Learning Module 3: Guidance for Standards I-VII

LOS 3a: Standard 1(A) – Knowledge of the Law

I. Professionalism

Standard I is broad in scope and directed toward competence within a small business environment. This standard makes it clear high ethical standards must apply even when an issue hasn't been identified in writing.

Standard I(A)

Standard 1(A) – Knowledge of the Law specifies that investment professionals must have a working knowledge of all applicable laws, as well as a framework for resolving ethical dilemmas.

Compliance

When providing a service to clients of a different country, perhaps with different laws governing its financial sector, CFA members must adhere to whichever regulations are the strictest. This may be one’s local laws or those of a client.

In some cases, it may also mean a hybrid of the two. While in other cases, local codes of ethics may be laxer than the CFA Code of Standards.

In these instances, members are required to adhere to CFA standards. Please refer to Table 1(A) for a few detailed examples.

Examples

Example 1

Circumstance:

A CFA member lives in a country with no securities laws and does business in a country whose laws are less strict than the Code of Standards.

Which laws apply?

The laws of the country in which the member is operating apply.

Duty

The member must adhere to the Code of Standards.

Example 2

Circumstance:

A CFA Member lives in a country with less strict laws than the Code of Standards and does business in a country with no securities regulations.

Which laws apply?

The laws of the country in which the member resides apply.

Duty

The member must adhere to the Code of Standards.

Example 3

Circumstance:

A CFA member resides in a country whose securities regulations are less strict than the Code of Standards and does business in a country with stricter laws.

Which laws apply?

The laws of the country in which the member does the business do apply.

Duty

Because the country's laws in which the member does business are stricter than the Code of Standards, members are obligated to follow the stricter laws of the country.

Note. **Adapted from** ***2017 CFA Curriculum (p. 48)*** **by CFA Institute, New York: 2017**

Global Application of Code of Standards

Similarly, the application of law may be dictated by a complex client situation in which several choices could be made in determining a course of action. Therefore, it is incumbent upon CFA members to interpret proper decision-making based upon whichever laws are most stringent in protecting client interests.

Avoiding unethical behavior is imperative, up to the point of separating from an employer or client relationship if a CFA member is knowledgeable of unethical behavior. Although there are intermediate steps to dissociate from unethical activity, the CFA does expect its members to do whatever necessary for its members to adhere to the Code of Standards, including employment separation and/or reporting of ethics violations to the CFA.

Finally, Standard 1(A) – Knowledge of the Law specifies that the Code of Standard is a minimum threshold for adherence to ethical behavior. Therefore, investment professionals are urged to make decisions that exceed minimal requirements whenever possible. At a minimum, investment professionals are required to stay informed, review procedures, and maintain current files.

Violation

CFA members will be held in violation of Standard 1(A) – Knowledge of the Law when they participate in violating any applicable law or the Code of Standards. Although members are expected to adhere to the Code of Standards, the CFA recognizes that members may not be fully informed of all facts giving rise to a violation of laws. Therefore, it is the willful disregard of ethical requirements that determines a violation.

The CFA urges members to report alleged violations, though failure to report does not necessarily constitute a violation in itself. Wherever local laws require the report of illegal behavior by investment professionals, it is expected that members will comply. All members are encouraged to consult with legal and compliance counselors for advice in this regard.

Question

John McIntyre has been offered by his U.S. employer a temporary investment analyst assignment in Singapore. John is well-versed in investment regulations within the United States, knowing that in most cases, these laws are more stringent than the CFA Code of Standards. When he arrives in Singapore, he is surprised to learn that laws governing the financial industry are stricter than his home office. To what level of regulation must McIntyre hold his professional conduct?

A. United States laws and regulations
B. Singapore laws and regulations
C. Code of Standards

Solution

The correct answer is **B.**

McIntyre is bound by CFA standards to adhere to whichever regulations are the strictest. In this case, while he operates in Singapore, he must follow Singapore laws and regulations.

LOS 3b: Standard I(B) - Independence and objectivity

Standard I(B) – Independence and Objectivity addresses the issue of gifts, payment, and favors that may compromise one's objectivity and service to clients. This includes advisors, analysts, and credit raters.

