Learning Module 5: Ethics Application

LOS 5a: Standard I – Professionalism

At the end of this reading, you should be able to:

- LOS a: evaluate practices, policies, and conduct relative to the CFA Institute Code of Ethics and Standards of Professional Conduct;
- LOS b: explain how the practices, policies, and conduct do or do not violate the CFA Institute Code of Ethics and Standards of Professional Conduct

Members and Candidates must follow and understand all applicable laws, rules, and regulations (including CFA Institute Code and Standards) of any government, regulatory body, licensing agency, or professional association controlling their professional activities.

Members and Candidates must follow the more stringent law, rule, or regulation in the event of a dispute. They must not knowingly engage in or facilitate any violation of such laws, rules, or regulations and must distance themselves from any such violation.

Inaction on the part of a member and continued association with persons engaged in unlawful or unethical behavior could be construed as involvement or assistance in the illegal or unethical behavior.

Application 1: Knowledge of The Law (Dissociating from Activity)

Sara Tsaiko has recently been hired as a performance analyst at Think Inc, a European hedge fund specializing in global macro strategies. Tsaiko is tasked with compiling a report on the fund manager's annual performance. Previously, a senior performance analyst – Martha Kraus, used to compile these reports. Tsaiko goes through previous reports and notices that the annual returns over the last several years have been materially overstated. Tsaiko is hesitant to inform her immediate supervisor of her findings and initially addresses this with Kraus. Kraus informs Tsaiko that there are no anomalies in her performance measurement calculations. Kraus insists that Tsaiko should replicate the calculation methods used in her previous reports. Tsaiko follows through with Kraus' request.

Why is Tsaiko in violation of Standard I(A) – Knowledge of the Law?

A. She performed analysis on previous performance reports without informing Kraus.
B. She failed to dissociate from the activity immediately – she should have declined to complete the report after discovering the deliberate overstatement.
C. She fails to disclose her findings to her supervisor or compliance department.

Solution

The correct answer **is C.**

Tsaiko has violated Standard I(A) – Knowledge of the Law. Tsaiko had reason to believe that Kraus deliberately overstated returns over several reporting periods. At this point, Tsaiko is not in violation of Standard I(A).

Tsaiko addresses her concerns to Kraus and follows through with her recommendation. To comply with Standard I(A) – Knowledge of the Law, Tsaiko should have reported her concerns to her supervisor (in this case, Kraus is not her supervisor) or with the compliance department if she had suspicions of any wrongdoing. By applying methods that overstate returns, Tsaiko is now in violation of Standard I(A). If the compliance department or supervisor finds no issue in the performance calculations, Tsaiko needs to dissociate from this activity. This could involve asking for another assignment or leaving her job at Think Inc in extreme cases.

Application 2: Following the Stricter Requirement

Charles Findlay is the CFO of Excel Financial – a corporate finance firm headquartered in New York. Findlay is leading the IPO underwriting process for a major client. New York regulation forbids managers from participating in IPO for their accounts. The underwriting process is split between Excel Financial and FJ Capital, headquartered in Ankara, Turkey. Turkey has no rules or regulations on executives participating in IPOs for their investment accounts. Findlay allocates a percentage of the IPO issuance to himself and other managers of FJ Capital.

Has Findlay violated Standard I(A) – Knowledge of the Law?

A. No, because the Standard does not forbid managers from participating in IPO's.
B. Yes, because Findlay does not follow the stricter rule of no participation in IPO's.

C. No, because the underwriting process is shared between FJ Capital and Excel Financial, Findlay is free to choose between what laws and regulations to follow.

Solution

The correct answer is **B.**

Standard I(A) – Knowledge of the Law does not forbid investment managers from participating in IPO's. Findlay has violated Standard I(A) – Knowledge of the law because he did not comply with the stricter rule. Findlay should always comply with more strict laws or regulations.

Application 3: Knowledge of The Law (Dissociating from Activity)

Simon Sikasa, a CFA candidate, is an employee at DSS Investments Inc. Sikasa has discovered that the company charges its clients at a rate greater than the cost of providing the service as per the client agreement. Sikasa has informed his supervisor of the fact. If the supervisor does not take any corrective measures to address this issue, what action should Sikasa *most likely* take?

A. Report this issue to the company's board of directors.
B. Dissociate themselves from the activities of the firm.
C. Take no action because the clients are not aware of these costs.

Solution

The correct answer is **B.**

Sikasa should dissociate himself from the firm's activities and report the matter to the board of directors and regulators. Members and candidates must not knowingly engage in or facilitate any violation of such laws, rules, or regulations and must distance themselves from any such violation.

A is incorrect. Reporting the issue to the board of directors is not enough. If the issue is not addressed, in addition to reporting the matter to the board of directors, the employee should dissociate himself from such activities.

C is incorrect. Inaction on the part of the candidate and continued association with persons engaged in unlawful or unethical behavior could be construed as involvement or assistance in the illegal or unethical behavior.

LOS 5b: Standard I(B) – Independence and Objectivity

Members and Candidates must exercise reasonable caution and discretion in their professional actions to establish and preserve independence and objectivity. They are prohibited from offering, soliciting, or accepting any gift, benefit, remuneration, or other inducement that could reasonably be considered to jeopardize their or another's independence and objectivity.

Any potential conflict of interest should be avoided.

Application 1: Research Independence

Susan Watts is a research analyst specializing in technology stocks has quickly become a valued firm member. Her boss has a positive outlook on Space Technologies – a stock he owns. He has made it very clear that Susan should change the firm's "Strong Buy" recommendation under no circumstance. Susan does a thorough independent analysis and concludes that Space Technologies is a "Strong Buy." She goes on to publish the report.
Has Susan violated Standard I(B) – Independence and Objectivity?

A. No, because she conducted her independent analysis and happened to come to the same conclusion as her boss.
B. Yes, because she reached the same "Strong Buy" recommendation as her boss.
C. Yes, because she was compromised by the opinions of her boss.

Solution

The correct answer is **A**.
Standard I(B) – Independence & Objectivity emphasizes that Members and Candidates should always perform analysis and disseminate investment reports that reflect their independent opinions. If Watts believed that her independence had been compromised, she should have discontinued her coverage of Space Technologies. In this case, Watts carried out her independent analysis and reached the same recommendation as her boss. Therefore, she has not violated Standard I(B).

Application 2: Influencing Manager Selection

Todd Martinez, CFA, receives a tip from a friend – XFM Pension fund is searching for a new external fund manager. His friend tells him that the selection manager is an avid golf player and frequently visits his local golf course. Martinez's friend introduces him to the selection manager, Michael Yang. Martinez intends to establish a close rapport with Yang. In his attempt to gain XFM Pension Fund's business, Martinez gifts Yang with expensive golf clubs and pays for several lunches at the golf club.

Which of the following individuals has violated Standard I(B) – Independence and Objectivity?

A. Martinez.
B. Yang.
C. Both Martinez and Yang.

Solution

The correct answer is **C**.

Both Martinez and Yang are in violation of Standard I(B) – Independence and Objectivity. Martinez is knowingly trying to influence Yang's selection decision. Additionally, as a selection manager, Yang should not accept gifts because it may impair his independence and Objectivity.

Application 3: Research Independence

Rick Martin, CFA, is a Spector Finance Group (SPG) corporate finance analyst. Martin is in the middle of the presentation with a potential client. At the end of the presentation, Martin proposes that an added benefit of contracting her firm will be research coverage on SPG.

Is there a violation of Standard I(B) – Independence and Objectivity?

A. Yes, because Martin is offering free research coverage of SPG in exchange for new business.
B. No, because she has not guaranteed positive research coverage of SPG.
C. No, because Martin is allowed to use any means to bring in new business.

Solution

The correct answer is **B**.

This is not in violation of Standard I(B) – Independence and Objectivity. Martin is allowed to offer coverage of SPG but cannot promise that the firm will produce research with a positive/buy recommendation. Any investment recommendation or reporting must be based on the analysts' independent and objective analysis of SPG.

Application 4: Preserving Independence

Jonathan Aser, CFA, is a fund manager at ABC Construct, an infrastructural company. ABC has been known to have undertaken huge national infrastructural projects. Jonathan intends to donate €100,000 to the election campaign of Mr. Pablo, who is running for the position of presidency. Mr. Pablo has high electoral ratings.

Jonathan believes that the donation will positively influence the allocation of the infrastructural projects to his firm. To comply with the CFA Institute Code and Standards, Jonathan should:

A. not donate.
B. donate as it is from his pocket.
C. reduce the size of his donation.

Solution

The correct answer is **A.**

Jonathan should refrain from donating to comply with Standard I(B), which prohibits candidates and members from offering, soliciting or accepting any gift, benefit, remuneration, or other inducement that could reasonably be considered to jeopardize their or another's independence and objectivity.

