Standards. The referral arrangement is fully disclosed to clients before they agree to do business with Pick. Therefore, clients can fully assess the effect of the agreement on the referral and how the agreement may affect their accounts before hiring Pick as their asset manager.

15. **B** Standard VI(B) Priority of Transactions recommends that members and candidates avoid the appearance of conflict of interest by not participating in IPOs. If a family member is a fee-paying client, the member or candidate should treat them like any other client, not giving any advantage or disadvantage to their accounts.

16. **B** Firms cannot alter historical performance records of composites simply because of a reorganization of the firm. This is required by GIPS Standard 0.A.15. Third-party verification of GIPS compliance and including all geographical offices in the definition of the firm are recommended, but not required.

17. **C** Composites are groups of portfolios that represent a similar investment strategy, objective, or mandate. Clearly, grouping all portfolios managed to mirror the S&P 500 Index return constitutes a composite according to this definition. Organizing composites by office or by a generic active management category is not acceptable as these categories do not reflect any sort of strategy, objective, or mandate.

18. **B** GIPS verification must be performed by an independent third party. The SEC audit does not constitute a GIPS verification.