Compliance

It is recognized that third-party firms may seek to increase a CFA member's dependence upon its research/market analysis, promotion of new securities offerings, or securities ratings. In these cases, it is not uncommon for a third-party firm to offer gifts such as event tickets, paid conference attendance, or job referrals. However, the Code of Standards specifies that its members must not accept these offers, as they can unduly influence an investment professional's obligations to remain independent and objective with regard to professional activities. Likewise, members working to earn a new investment allocation must not offer such gifts as hiring incentives.

Special note is given to travel considerations. Although a firm may view the offer to fly its investment professionals on a third-party's chartered jet as a cost-savings measure for the firm, the opportunity for conflict of interest arises. These private transportation circumstances also allow a third party to influence CFA members' investment recommendations and offer the opportunity for a third party to probe for investment options outside the acceptable course of business. Similarly, offers to pay for lavish accommodations or pay for sponsored conferences and events often risk members' independence and objectivity.

Receiving gifts from clients is distinguished from that of third-party influencers in that a client has already entered into a contractual relationship with the investment professional. In these cases, a client gift can be considered acceptable supplementary compensation. CFA members should disclose gifts from clients to their respective employers. If, perhaps, a client arrangement proceeds the investment professional's employment with a firm, then upon employment, the member should discuss past gifts with an employer. This allows an employer to determine the extent to which an employee may remain independent and objective.

Standard I(B) – Independence and Objectivity also address retaliatory practices between sell-side and buy-side agents. Actions such as downgrading a stock can create a significant impact in the marketplace. Members must avoid the impulse to retaliate against analysts who lower stock ratings to preserve the independence and objectivity of those analysts.

Violation

To avoid violation of Standard I(B) – Independence and Objectivity, CFA members are encouraged to create a restricted list of analysts and rating agencies who refuse to distribute appropriately negative research for certain companies. Also, CFA members should restrict travel cost arrangements by third parties to avoid ethical conflict, limit gifts, restrict employees' investment in IPOs to limit conflict of loyalty, establish a formal independence and objectivity policy and appoint an officer to oversee compliance with these concerns.

Question

Grey Gordon, CFA, is a securities analyst assigned to K-Trail Flatbeds, a major producer of trailers for the trucking industry. K-Trail's headquarters are located in Meadow Lake, Saskatchewan, approximately four hours by automobile from the nearest airport. Gordon contacts K-Trail's management to gather information for a report he is preparing; the chief financial officer invites Gordon to meet the management team at K-Trail, indicating that he will send the company's private jet to fly Gordon to Meadow Lake and return him home the same day.

Gordon estimates that he would require 18 hours to visit K-Trail using commercial travel. If Gordon accepts the offer and makes the trip to K-Trail's headquarters on the corporate jet, Gordon:

A. Has not violated Standard I(B) – Independence and Objectivity.
B. Has violated Standard I(B) – Independence and Objectivity unless he discloses the trip and the payment of his travel expenses in his report on K-Trail.
C. Has violated Standard I(B) – Independence and Objectivity unless he reimburses Northwest for the cost of the trip.

Solution

The correct answer is **A.**

Standard I(B) – Independence and Objectivity requires members to maintain independence and objectivity. Members should encourage clients to limit the use of corporate aircraft, but exceptions can be made if transportation would not otherwise be available or would be inefficient. This exception to the rule is of major importance.

LOS 3c: Standard I(C) - Misrepresentation

Standard I(C) – Misrepresentation indicates that CFA members must not knowingly misrepresent information related to investment analysis, recommendations, or professional actions.

Compliance

Misrepresentation can be defined as omissions of information, or manipulating facts related to securities, or giving false impressions of a firm. This relates to oral communication advertisements, electronic communication, and written communication.

Members are prohibited from guaranteeing returns on unstable investments. Exceptions to this are cases in which the investment itself has guarantees built into the product's structure or if a firm has committed to covering any loss by the client.

As it relates to representing a firm’s reputation, it is unethical to misrepresent professional credentials, the performance of a firm, or experiences with a category of investment. Likewise, individual investment professionals may not falsify their records of performance.