B is incorrect. Jonathan is donating to influence the selection of the city’s pension manager. Standard I(B) states that members and candidates are prohibited from offering, soliciting, or accepting any gift, benefit, remuneration, or other inducement that could reasonably be considered to jeopardize their or another's independence and objectivity.

C is incorrect. Reducing the donation does not change the aim that Jonathan is trying to achieve, which is to influence the pension plan manager selection. No matter the amount, the aim is to improperly influence the allocation of infrastructural projects to his firm, which goes against Standard I(B).

LOS 5c: Standard I(C) – Misrepresentation

Members and Candidates must not make any false statements about investment analysis, recommendations, actions, or other professional activity with the intent to deceive.

Members and candidates are prohibited from making any claims that promise or guarantee a certain rate of return on volatile assets under this criterion.

Application 1: Non-correction of Errors

Salma Farak is the CFO of a multinational insurance firm. The new promotional material created by the marketing department states that she is a CFA Charterholder. She just sat the Level III CFA Exam and is awaiting her result. Farak is aware of the misstatement and does not inform the marketing department of the error. The marketing department distributes the material to current and prospective clients over the next financial year.

Has Farak violated Standard I(C) – Misrepresentation?

A. No.
B. Yes, because she does not make the error known to the marketing department.
C. Yes, because she is responsible for making sure the marketing department understands her qualifications.

Solution

The correct answer is **B.**

Although Farak is not directly responsible for the misrepresentation of the qualifications, she allowed this material to be disseminated over some time.

Application 2: Plagiarism

Jessica Klein is preparing an investor briefing for her clients. She would like to briefly explain various financial concepts, such as price-to-sales (P/S) and real returns. She finds these descriptions on a popular finance website and copies these explanations (verbatim) without acknowledging the authors.

Has Klein violated Standard I(C) – Misrepresentation?

A. No, because these concepts are popular finance jargon – all the explanations are identical regardless of the source.
B. Yes, because she failed to reference the original authors.
C. No, because she does not need to acknowledge the original authors.

Solution

The correct answer is **B.**

Klein has violated Standard I(C) – Misrepresentation. For Klein to be compliant, she should always acknowledge the original author of any reference material.

Application 3: Guaranteeing Returns

Joseph Aphaja, CFA, is a portfolio manager at Invenco Inc., managing funds mostly made up of government bonds. Joseph has advertised his firm’s services on a tv ad by claiming that their returns are guaranteed at a risk-free rate since they invest mostly in government securities. Which of the following is *most likely* correct regarding Joseph’s claim? Joseph

A. should not claim to offer a guaranteed return.
B. is fully compliant with the CFA Institute Code and Standards.
C. is justified to claim the guaranteed return since the firm majorly invests in government securities.

A is correct. Joseph should not guarantee investors a certain return even if his firm invests in risk-free securities like government bonds. Additionally, the fund does not invest 100% in risk-free securities, and therefore there is a possibility that the fund's return will not be equal to the risk-free rate. According to Standard I(B), members and candidates are prohibited from making any claims that promise or guarantee a certain rate of return on volatile assets under this criterion.

B is incorrect. Joseph is not in compliance with the CFA Institute Code and Standards because he should not promise or guarantee a certain rate of return on volatile assets.

C is incorrect. Joseph should not claim to offer a guaranteed return even if it was investing 100% in government securities which it does not.

LOS 5d: Standard I(D) – Misconduct

Members and Candidates shall not engage in any professional activity that involves dishonesty, fraud, or deception or act in a way that harms their professional reputation, integrity, or competence.

This does not apply to legal violations stemming from acts of civil disobedience in favor of personal convictions if the member's professional reputation, integrity, or competence are not harmed.

Application 1: Civil Disobedience

Courney Isaiah, CFA, is an investment analyst at XAS investments. Courney is a member of Protect Environment Organization, which champions environmental protection. In his free time, Courney organizes a march to protest the government's increase in the use of fossil fuels and environmental degradation. During the protest, Courney was arrested and fined €2,000. In the contract signed with XAS investments, any employee arrested for committing offenses within the company is immediately terminated.

Under the CFA Institute Code and Standards, the Courney's actions:

A. violated the CFA Institute Code and Standards because she violates her employment contract.
B. does not violate the CFA Institute Code and Standards.
C. violates the CFA Institute Code and Standards because she was arrested and fined.

Solution

The correct answer is **B.**

The analyst has not violated the CFA Institute Code and Standards by organizing a march to protest the government's actions. The CFA code and standards on misconduct do not apply to legal violations stemming from acts of civil disobedience in favor of personal convictions if the member's professional reputation, integrity, or competence are not harmed.

A is incorrect. Employers may have the right to terminate an employee's employment contract if they get a criminal record, but this is at the employer's discretion. Organizing a public assembly to protest personal convictions does not constitute a violation of the CFA Institute Code and Standards.

C is incorrect. Organizing a public assembly to protest personal convictions does not constitute a violation of the CFA Institute Code and Standards.

Application 2: Fraud and Deceit

An equity analyst includes a receipt that is not part of his expenses for a company trip. He previously missed out on a legitimate expense of the same value the month before. He is looking to be reimbursed for the previous month's expenses.

Is the analyst in conflict with Standard I(D) – Misconduct?

A. No, because the reimbursement he is seeking is of the same monetary value as his legitimate expense.
B. Yes, because his conduct is deceitful.
C. Yes, because he is not allowed to claim any expenses.

Solution

The correct answer is **B.**

The analyst has violated Standard I(D) – Misconduct because his actions were deceitful. His actions have adversely damaged his integrity.

Application 3: Personal Actions and Integrity

Jane Ferro is the Head of Trading at Nix Brokerage. In her spare time, she is an avid woman's rights activist. She was recently arrested at a peaceful protest over the weekend. She is accused of creating public disruption.

Are Ferro's actions considered to violate Standard I(D) – Misconduct?

A. Yes, Ferro's arrest questions her professionalism.

B. No, the crime Ferro is accused of is not serious enough to damage her reputation.

C. No, her actions do not reflect poorly on her professional reputation and integrity.

Solution

The correct answer is **C.**

Standard I(D) – Misconduct is meant to cover conduct that reflects poorly on a member's or Candidate's *professional* reputation, integrity, or competence. Ferro is allowed to participate in causes that she aligns with.

LOS 5e: Standard II – Integrity of Capital Markets

Standard II(A) – Material Non-Public Information

CFA Institute members and candidates should not act on material nonpublic information in their possession or cause others to act on it.

If the publication of information will affect the price of a security or if reasonable investors would wish to know about it before making an investment decision, it is considered material. It is considered “nonpublic” until the information has been disseminated or made available to the broader public.

Application 1: Disclosure of Material Information

Anne Feinstein is an equity analyst based in Sydney and covers the Korean manufacturing sector. She is on a conference call with five leading analysts and the CFO of a major fashion retail company. In the call, the CFO discloses that most of the firm's workforce is set to go on strike indefinitely. This would cripple production and productivity, so the CFO informs the analyst that the firm is expected to miss its expected earnings expectations for the next two quarters. Feinstein goes on to update her recommendation to a "Sell."

Has Feinstein violated Standard II(A) – Material Nonpublic Information?

A. Yes, she is not allowed to take any investment actions on nonpublic information.
B. No, the information is considered public because the conference call included several other analysts – therefore, the information is public.
C. Yes, Feinstein is not permitted to talk to management. She is not allowed to get insider information.

Solution

The correct answer is **A.**

She has violated Standard II(A) – Material Nonpublic Information because she changed her investment recommendation. Feinstein needs to determine whether the material information she received is publicly known. The information would be considered nonpublic – it has not been disseminated to the broader public. As a result, Feinstein is not allowed to act on the information.

Application 2: Using Expert Networks

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

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

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

Solution

The correct answer is **B**.

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

Application 3: Mosaic Theory

Alison Kaitu is an equity analyst that covers the consumer discretionary sector. She is working on a research report on Zang Corporation. Zang Corporation is listed on the NYSE and quickly became a "hot" stock. Zang Corp. has beat analyst earnings expectations over three successive quarters in a very competitive manufacturing industry. Kaitu, however, is suspicious of Zang's extraordinary growth and performance published in its filings. She decides to visit Zang's manufacturing plants and observes that many of the factories have been closed or have limited production activity. Kaitu issues a "sell" recommendation based on the combination of her fundamental analysis and the observations she gained on her visit.

Has Kaitu violated Standard II(A) – Material Nonpublic Information?

A. Yes, she used material information to arrive at her recommendation.
B. No, she is allowed to use a combination of public information and nonmaterial nonpublic information to arrive at her conclusions.
C. Yes, her knowledge of Zang's manufacturing activities would be considered insider information.

Solution

The correct answer is **B**.

Kaitu is permitted to use a combination of public information (Zang's fillings) and nonmaterial nonpublic information (her observations at Zang's manufacturing plants). Before issuing her recommendation, she needed to determine the materiality of her observations. In this case, her observations were taken independently. Additionally, any other investor or analyst could potentially make the same observations if they went deeper into their investigations of Zang. Her observations alone would not be considered material. Under the mosaic theory, Kaitu has not violated Standard II(A) – Material Nonpublic Information.

Application 4: Using Information Nonpublic

Wilson Orengo, CFA, is an investment manager at Jumji Inc., an investment company. During a weekend night out at a local joint, Orengo overhears Enock Otieno, CEO of a Royal bank, talking about an acquisition the bank intends to make in a few months. The following day Wilson buys himself the banks' shares in anticipation of the acquisition announcement. Wilson did not buy shares for his client's accounts.

Under the CFA Institute Code and Standards, Wilson's actions:

A. violates the CFA Institute Code and Standards because he bought his shares before buying for his clients.
B. does not violate the CFA Institute Code and Standards because the shares bought are his

own.

C. violates the CFA Institute Code and Standards because of using information nonpublic

Solution

The correct answer is **C.**

Wilson violated Standard II(A) because of using information nonpublic. The bank making an acquisition is not public information. Additionally, this information is material because its disclosure would affect the price of the bank's shares.

A is incorrect. Wilson violates the CFA Institute Code and Standards but not because he bought himself the bank’s shares and not his employer. He violates Standard II(A) because of trading on nonpublic information.

B is incorrect. CFA Institute members and candidates should not act on material nonpublic information in their possession or cause others to act on it.

LOS 5f: Standard II(B) – Market Manipulation

CFA Institute members and candidates are prohibited from engaging in tactics that artificially increase trading volume to deceive market participants under the Integrity of Capital Markets, Market Manipulation policy.

Application 1: Manipulation of Model Inputs

Andy Knoxville is the head of structured products at Kings Investment Bank. As the structured products team leader, he is responsible for creating new and creative products that attract potential investors. He notices that there is substantial interest in low-volatility products. Consequently, Knoxville creates "low-vol" products that contain inputs intended to suppress the negative impact of higher volatility in the market. A part of Steven's compensation is directly linked to the number of clients that purchase these "low-vol" products. In periods of low volatility, clients that bought these products were extremely successful. Since the beginning of the coronavirus epidemic, high levels of volatility have led to numerous defaults.

Has Knoxville violated Standard II(B) – Market Manipulation?

A. No, clients should be aware of the complexity of the "low-vol" structured product.
B. No, he did not artificially manipulate any stock's price, volume, or volatility.
C. Yes, intentionally manipulated the inputs of the model to conceal the effects of higher volatility on the returns of the product.

Solution

The correct answer is **C.**

Steven violated Standard II(B) – Market Manipulation. Intentionally manipulating model inputs is considered a form of information-based manipulation. Steven's manipulation was intended to attract more business and increase his compensation. His actions would cause investors to lose trust in capital markets and poorly reflect the investment profession.

Application 2: Pump-Primping Strategy

John Reynolds, CFA and CEO of Naxis Future Exchange (NFE), introduces a new equity index futures contract into the market. In an attempt to attract individuals and major brokers to trade on its exchange, Naxis offers significant discounts on its trading fees. To be eligible for the reduction in trading fees, firms must agree to a minimum trading volume of the new contract over the next six months. Naxis hopes that the demonstration of consistently large liquidity will attract new brokerages and retail traders to its exchange.

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

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

Solution

The correct answer is **C.**

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

Application 3: Market Manipulation

Larry Linkard, CFA, is a public relations and investment strategist at VCX securities, the leading investment bank in an IPO of a telecommunication service provider that has been performing well recently. VCX is finding it difficult to sell the IPO due to the recent negative publicity the telecommunication company has received due to management misconduct. The management of the telecommunication company is currently under investigation by the regulator.

Larry released a statement to the public to sell the IPO, implying that the telecommunication management has been cleared of any wrongdoing. Under the CFA Code and Standards, Larry:

A. violated the Code and Standards.
B. did not violate the Code and Standards as no investors were harmed.
C. did not violate the Code and Standards as the company's performance is exceptional.

Solution

The correct answer is **A.**

Larry violated the CFA Institute Code and Standards because he attempted to manipulate the demand for the shares of the telecommunication company. Standard II(B) prohibits members and candidates from engaging in tactics that artificially increase trading volume to deceive market participants.

B is incorrect. The fact that Larry is deceiving the public into buying the shares of the telecommunication company is a violation of the CFA Institute Code and Standards whether investors are harmed or not.

C is incorrect. The telecommunication company's performance should not be used as an excuse for Larry to deceive investors.

LOS 5g: Standard III – Duties to Clients and Prospective Clients

Standard III(A) – Loyalty, Prudence, and Care

Members and Candidates owe their clients a responsibility of loyalty, and they must act with reasonable caution and sound judgment. Members and Candidates must work in the best interests of their clients, putting their clients' needs ahead of their employer's or own.

Application 1: Client Approval

Hadassah Zachary, CFA, manages Kate Chege's investment portfolio. Chege has a heavily concentrated position in SunBeam Technologies. She received the majority of her shares after her father – the ex-CEO of Sunbeam – passed away. Zachary has expressed the need for and benefits of diversifying her portfolio. Chege has refused to diversify her holdings and has prohibited the sale of Sunbeam stock in her investment policy statement. News has just broken about SunBeam Technology filing for bankruptcy. Zachary is quick to act and attempts to get in touch with Chege, with no success. The stock price is falling dramatically, and Zachary proceeds to sell the shares and reinvest the proceeds into safer yielding assets.

Has Zachary violated Standard III(A) – Loyalty, Prudence, and Care?

A. No, because she acted in Chege's best interest.
B. Yes, because she failed to diversify Chege's portfolio.
C. Yes, because she did not follow instructions found on the investment policy statement.

Solution

The correct answer is **C.**

Zachary was trying to act in Chege's best interest. However, Chege's investment policy statement *prohibits* the sale of Sunbeam stock. While it may appear that Zachary did the right thing for Chege's portfolio, she has violated Standard III(A) – Duties to Client. To comply with Standard III(A), Zachary must disclose any investment action and wait for Chege's approval.

Application 2: Excessive Trading

Samuel Taylor is a wealth manager at Schuster Partners. A percentage of her management fees is derived from trading commissions. Taylor trades excessively in each of his client trading accounts, but the trades are appropriate and in line with his client's asset allocations. However, the trading activity exceeds what is required to implement her client's objectives.

Do Taylor's actions comply with Standard III(A) – Loyalty, Prudence, and Care?

A. Yes, because Taylor is allowed to direct trading activity and frequency.
B. Yes, because the trades are appropriate and in line with his client's asset allocations.
C. No, because the trading activity exceeds what is necessary to meet her client's objectives.

Solution

The correct answer is C.

Taylor's actions do not comply with Standard III(A) – Loyalty, Prudence, and Care. Although the trades are appropriate and in line with her client's asset allocations, the excessive trading frequency raises concerns about whether Taylor is acting in the best interests of her clients. Excessive trading that generates higher commissions for the manager without corresponding benefits to the clients can be seen as prioritizing her own interests over those of her clients, which violates the standard of loyalty, prudence, and care.

Application 3: Soft Dollars

Grace Morris is the CEO of a financial advisory firm – Morris Advisors. Morris routinely uses the same broker for all her client-account trades. The broker offers average prices and below-average execution and research. In exchange, the broker pays Morris Advisors' employees' travel expenses and the firm's rent. All research obtained is used to inform her investment recommendations and advice for her clients.

Is Morris in conflict with Standard III(A) – Loyalty, Prudence, and Care?

A. No, because it is her discretion which broker she selects.
B. Yes, because she fails to get the best execution and price for her clients.

C. No, because the research received benefits from all her clients.

The correct answer is **B**.

Morris has violated Standard III(A) – Loyalty, Prudence, and Care. She uses her client's brokerage for services that do not *directly* benefit her clients. Additionally, she fails to get the best execution and price for her clients.

Application 3: Loyalty

Robert Ojot, CFA, is an investment manager at BNM investment bank. VCX Plc has been issuing its popular commercial papers through BNM investment bank. Robert has been recommending the shares of VCX Plc to his clients because of the value his bank gets by selling VCX's commercial paper. Robert feels that if he gives a different recommendation, his company is at the risk of losing the business with VCX Plc. Under the CFA Institute Code and Standards, Robert's action:

A. violates the CFA Institute Code and Standards.
B. does not violate CFA Institute Code and Standards because VCX Plc is well-performing.
C. does not violate the CFA Institute Code and Standards because no investors have lost their money.

Solution

The correct answer is **A**.

Robert is recommending VCX to his clients because of the value that VCX has been giving to his company, and for fear of losing this business if they gave a different recommendation is a violation of Standard III(A).