A special mention of social media is made within Standard I(C) – Misrepresentation. The CFA Institute recognizes that in some cases, the anonymous nature of communication on social media platforms may entice members to communicate differently than one would on more traditional platforms. In all cases, investment professionals are urged to provide as much truthful information as is appropriate in a public setting. It may be tempting to bolster one’s achievements or qualifications within online chat rooms, even between other investment professionals. This is strictly prohibited regardless of the purported anonymity of the forum.

All analysis and statistical data used in written communication created outside a member’s firm must be sourced. Failure to do so will result in plagiarism, which misrepresents the author of said work. The exception to these are cases in which agents have developed data within the same firm.

Violation

Knowing misrepresentation indicates that a member knew or should have known that information was being distorted and could well have impacted investment outcomes.

To prevent violation of Standard I(C) – Misrepresentation, all professionals within a firm should know the limits of an employer’s qualifications and services. Additionally, a firm may choose to restrict the agents who are permitted to speak for the organization.

Related to external communications, one should verify information credited to outside sources. Additionally, a firm is obligated to update its web pages on time.

Finally, a formal plagiarism policy should be established to ensure that data is credited to its appropriate source in all forms of communication.

Question

Anna Roy, a CFA member and investment analyst, attends a client lunch where a portfolio manager professes, “You can be sure we’ll outperform the Real Estate index this year due to our fine research analysts.” Roy recognizes this statement as:

A. A violation of plagiarism policy under Standard I(C) – Misrepresentation.
B. A violation concerning the prohibition of guaranteeing returns under Standard I(C) – Misrepresentation.
C. Flattering and appropriate as a marketing technique.

Solution

The correct answer is **B.**

CFA members are forbidden from guaranteeing a specific rate of return on investments. Therefore, the statement is in violation of Standard I(C) – Misrepresentation.

LOS 3d: Standard I(D) - Misconduct

Standard I(D) – Misconduct addresses issues of honesty vs. deceit. It indicates that CFA members must not compromise their reputation, integrity, or competence. Standard I(D) – Misconduct contrasts with Standard 1(A) – Knowledge of the Law in that Standard 1(A) addresses applicable laws, and 1(D) is concerned with all behavior that could impact professional integrity.

Compliance

Preservation of integrity covers a broad scope of behavior. It can be interpreted as refraining from drinking alcohol during business hours and conducting due diligence related to recommendations. Any and all behaviors that upset a member's integrity or threaten the reputation of CFA Institute should be called into question. Therefore, whether the perception of misconduct relates to social behavior or professional competence, CFA members must hold themselves to the highest management standard.

Standard, I(D) covers conduct during normal business hours and in cases that a CFA member participates in financial services to charities or other non-profit organizations. For example, an investment professional may volunteer to serve a charity by negotiating the purchase of capital equipment. In doing so, if (s)he pays the overall purchase price to compensate for time and trouble, without express permission to do so, then it can be viewed in the light of Standard I(D) – Misconduct.

Violation

Standard I(D) – Misconduct expressly communicates that following the CFA Code of Standards to the letter is insufficient. Members must also hold themselves to high moral ideals by complying with the spirit of CFA Ethics and Standards.

A common concern related to misconduct is professional expenses. For example, an employee may augment expense receipts for client meetings, insurance reimbursement, or travel costs. All of these requests for expense payments would be considered an intent to defraud and, therefore, are a violation of Standard I(D) – Misconduct.

Question

Which of the following is *least* likely a violation of Standard I(D) – Misconduct?

I. Being intoxicated at the office

II. Being convicted of misdemeanor public nuisance over a holiday weekend

A. I only
B. II only
C. None of the above

Solution

The correct answer is **B.**

According to Standard I(D) “Members shall not engage in any professional conduct involving dishonesty, fraud, deceit, or commit any act that reflects adversely on their professional reputation, integrity, or competence.” The standard is not intended to regulate one’s personal behavior. Therefore, conviction of a misdemeanor public nuisance could be considered a passable act, not in violation of Standard I(D) – Misconduct.

LOS 3e: Standard II(A) - Material non-public information

II. Integrity of Capital Markets

Standard II discusses sharing of material information qualified as non-public, as well as the intent to manipulate markets. It prohibits CFA members from acting in a way to distort market value through manipulation.