B is incorrect. Even though VCX's commercial paper is popular should not be a basis for recommending the company's securities to investors. Robert should perform a proper analysis of the firm and recommend without external influence from VCX.

C is incorrect. Members and Candidates owe their clients a responsibility of loyalty, and they must act with reasonable caution and sound judgment. Investors losing their money is not a basis for recommending a company's securities.

LOS 5h: Standard III(B) – Fair Dealing

Members and candidates must treat all clients fairly and objectively when offering investment research, making investment recommendations, taking investment action, or engaging in other professional activities.

The Code and Standards permit CFA Institute members and candidates to provide more personalized, specialized, or in-depth service to clients who are willing to pay higher fees for premium services, if:

i. these services do not disadvantage other clients who are not willing to pay higher fees,
ii. the different levels of service are disclosed to clients, and
iii. the offerings are made available to all.

Application 1: IPO Distribution

Adam McNarry is the CFO of Astra Capital Advisors (ACA). ACA specializes in corporate advisory and capital raising activities. His client, GreenFarm Ltd., is looking to go public. ACA receives an overwhelming amount of expression of interest from both retail and institutional investors. The new issue is twice oversubscribed. McNarry proceeds to remove all shares allocated to fee-paying family-member accounts. The shares are then prorated among all the clients.

Has McNarry violated Standard III(B) – Fair Dealing?

A. No, because his exclusion of family-member accounts would increase the allocation to his other clients.
B. Yes, because fee-paying family accounts should be treated the same way as other clients.
C. No, because he was prioritizing his client's accounts over his family member accounts.

Solution

The correct answer is **B.**

McNarry has violated Standard III(B) – Fair Dealing. McNarry should treat all his fee-paying clients equally. In this case, McNarry should not have removed his family members' allocation in

GreenFarm Ltd.

Application 2: Additional Services for Select Clients

Josephine Clark emails all her clients to inform them about a change in her investment recommendation of Nix Technologies. She then calls her two biggest clients to review her conclusions and respond to any queries.

Would Clark's actions violate Standard III(B) – Fair Dealing?

A. Yes, because she is giving greater consideration to her two biggest clients.
B. No, because she informed all her clients about the change in her recommendation.
C. Yes, because she has discriminated against some clients and favored others.

Solution

The correct answer is **B.**

Clark has not violated Standard III(B) – Fair Dealing. Clark disseminated her change in the recommendation to all her clients. Clark can offer personal services to clients that may have a significant amount of assets in the firm. Clark would violate if she failed to disseminate her recommendation to all her clients but a select few.

Application 3: Fair Dealig with Clients

Nicole Albert is an investment manager at Nobil Inc. Nicole has sent out a recommendation on security to her clients. Before sending out this information, Nicole informed all of her high-net-worth clients of the recommendation. Under the CFA Institute Code and Standards, Nicole’s action:

A. violated the CFA Institute Code and Standards by informing the few high net worth clients.
B. did not violate the CFA Institute Code and Standards because the recommendation was sent out to all clients.
C. did not violate the CFA Institute Code and Standards because the high-net-worth

individuals bring the firm a lot of money

Solution

The correct answer is **A.**

Nicole has violated the CFA Institute Code and Standards by giving the high-net-worth clients the recommendation before the other clients. According to Standard III(B) , members and candidates must treat all clients fairly and objectively. Premium services can be offered, but the different service levels are disclosed to all clients.

B is incorrect. Nicole sent the recommendation to all her high-net-worth clients and not all her clients. She violated Standard III(B).

C is incorrect. Despite the high-net-worth clients bringing more value to the firm, Nicole is still violating Standard III(B).

LOS 5i: Standard III(C) – Suitability

Members and Candidates are in charge of managing a portfolio according to a specified mandate, strategy, or style; they must only make investment recommendations or conduct investment actions that are compatible with the portfolio's stated objectives and limits. They should also make sure the investment is appropriate for the client's financial circumstances and goals and mandates. Members and candidates should inquire about their investment experience, risk, and return objectives to establish a client's suitability for a particular investment.

Application 1: IPS Update

Joseph Layfield has a financial portfolio worth USD 100,000. His father passed away and left him with a USD 5 Million inheritance. Over two years, Umar Farheed, his investment adviser, has not made any changes to his IPS. Farheed manages Layfield's portfolio with the same objectives and constraints listed in his initial IPS.

Has Farheed violated Standard III(C) – Suitability?

A. No, he is managing Layfield's portfolio in line with his IPS.
B. Yes, he has failed to update Layfield's portfolio to incorporate Layfield's change in circumstance.
C. No, Layfield's inheritance does not materially change his objectives and needs.

Solution

The correct answer is **B.**

Layfield receiving his inheritance would be considered a material change in his circumstances. Layfield can assume more risk and can broaden his investment holdings. Farheed has violated Standard III(C) – Suitability by failing to update Layfield's IPS to reflect his significant change in circumstance.

Application 2: Following an Investment Mandate

Travis Green is a portfolio manager responsible for InvesTank's high-growth fund. He purchases high-income (low growth) stocks of several utility firms. He believes that these stocks are significantly undervalued and would provide a positive return for the fund.

Would Green's purchase of high-income stocks violate Standard III(C) – Suitability?

A. Yes, because he is not following the fund's investment mandate.
B. No, because he has the discretion of the fund's stock selection.
C. No, because the potential upside to the fund from his selection would benefit the fund's beneficiaries.

Solution

The correct answer is **A.**

Green has violated Standard III(C) – Suitability. The purchase of the high-income stocks does not fit the investment mandate (high-growth fund) that Green manages. Green *must* manage the fund according to the investment mandate of the fund.

Application 3: Suitability of an Investment

Jackson Howard, CFA, is a fund manager at BVG Inc. Jackson manages several pension funds. Recently, cryptocurrency has gained higher returns, as reported by a popular online crypto analyzer. Jackson recommends cryptocurrencies to several pension plans. Under the CFA Institute Code and Standards, Jackson’s actions:

A. violated the CFA Institute Code and Standards
B. does not violate the CFA Institute Code and Standards as cryptocurrency would offer good returns.
C. does not violate the CFA Institute Code and Standards because cryptocurrency is a new asset class.

Solution

The correct answer is **A.**

For Jackson to recommend a security to its clients, it should ensure the investment is appropriate for the client's financial circumstances and goals and mandates. Pensions are not allowed to take on a lot of risks, while cryptocurrency is considered very risky and would not fit into a pension fund’s portfolio.

LOS 5j: Standard III(D) – Performance Presentation

Members and Candidates should make reasonable steps to ensure that information about investment performance is fair, accurate, and complete.

Application 1: Performance Presentation and Former Employer

Tina Jensen is a well-respected global macro fund manager. Icon Partners is impressed by Jensen's performance; she has consistently outperformed her peers in the global macro strategy space. Icon Partners successfully poaches her from her previous employer and sends out marketing material created by Jensen, stating her performance history and uploading her performance information on the company's website. In her biography for the company website, she discloses that her performance history occurred at her previous firm. Still, she fails to disclose the years she underperformed the stated benchmark.

Has Jensen violated Standard III(D) – Performance Presentation?

A. No, because she does not need to disclose her years of underperformance.
B. No, because she disclosed that her performance history occurred at her previous employer.
C. Yes, because she is selective about what results to disclose.

Solution

The correct answer is **C**.

Jensen is required to give a fair and complete representation of her performance history. As a result, Jensen has violated Standard III(D) – Performance Presentation. Stating that her performance was achieved at her previous firm is a required disclosure. The omissions of her years of underperformance conflict with Standard III(D) – Performance Presentation.

Application 2: Performance Presentation and Simulated Results

Andrew Mason is a quantitative research analyst at QuantFirst. He has been developing a stock screening algorithm that identifies stocks that exhibit long-term momentum. In his research, he finds that his algorithm successfully selected stock found in the S&P 500 with the desired qualities between 2010-2020. His manager is satisfied that the algorithm works. While preparing the marketing material of this new algorithm, he is careful to disclose that the results are simulated from historic data (2010-2020) and that the future success of the algorithm cannot be guaranteed. However, he fails to disclose that the simulation only yielded successful S&P 500.

Do any of Mason's actions violate Standard III(D) – Performance Presentation?

A. No, because he informs potential clients that the future success of the algorithm cannot be guaranteed.
B. Yes, because the success of his algorithm is time-dependent. He is selective about the period chosen.
C. Yes, because he omits that the algorithm has only produced successful results for stocks found in the S&P 500.

Solution

The correct answer is **C**.

Mason has violated Standard III(D) – Performance Presentation by failing to accurately and fairly disclose the circumstances in which the algorithm produced successful results. The use of historical data and the time period selected is permitted if he makes complete disclosures.

Application 3: Selective Performance Presentation.

Olivia Timberlake, CFA, is a portfolio manager at Lincaly Inc., an investment company. Olivia manages several funds that follow different investment strategies. In her marketing material, Olivia only mentions the better-performing fund to show the performance of her firm’s funds. Under the CFA Institute Code and Standards, the fund Olivia’s action

A. violated the CFA Institute Code and Standards.
B. does not violate the CFA Institute Code and Standards because she mentioned one of its funds.

C. does not violate the code because she did not lie about the performance of the fund.

The correct answer is **A.**

Olivia violated the CFA Institute Code and Standards by not fully disclosing the performance of its funds to investors. According to Standard III(D), Members and Candidates should make reasonable steps to ensure that information about investment performance is fair, accurate, and complete.

LOS 5k: Standard III(E) – Preservation of Confidentiality

Members and Candidates are obligated to preserve confidential information regarding current, former, and prospective clients unless:

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

By following compliance processes, members and candidates should make reasonable attempts to prevent the unintentional disclosure of confidential information.

Application 1: Disclosing Confidential Information

Michelle Antalaya, a financial advisor, has just finished a meeting with one of her clients. Michael Brown wants to make a charity donation worth USD 250,000 to reduce his income tax liability. Brown has permitted Antalaya to offer suggestions of different charities and hold discussions with various charities on his behalf. She is allowed to disclose the size of the donation. Brown mentions that if he is satisfied with the charity selected, he will make recurring donations in the future – this information is not to be disclosed. Antalaya holds a meeting with her close friend and CFO of GirlTalk and discloses the size and the possibility of recurring donations. Brown decides to donate the proceeds to a different charity.

Which of Antalaya's action(s) violate Standard III(E) – Preservation of Confidentiality?

A. None
B. Disclosing details about the size of the donation.
C. Disclosing details about the possibility of recurring donations in the future.

Solution

The correct answer is **C**.

Antalaya has violated Standard III(E) – Preservation of Confidentiality by disclosing the possibility of recurring donations. Brown gave Antalaya permission to disclose the size of the donation – this in itself would not have been a violation.

Application 2: Disclosing Possible Illegal Activity

Jason McCartney manages the investment portfolio of a wealthy businessman – Carlo Nunes. His client is under informal investigation due to suspected illegal drug activity. McCartney has noted a large increase in money coming into his Nunes' investment accounts. When he asks Nunes about the uncharacteristic increases in his cash inflows, he is unable to share any details about the source of the funds. The laws stipulate that client confidentiality can be broken considering any illegal activity

What is the *most* appropriate course of action for McCartney to comply with Standard III(E) – Preservation of Confidentiality?

A. McCartney should disclose any information that could assist in their investigation to the relevant authorities.
B. McCartney should maintain client confidentiality even if it is required by law.
C. McCartney should consult his firm's compliance department to determine the relevant policies on the disclosure of confidential information.

Solution

The correct answer is **C**.

McCartney should check with his compliance department before taking any action. Additionally, if the relevant authorities seek Nunes' information, McCartney is required by law to make the required disclosures. Under Standard III(E) – Preservation of Confidentiality, McCartney does not have the authority to make any disclosures without Nunes' permission or a requirement by law.

Application 3: Disclosing Possible Illegal Activity

Jacinta Klopp is a portfolio manager at Dwal Investment Inc. While discussing the performance of a client’s account, Klopp realizes that the client's funds are acquired by selling drugs. Under the CFA Institute Code and Standards, the Jacinta should

A. report the client to the authorities.
B. maintain the confidentiality of the information with the client.
C. advice the client to fund their accounts through legally acquired funds.

Solution

The correct answer is **A.**

Member and candidates should maintain confidentiality unless it relates to illegal conduct, is needed by law, or the client consents to dissemination. Failure to report this illegal source of funds violates Standard III(E) that relates to the preservation of confidentiality.

LOS 5l: Standard IV – Duties to Employers

Standard IV(A) – Loyalty

Members and Candidates must act in the best interests of their employers, not denying them the benefit of their skills and abilities, divulging sensitive information, or harming them in any other way. Members and Candidates should act in the best interests of their current employer and refrain from engaging in any activity that would clash with their duties until the resignation takes effect. Before terminating the relationship, one can make plans or preparations to change firms.

They should not give the new employer any confidential information or take any of the old employer's assets without consent.

Application 1: Soliciting Former Clients

Judy Francis is an investment manager for several high-net-worth individuals. She is frustrated by the working environment at EY Partners. Francis has notified her employer of her intentions to leave the firm. Before her termination comes into effect, Francis asks two of her biggest clients to move to her new employer Lynx Capital. Her clients decline and maintain their relationship with her former employer.

After joining Lynx Capital, she contacts prospective clients that EY Partners was soliciting, and she manages to get these clients to sign with Lynx. Additionally, she gets in touch with current EY Partners clients using publicly available information. Francis had not signed a non-compete agreement when she was employed at EY Partners.

Which of Francis' actions *most likely* violate Standard IV(A) – Loyalty?

A. Soliciting clients at EY Partners before her termination was in effect.
B. Signing EY Partners' prospective clients after joining her new firm.
C. Contacting EY Partners' current clients using publicly available information.

Solution

The correct answer is **A.**

Francis has violated Standard IV – Loyalty by soliciting clients before leaving her former employer. Her actions are not in the best interest of her employer. Francis can contact her former clients and her former employer's prospective clients provided she did not sign a non-compete.

Application 2: Ownership of Completed Prior Work

Zachariah Davis has recently completed an unpaid internship at Zane Brokers. During his internship, he worked on automating trading reporting procedures. His work involved developing and improving existing code. Davis has been hired as a trading assistant at a different brokerage firm. His primary task is to establish reporting procedures, like his work at Zane Brokers.

Which of Davis' potential actions would *least likely* violate Standard IV(A) – Loyalty?

A. Copying the code he used at Zane without permission.
B. Using his experiences and knowledge at Zane to recreate the code at his new employer with minor tweaks to fit his new employer's needs.
C. None of the above.

Solution

The correct answer is **B**.

Davis can use the experience and knowledge gained during his internship at his new employer.

However, any work produced during his internship belongs to his employer. Using a copy of the code without permission from his former employer would be a violation.

Note: The unpaid internship is not relevant; Davis presumably used company resources to develop the work product.

Application 3: Starting A New Firm

Craig Fisher currently works at Generous Finance – an impact investing fund. He is planning to start a firm with his business partner. They have recently applied to secure a brokerage license from the relevant regulatory authorities. Fisher has not notified his employer about his intentions of starting his firm. Neither Fisher nor his partner has solicited any clients at their current employers.

Has Fisher violated Standard IV(A) – Loyalty?

A. No.
B. Yes, because he has not notified his current employer about starting his firm.
C. Yes, because he is not allowed to set up his firm before leaving his employer.

The correct answer is A.

Fisher has not violated Standard IV(A) – Loyalty. His preparations in setting up his firm do not conflict with his current obligations at his current employer. Fisher could potentially violate Standard IV(A) if he made the preparations during office hours or at his employer's expense.

Application 4: Taking Former Employer's Client List

Peng Chao, CFA, is a portfolio analyst at CVF Inc. Peng has given his one-month resignation notice. During this period, he has taken the contacts of his employer’s clients, who he brought. He intends to market his new employer’s investment products to these clients once he starts his new job. Under the CFA Institute Code and Standards, Peng’s action:

A. violates the CFA code and standards.
B. does not violate the CFA Institute Code and Standards because he brought these clients to the former employer.
C. not violate the CFA Institute Code and Stand because he did not market to clients before leaving his employee.

Solution

The correct answer is **A.**

The former employer’s client's contacts are the former employer's property and can not be taken without permission. Peng violated the Standard IV(A) by taking the contact list.

LOS 5m: Standard IV(B) – Additional Compensation Arrangements

Members and Candidates must acquire written consent from all parties concerned before accepting gifts, benefits, remuneration, or other incentives that competes with or could reasonably be expected to create a conflict of interest with their employer's interest.

Members and candidates must acquire written authorization from their employer before accepting any gift, benefit, or salary that could reasonably be expected to cause a conflict of interest with their employer's interest.

Application 1: Notification of Client Bonus Compensation

Samuel White is a senior portfolio manager at Ascot Capital. He manages the investment portfolios of several high-net-worth individuals. His client, Susan Jenkins, has proposed the following bonus:

"A fully paid luxury trip to Greece for your family that is contingent on beating the return on the FTSE 100 over the following year."

He receives written permission from his employer after making detailed disclosures to his firm's compliance department.

Another client of his, Davis Elliot, recently gifted White a set of golf clubs for his superior performance over the year. White does not disclose this gift to his supervisor or the compliance department at his firm.

Has White violated Standard IV(B) – Additional Compensation Arrangements?