Standard II(A) – Material Non-Public Information

Standard II(A) – Material Non-Public Information indicated that members who possess material, non-public information could unduly impact the markets. Therefore, they must not act or cause others to act on this information.

Compliance

It is expected that investment professionals will make recommendations based on publicly available information, incorporating necessary due diligence concerning market analysis. Trading with the use of material, non-public information is viewed as market manipulation in that it skews market value via manipulation.

The definition of material, non-public information is any knowledge that is not readily available and will clearly impact market value. A non-exhaustive listing of material information includes news of mergers and acquisitions, patent approvals, change in leadership, significant legal action, bankruptcy, or government reports of economic trends.

In addition to specific information used, the source of said information also has an impact on materiality. For example, an inside source close to the information is said to have a greater sense of veracity than a corporate competitor. Likewise, a member of any government agency who's in the position to approve a new product or patent would be considered material.

Related to the non-public aspect of information, disseminating data must be publicly available via the Internet or another easy-to-reach source. Noteworthy is the notion that a partial distribution of information to a limited group of financial analysts does not constitute public information. For example, if an analyst is on a conference call with a client in which non-public, material information may be disclosed; and the analyst fails to secure the area in which information is being exchanged (i.e., other employees may pass through the conference room while a call is in progress), then the analyst can be considered in violation of Standard II(A) – Material Non-Public Information.

To protect savvy financial analysts, Standard II(A) – Material Non-Public Information clearly states that conclusions which overlap with material, non-public information may be drawn from extensive research of publicly available data. For example, press releases or government filings are just two types of information that an analyst may utilize as research. Therefore, should these experts draw correct conclusions that mirror material, non-public information, it should not be considered misconduct.

With regard to the use of outside investment experts, it is permissible for CFA members to pay for knowledge related to specific industries. However, it is incumbent upon the member to ensure that the data received is not material, non-public information before sharing it with clients.

To achieve compliance with Standard II(A) – Material Non-Public Information, the following are recommended steps to be followed by an investment firm:

- Adopt compliance procedures to prevent misuse of material, non-public information.
- Adopt disclosure procedures to ensure that material information is thoroughly distributed to the marketplace.
- Issue press releases before analyst meetings to prevent disclosure of material, non-public information.
- Enact a "firewall" to restrict the flow of proprietary information within a firm. Additionally, monitor trading activity on any stocks for which a firm may hold material, non-public information.

- Prevent personnel from interacting with more than one departmental area within a firm. For example, investment banking and corporate finance should maintain a self-contained body of employees.
- Maintain detailed records of communication between various departments within a firm and records with outside agencies.

Violation

Any trading based on material non-public information is considered a violation of Standard II(A) – Material Non-Public Information. Although the burden of proof lies with a disciplinary board concerning materiality, non-public, and source, suspicion of violation is a serious matter. Therefore, strict adherence to the highest level of Standard II(A) – Material Non-Public Information should be a major concern for all investment firms.

Question

Muriel Gagnon, a CFA member, resides in and manages portfolios in a country where securities laws do not prohibit the sharing of material non-public information. Gagnon has an opportunity to benefit her clients by sharing quarterly financial results for Cote Industries two days before they become public. To comply with Standard II(A) – Material Non-Public Information, Gagnon has the following option:

I. Immediately make investment recommendations for each client based upon Cote Industries’ financial results.

II. Ask an analyst from another firm for advice after discussing the specific investment recommendations that she could share with clients.

III. Make securities trades on behalf of her clients without discussing specifics of Cote Industries' quarterly results.

A. I and III, only
B. II only
C. None of the above

Solution

The correct answer is **C.**

Muriel Gagnon must wait for Cote Industries' quarterly financial results to become public before she can discuss this material, non-public information with anyone. Therefore, none of the options provided would be appropriate.

LOS 3f: Standard II(B) - Market manipulation

Standard II(B) – Market Manipulation dictates that members refrain from any activity that will fraudulently manipulate volumes of trading and/or causes a distortion of securities pricing.

Compliance

Two key attributes of market manipulation are information-based and transaction-based.