A. No, because he received written consent from his employer regarding the bonus.
B. Yes, because he is not permitted to receive any form of additional compensation.
C. Yes, because he fails to disclose the gift he received from Elliot.

Solution

The correct answer is **A**.

In this case, White has not violated Standard IV(B) – Additional Compensation Arrangements. White received consent from his employer – the additional compensation has been permitted.

However, White has violated Standard I(B) – Independence and Objectivity by failing to disclose the gift received from Elliot. For White to comply with Standard I(B), he must disclose any gifts received for past performance.

Note: Candidates need to distinguish between a gift and additional compensation agreements and the necessary disclosures required in both circumstances.

Application 2: Notification of Outside Compensation

Troy Mavis is a board member of Peak Animations. Davis does not receive any monetary compensation for the duties performed in his role. However, he receives complimentary access to Peak movie premieres and Peak Amusement Parks. Mavis purchases Peak Animations stock for suitable client accounts. Mavis does not disclose this arrangement to his employer. Mavis believes he does not need to disclose this because he does not receive monetary compensation.

Has Mavis violated Standard IV(B) – Additional Compensation Agreements?

A. No, because he does not receive monetary compensation for his service on the board.
B. Yes, because he fails to disclose the non-monetary benefits received for his service on the board.
C. No, because his service as a board member does not conflict with his work arrangements.

Solution

The correct answer is **B**.

Mavis is required to disclose *any* benefits (monetary or non-monetary) to his employer for services rendered as a board member. The disclosure is required because his service as a board member may present a conflict of interest, especially because he handles client accounts that hold Peak Animations stock.

Application 3: Additional Compensation

DER Inc. plans to offer its shares in an IPO. As such, it has arranged a meeting with CFA-certified analysts to discuss the upcoming IPO. In addition to paying for the transportation and food expenses for the analysts, the company has given each analyst a new phone worth €1200. Under the CFA Institute Code and Standards, the analysts should

A. seek permission from their clients before accepting the gifts.
B. not accept the gift.
C. accept the gift, then inform their employers.

Solution

The correct answer is **B.**

The analysts should not accept the gift as it would appear to cause a conflict of interest with DER Inc.'s upcoming IPO. The value of the gift is too high, and it could compromise their actions in relation to the IPO whether they inform their employers or not.

LOS 5n: Standard IV(C) – Responsibilities of Supervisors

Members and Candidates are responsible for ensuring that anybody under their supervision or responsibility follows all applicable laws, rules, regulations, and the CFA Institute Code and Standards.

Application 1: Supervising Research Activities

Joy Silverstone, CFA, is the head of research at KK Securities. She recently had a meeting with her team of equity analysts regarding a change in her recommendation of SenSen Motors. She is about to issue a report that downgrades SenSen Motors from a buy to sell. KK Securities has no formal procedures for disseminating a change in investment recommendations – there is an unwritten "trust" policy among the group of analysts.

An analyst in her team, Ferdinand Glassman, proceeds to inform one of the firm's largest institutional investors about the change in the recommendation – before it has been widely disseminated. The institutional investor proceeds to sell a portion of their holdings in SenSen Motors.

Has Silverstone violated Standard IV(C) – Responsibility of Supervisors and Standard III(B) – Fair Dealing?

A. She has violated both standards.
B. She has violated Standard IV(C) – Responsibility of Supervisors *only*.
C. She has violated Standard III(B) – Fair Dealing *only*.

Solution

The correct answer is **B**.

Silverstone has violated Standard IV(C) – Responsibility of Supervisors by failing to implement procedures to prevent the premature dissemination of changes in investment recommendations. As the head of research, she should ensure that KK Securities has adequate procedures for disseminating investment recommendations.

In this case, Glassman (not Silverstone) has violated Standard III(B) – Fair Dealing by giving one client preferential treatment. Standard III(B) – Fair Dealing requires that Members and Candidates give all clients an equal opportunity to take investment actions.

Application 2: Supervising Trading Activities

Fabien Edwards is a junior trader at Stevenson Brokerage. Edwards is primarily responsible for executing large trades on Stevenson's largest retail clients.

Francesca Duplass is the compliance officer responsible for monitoring the firm's trading activity. Both Duplass' and Edwards' bonus compensations are linked to the trading volume generated over a financial year.

Duplass has noticed increased trading in the client accounts that Edwards handles. She observes that block orders that could have been completed in one trading session have been split over several trades. Duplass fails to investigate the increased trading activity and does not bring this to the attention of the head of compliance.

Has Duplass violated Standard IV(C) – Responsibility of Supervisors?

A. No, because she is not directly responsible for the increased trading activity.
B. No, because she does not know the circumstances surrounding the increased trading activity; therefore, she does not need to investigate further.
C. Yes, because she fails to review and investigate Edwards' trading activity adequately.

Solution

The correct answer is **C**.

Duplass's failure to investigate the 'suspicious' trading activity, especially when there is an incentive to "over-trade," violates Standard IV(C) – Responsibility of Supervisors. Duplass should be conscious of actual and potential conflicts of interest that may arise between his self-interest and discharging supervisory duties. In this case, it appears that Duplass would benefit from failing to act appropriately in her supervisory role.

Application 3: Supervising Departments

Loise Losiwa, CFA, is the CEO of the research department at Moninga Inc, an established brokerage firm. Loise has decided to change her recommendation of certain pharmaceutical products from sell to buy. As per Moninga's procedures, Loise orally discusses with heads of the department under her about her new propositions before the research report is published. As a result of this conversation, one of the heads of departments, Jason Hull, buys pharmaceutical shares for his own account and those of his high net-worth clients. Moreover, some heads of departments spread the word to some of Moninga's customers.

Loise *most likely:*

A. violated the CFA Institute Code and Standards.
B. did not violate CFA Institute Code and Standards since she followed the company's procedures.
C. did violate CFA Institute Code and Standards because she consulted her juniors about her recommendation.

Solution

The correct answer is **A.**

Loice has violated Standard IV(C) because she failed to reasonably and sufficiently supervise the actions of those under her. She failed to establish reasonable procedures to prevent the dissemination of information by Jason Hull and other heads of departments.

LOS 5o: Standard V – Investment Analysis, Recommendations, and Action

Standard V(A) – Diligence and Reasonable Basis

Members and Candidates must:

i. Analyze investments, give investment recommendations, and take investment activities with diligence, independence, and completeness.
ii. Have a reasonable and adequate basis for any investment analysis, recommendation, or action, backed by suitable research and investigation.

Diligence and Reasonable Basis informs that recommendations be made based on a firm's independent research or the quantitative research of other reputable sources.

Application 1: Group Research Opinions

Calvin Samuelson is a junior fixed-income analyst at FreeHouse Securities. He is tasked with writing a report on the Fed interest rate expectations over the next two quarters. Samuelson completes his report and submits it to the investment review committee – as mandated by the firm's procedures.

An excerpt from the report's states:

"With the economic slowdown caused by the COVID-19 pandemic, we expect that the Fed will hold the Fed Funds rate steady at 0.25% over the next two quarters."

The majority of the investment committee does not agree with Samuelson's conclusions. The committee overwhelmingly believes there will be a strong bounce back in economic activity and share concerns about unanticipated inflation. They believe the Fed will react by increasing the benchmark rate by 25bps over the next two quarters.

Samuelson does not agree with the consensus conclusion and believes that there is no reasonable and adequate basis for the committee's conclusions but proceeds to leave his name on the report.

Has Samuelson violated Standard V(A) – Diligence and Reasonable Basis?

A. Yes, because his report is supposed to reflect his views and conclusions.
B. No, because the firm's internal policies require a consensus opinion.
C. Yes, because he fails to dissociate from the report when he believes that there is no reasonable basis for the conclusions of the report.

Solution

The correct answer is **C**.

Samuelson has violated Standard V(A) – Diligence and Reasonable Basis by failing to dissociate from the report. The conclusions of *any* research report or investment recommendation are inherently subjective.

In this case, the investment committee may have valid reasons for conclusions that differ from Samuelson's. The firm can publish a report substantially different from Samuelson's findings if there is a reasonable and adequate basis for its conclusions. If Samelson believes there is no reasonable basis for the conclusions, he should dissociate from the report – by declining to have his name on the published report.

Application 2: Reliance on Third-Party Research

Phillip Russo is the CEO of a mid-sized asset management firm. His firm relies heavily on external research to inform the firm's investment recommendations and actions. Russo's firm subscribes to a service from a reputable boutique research firm. The research firm has recently been awarded a prize for its stellar research coverage of the North American durable goods sector. Russo is confident in the rigor and quality of the research published by the firm and does not perform any independent due diligence to determine the quality and accuracy of the data received. Russo always attributes the source of the research and explains this to his clients.

Which of Russo's actions are *most* likely a violation of the CFA Institute's Standards?

A. None of his actions violates any standards.
B. His use of external research to inform the firm's investment actions.

C. His failure to perform due diligence on external research.

Solution

The correct answer is **C**.

Russo has violated Standard V(A) – Diligence and Reasonable Basis by failing to perform due diligence on external research. Russo can use external research if he attributes the research to its original author or publishing entity.

LOS 5p: Standard V(B) – Communication with Clients and Prospective Clients

Members and Candidates must:

i. Immediately disclose to customers and prospective clients the basic format and broad principles of the investing procedures they employ to analyze investments, choose securities and construct portfolios, as well as any modifications that may materially influence those processes.
ii. Make significant restrictions and risks connected with the investment process known to clients and prospective clients.
iii. Use reasonable judgment in determining which aspects are critical to their investment analysis or recommendations and incorporate those considerations in discussions with clients and prospective clients.
iv. Distinguish between fact and opinion when presenting investing analysis and suggestions,

Application 1: Opinion as Fact

Emmanuel Oluwo works as an oil and gas analyst at GeoField Consultancy Group. He has been working on a report that attempts to assess the crude oil production capacity of Naija Oil Corporation. His assessment will form part of his updated investment recommendation.

Naija Oil Corporation has recently tapped a significant oil resource on the northwest coast of Nigeria. Oluwo's report includes his estimate (through a series of calculations) of the expanded production capacity of the newly tapped oil field.

In his conclusion, Oluwo states:

"Based on the increase in the production capacity of 500,000 barrels per day, I recommend that Naija Oil Corp is a strong BUY."

Has Oluwo violated Standard V(B) – Communication with Clients and Prospective Clients?

A. Yes, because he presents his estimate of the increase in capacity of 500,000 barrels per day as a fact and not opinion.
B. No, because he is permitted to include any relevant information in his research report.
C. Yes, because he does not provide a detailed explanation about the methodology applied in estimating the production capacity of the new oil field.

Solution

The correct answer is **A**.

Oluwo has violated Standard V(B) – Communication with Clients and Prospective Clients. Oluwo's calculation of the increase in production is a quantitative estimate (an opinion) and not fact. Opinions must clearly be distinguished from facts in research reports. Oluwo should have details about his estimation methodology prepared and available on request.

Application 2: Notification of Fund Mandate Change

Regis Partners is a fund manager that specializes in large-cap European stocks. One of the key screening criteria is selecting stocks with a minimum market capitalization of EUR 5 billion. The Eurozone's economic outlook and growth prospects have diminished over the past five years, and Regis has altered the growth rate estimates for several of the firms in its 'Euro large-cap growth' fund.

In an attempt to broaden the fund's investment universe, Regis's CFO changed the permitted market capitalization to EUR 2.5 billion. Regis CFO ensures that the firm's marketing and promotional material include the change in the market capitalization criteria and informs all prospective clients about the updated investment process.

Are any of Regis's CFO actions in conflict with Standard V(B) – Communication with Clients and Prospective Clients?

A. None of his actions conflict with Standard V(B).
B. Yes, his failure to inform the firm's existing clients of the change in the market capitalization.

C. Yes, he is not permitted to change the screening criteria of the fund without notifying the firm's existing clients.

Solution

The correct answer is **B**.

To comply with Standard V(B) – Communication with Clients and Prospective Clients, Regis's CFO must inform all *potential* and *existing* clients about the change in the investment process.

Regis's CFO took appropriate but incomplete measures in communicating the change in the fund's investment mandate. Communicating the change in the mandate is a necessary step in providing clients the information required to judge the suitability of their investment in Regis's Euro large-cap growth fund.

LOS 5q: Standard V(C) – Record Retention

Members and Candidates must create and keep relevant documents to support their investment analysis, suggestions, actions, and other investment-related discussions with customers and prospects.

Application: Records of The Firm

Scott Garcia is the head of quantitative research at Green Point Investments. Over the six years at Green Point, he has contributed and developed the firm's quantitatively driven investment strategies. Garcia has diligently documented the assumptions and reasoning behind his work product. Garcia has resigned and has plans to start a consultancy firm. With the permission of his employer, he copies the records of the supporting documentation of strategies he has previously worked on.

Has Garcia violated Standard V(C) – Record Retention?

A. Yes, because he is not permitted to make copies of any material developed at his previous employer.
B. No, because he received permission to make copies of the supporting documentation.
C. No, because he maintains all documents related to the work on the firm's investment strategies.

Solution

The correct answer is **B**.

All the records developed by Garcia are the property of the firm. Garcia has not violated Standard V(C) – Record Retention because he received permission from his employer to make copies of the supporting documentation. If Garcia had not received permission, he would recreate the supporting documentation and strategies through publicly available information.

LOS 5r: Standard VI – Conflicts of Interest

Standard VI – Conflicts of Interest

There are bound to be conflicts of interest and loyalty within any business organization, leading to an ethical dilemma. Standard VI specifies that CFA members and candidates must disclose any potential conflicts between clients and employers, individual interests, and the like. The purpose of this is to protect employers from an unknown clash of concerns that may promote unethical decisions.

Standard VI(A) – Disclosure of Conflicts

Standard VI(A) – Disclosure of Conflicts dictates that CFA members must disclose any and all circumstances which might result in a conflict of independence and objectivity or interfere with loyalty to clients or employer.

Compliance

The most effective means of compliance with Standard VI(A) – Disclosure of Conflicts is to avoid conflicts or the appearance of conflicts. However, conflicts of interest or loyalty often arise within the financial services industry, most frequently related to compensation.

Regarding compensation packages that could cause conflicts of interest related to client loyalty, such as performance fees or referral fees, the best practice is to publish compensation policies within promotional literature. Additionally, if a member obtains option securities as part of his/her compensation, the amount and expiration of these options should be published in a public forum.

When a conflict cannot be avoided, disclosure is the best way to solve this ethical dilemma. Reportable circumstances include any event that disables an investment professional from being independent and objective (see Standard I(B) – Independence and Objectivity). For example, an analyst's spouse may be gifted a significant amount of stock in a company for which s/he makes recommendations. In the analyst's personal interests, it is to encourage the purchase of this stock to foster increased demand. However, a professional analyst must remain impartial in their review and recommendation. Therein lies a conflict of interest. In this case, to comply with Standard VI(A) – Disclosure of Conflicts, an analyst should disclose personal circumstances to an employer and request to be removed from the firm's research team for this security.

Conflicts can also occur between departments of a firm. For example, to gain business from a company, a marketing professional may ask an analyst to write a favorable recommendation for that company. This would result in a lack of objectivity required of members. Members and their firms must attempt to resolve such conflicts through disclosure and evaluation.

Violation

As previously stated, the most effective means of compliance with Standard VI(A) –Disclosure of Conflicts is to avoid conflicts or the appearance of conflicts. Additionally, if a member's firm does not permit disclosure of conflicts, the investment professional should consider disassociating from the activity.

Question

Augusto Martinez is employed as an investment manager for Mondo Principal, a large brokerage firm. While Martinez is employed by the firm, Wealth Assets Inc. seeks Martinez' advice on client portfolios. Wealth Assets specifies that the work can be done during evenings or weekends and that a fee will be provided to Martinez for his effort. Martinez received written consent three months ago from his immediate supervisor at Mondo to undertake this outside work for a limited period of 8 weeks.

Which of the following is an accurate statement related to Standard VI(A) –Disclosure of Conflicts?

A. Martinez did not violate Standard VI(A) – Disclosure of Conflicts.

B. Martinez violated Standard VI(A) – Disclosure of Conflicts.

C. Martinez may have violated Standard VI(A) – Disclosure of Conflicts if he continues to work for Wealth Assets.

Solution

The correct answer is C.

Martinez received written permission from his immediate supervisor at Mondo Principal, thereby alleviating concern related to employee loyalty and conflicts. However, since that permission was given for a specified period of eight weeks, Martinez may be in violation of Standard VI(A) – Disclosure of Conflicts if his work for Wealth Assets continues three months later.

LOS 5s: Standard VI(B) - Priority of transactions

Client and employer investment transactions must take precedence over investment transactions in which a member or candidate is the beneficial owner.

Application 1: Family Account as Equals

Gia Davies, a senior trader at InvestCorp Brokerage, has recently helped her sister open up a standard fee-paying brokerage account with InvestCorp's Brokerage Divison. One of InvestCorp's investment banking clients, InfoTrak Inc., is set to go public in the next few weeks through an initial public offering.

Which of Davies's actions would *most likely* violate Standard VI (B) – Priority of Transactions?

A. Taking no action and allowing her sister's account to be treated like any other standard fee-paying account.
B. Increasing the allocation of InfoTrak's shares in her sister's brokerage account.
C. Failing to disclose the family relationship to the compliance team.

Solution

The correct answer is **B**.

Davies increasing her sister's allocation in InfoTrak's shares would violate Standard VI (B) – Priority of Transactions. Her sister is a fee-paying client and should be treated like any other client – she should not receive favorable treatment. Her allocation should be treated in the same manner as any other fee-paying client.

Application 2: Personal Trading and Disclosure

Benjamin Cook was a research intern at a prominent active management firm. He purchases a luxury car and several designer accessories during his eight-month-long internship. Regina Perry, chief compliance officer at the firm, is responsible for monitoring personal stock trades for all employees. She investigates Cook's personal trades and finds that Cook had made significant profits by selling (shorting) stocks just before they were put on the firm's "SELL" list.

Cook had omitted several personal transactions on his monthly personal trading form. In addition, he failed to submit his trading forms over the last two months of his internship.

Have Cook and (or) Perry violated Standard VI(B) – Priority of Transactions?

A. Neither Cook nor Perry has violated Standard VI(B) – Priority of Transactions.
B. Cook violated Standard VI(B) – Priority of Transactions.
C. Both Cook and Perry have violated Standard VI(B) – Priority of Transactions.

Solution

The correct answer is **B**.

Cook violated Standard VI(B) – Priority of Transactions by placing his trades before his client's trades.

Additionally, Perry, the chief compliance officer, has violated Standard IV(C) – Responsibility of Supervisors by allowing Cook to continue his duties without accurate and infrequent submission of his personal transaction form. Note that if Cook had passed on the firm's recommendations to an individual who traded the security, the use of the information would be a violation of Standard II(A) – Material Nonpublic Information.

LOS 5t: Standard VI(C) – Referral Fees

Members and Candidates must disclose any remuneration, consideration, or advantages received from or provided to anyone to recommend products or services to their employer, clients, and prospective clients, as applicable.

Application 1: Disclosure of Interdepartmental Referral Agreements

Britney Sullivan works in the research department at Zeus Investment Bank. She receives compensation for each referral to the brokerage department that results in any trading activity. She refers numerous clients to the brokerage department at Zeus Investment Bank but fails to disclose this arrangement to her clients.

Has Sullivan violated Standard VI(C) – Referral Fees?

A. No, because she only needs to disclose referral arrangements to her employer.
B. No, because the referral arrangements and payments are made within the firm.
C. Yes, because she did not disclose the referral arrangements to her clients.

Solution

The correct answer is **C**.

Sullivan has violated Standard VI(C) – Referral Fees by failing to disclose the referral arrangement at Zeus Investment Bank. Standard VI(C) – Referral Fees does not distinguish between compensation paid to external or internal referees. Members and Candidates must disclose *all* referral compensation. Therefore, Sullivan is required to disclose the internal referral compensation in place at the point of referral. The disclosure must include the *amount* and *nature* of the compensation.

Application 2: Disclosure of Referral Arrangements and Informing Firm

Phillip Evans is a portfolio manager at Bridging Finance Corporation. Evans has routinely asked the trading desk to direct a small portion of its trading activity to Jaystar Brokerage, a mid-size broker/dealer headed by his brother-in-law. Jaystar's commissions are above the industry average, and the traders find the research provided to be uninformative. Evan's brother-in-law reciprocates this arrangement by frequently recommending Bridging Finance Corporation and Evans to all his clients. This arrangement is not disclosed to his employer or clients referred to by Jaystar Brokerage.

Has Evans violated Standard VI(C) – Referral Fees?

A. Yes, because he fails to disclose the nature and value of the referral arrangement to his employer.
B. No, because his brother-in-law reciprocates by referring his clients to Bridging Finance Corporation.
C. No, because he is prohibited from receiving any referral compensation.

Solution

The correct answer is **A**.

Evans has violated Standard VI(C) – Referral Fees by failing to inform his employer of the referral arrangement. Evans must disclose the nature and value of the referral arrangements to his employer; conversely, his brother-in-law must disclose the arrangement to his clients. Standard VI(C) – Referral Fees does not prohibit any referral compensation; however, full and timely disclosures are required.

LOS 5u: Standard VII – Responsibilities as a CFA Institute Member or CFA Candidate

Standard VII(A) - Conduct as participants in CFA Institute programs

Members and Candidates must not participate in any activity that jeopardizes CFA Institute's or the CFA designation's reputation, integrity, or security of CFA Institute programs.

Application 1: Writing After Exam Period End

Fiona King, a CFA Level III candidate, took a five-minute bathroom break during the morning session of the Level III exam. The proctor announces that it is time to stop writing. King attempts to make further corrections on her exam script after the proctor had called time. She ignored repeated requests from the proctor to stop writing. She finally adheres to the proctor's instructions after making minor corrections. When asked for her reasoning behind violating exam procedures, she states that she *assumed* that she had more time than other candidates because she had taken a bathroom break.

Would King's actions constitute a violation of Standard VII(A) – Conduct as Participants in CFA Institute Programs?

A. Yes, because she continues to make minor corrections after the exam has ended.
B. No, because she is only making minor corrections to her exam script.
C. No, because she assumed she had extra time after taking a five-minute bathroom break.

Solution

The correct answer is **A**.

By continuing to make changes to her exam script (minor or significant) after time was called, King has violated Standard VII(A) – Conduct as Participants in CFA Institute Programs. Additionally, she has violated the CFA Program's rules and regulations by ignoring the proctor's instructions. Candidates are permitted to take supervised bathroom breaks; however, these breaks will count against the time allocated for the exam.

Application 2: Sharing Exam Content

Douglas Wright, an Australian Level I candidate, just completed the CFA Level I examination. Immediately after the exam, he posts a series of tweets that highlight his exam experience.

He posts the following:

"The CFA Institute is a joke! The Level I exam was truly awful, the examiners expected too much. It was far too difficult. I was extremely prepared for the financial reporting and analysis section and was disappointed that there weren't as many questions as expected. I counted 25 in total; this is far different from the 48 I expected. I was also surprised to see no derivatives questions in the afternoon session. I think I did enough to pass..."

How has Wright most likely violated Standard VII(A) – Conduct as Participants in CFA Institute Programs?

A. By expressing his opinion about the difficulty of the Level I exam.
B. By revealing details about parts of the Candidate Book of Knowledge (CBOK) that were tested or omitted in the Level I exam.
C. By expressing a negative opinion about the CFA Institute and examiners.

Solution

The correct answer is **B**.

King has violated Standard VII(A) – Conduct as Participants in CFA Institute Programs by sharing parts of the CBOK that weren't covered in the Level I exam. King is allowed to express his opinions about the CFA Institute and its examiners, the difficulty of the exam, and performance without violating Standard VII(A) – Conduct as Participants in CFA Institute Programs. By revealing what was or what wasn't tested, Wright may have inadvertently assisted other candidates in different time zones, thereby undermining the integrity of the exam.

LOS 5v: Standard VII(B) - Reference to CFA Institute, the CFA Designation, and the CFA Program

Application 1: Stating Facts About the CFA® Designation and CFA® Program

Dorothy Chen, CFA, is in conversation with one of her mentees – Hannah Blake. Blake is considering sitting the CFA Level I exam and is asking Chen for her advice. Chen states that going through the CFA® Program enhanced her knowledge of the investment industry and profession. Additionally, she praises the rigor and high ethical standards emphasized by the CFA Program. Chen informs Blake that she passed all three exams in three consecutive years.

Chen's LinkedIn profile states that she is an active member of the CFA Institute. However, she is yet to pay her current annual membership dues.

Which of Chen's statements would *most likely* be considered a violation of Standard VII(B) – Reference to CFA Institute, CFA Designation, and the CFA® Program?

A. The CFA® Program enhanced her knowledge of investment, industry, and profession.
B. Informing Blake that she passed all three exams in three consecutive years.
C. Her LinkedIn profile states that she is an active member of the CFA Institute.

Solution

The correct answer is **C**.

Chen has violated Standard VII(B) – Reference to CFA Institute, CFA® Designation, and the CFA®Program by implying that she is a CFA Institute member in her LinkedIn profile *without* paying her annual membership dues. Her statement regarding passing all three exams in three consecutive years is a fact and is therefore not a violation of Standard VII(B).

Application 2: Improper Reference to The CFA® Program and Designation

Which of the following is an improper reference to the CFA® Program and/or designation?

A. "Enrolling in the CFA® program has made me a better equity valuation analyst than my peers."
B. "I am February 2021 CFA Level I candidate."
C. "I have passed all three levels of the CFA® Program and may be eligible for the charter subject to the completion of the required work experience."

Solution

The correct answer is **A**.

Answers B and C make correct reference to the CFA® Program and Designation. Implying that passing all three levels of theCFA® Program makes an individual a better analyst is a violation of Standard VII(B) – Reference to CFA Institute, CFA® Designation, and the CFA®Program. Claiming superior ability by obtaining the designation or passing the examinations is *strictly prohibited* under Standard VII(B).