Information-based manipulation involves the distribution of false or misleading information as a means of distorting volume trading and market price valuation. An example of the distribution of misleading information is the over-inflation of the projected value for a security, only to sell off the majority of holdings once the market price achieves an artificially high level. The common term for this practice is “pump and dump.”

Related to information-based manipulations, social media networks are a particularly viable target for such practices. The anonymity of those providing misinformation and the availability of amateur traders make this channel type an often preferred medium for market manipulation. Logging on to chat rooms to share inflated information about a holding to generate excitement for that security can be construed as market manipulation.

Transaction-based manipulations include making trades that would trigger a falsification in price-setting mechanisms, thereby misleading market participants. In addition, any transaction that artificially gives the impression that there is a movement within a financial instrument beyond expected market activity is subject to review for manipulation.

A firm can bolster its compliance with Standard II(B) – Market Manipulation by taking added precautions before making recommendations. Smaller firms, for example, are more easily manipulated based upon lighter trading and low liquidity. Therefore, prudence in releasing public information is critical. Additionally, healthy cynicism related to third-party research reports or press releases that make extreme marketing claims is advised. Finally, as a reminder, all research must include a disclaimer as required by the SEC.

Violation

The key to violation is the intent to deceive parties who depend upon accurate market information. For example, knowingly using inaccurate reporting under the guise of analysis would be an abuse of Standard II(B) – Market Manipulation.

Question

James Murrow, CFA, would like to make a large purchase of Smith Corporation. He is concerned, though, that due to infrequent trading of Smith Corp., buying a large volume of the company would result in an immediate price jump of the stock. To this end, Murrow wants to know if this is a violation of Standard II(B) – Market Manipulation.

You would indicate to James Murrow that:

A. He would violate Standard II(B) – Market Manipulation via transaction-based manipulation.
B. He would violate Standard II(B) – Market Manipulation through information-based manipulation.
C. No violation would occur.

Solution

The correct answer is **C.**

Murrow would commit no violation by purchasing stock in Smith Corporation. He would not intentionally distort prices through fraud or deceit. The overall lack of trading on Smith Corporation is not within his control. Therefore, a price jump based on Murrow's purchase is a natural reaction of an otherwise ethically traded security.

LOS 3g: Standard III(A) - Loyalty and prudence

III. Duties to Clients and Prospective Clients

Standard III addresses client loyalty, discretion, and care; fair dealing; suitability; performance presentation; and maintaining confidentiality. Investment professionals are obligated to put the interests of their clients before that of their organization or their personal interests.

Standard III(A)

Standard III(A) – Loyalty, Prudence, and Care compels CFA Members to put the interest of their clients before their employers or their own interests.

Compliance

Trust is key to developing a client relationship. More often than not, an investment manager has greater knowledge of the financial services industry than a client. Communication between investment professionals and clients will often reveal parameters set by a client. Those parameters must be maintained, in addition to the balance of risk and return.

In addition to the paramount importance of client loyalty, prudence requires that investment professionals practice discretion and care. In other words, all CFA members must practice due diligence and caution when handling clients' finances.

An aspect of ensuring that Standard III(A) – Loyalty, Prudence, and Care is maintained is to strictly adhere to Standard I(A) – Knowledge of the Law. Members are obligated to observe the strictest set of laws in any given client environment.

Related to fiduciary responsibility, in not all cases is a member to be considered a fiduciary. This will be determined by the type of client, the level of advice, and the circumstances surrounding any given transaction. Fiduciary duties include acting for the best interests of a client, including managing investments. In essence, fiduciaries achieve an advanced level of trust. As a professional whose primary role is to facilitate transactions and not directly advise a client, the level of fiduciary duty is diminished from a legal standpoint. Regardless of this distinction, all investment professionals are obliged by Standard III(A) – Loyalty, Prudence, and Care to put the interest of their clients before their employers or their own interests.

With regard to managing pensions or trusts, loyalty is not necessarily owed to the client hiring a firm but to the beneficiaries of that account. Likewise, in the event of an index fund, beneficiaries of an investment may not be known. In this case, it is incumbent upon a CFA Member to adhere to the stated mission of that fund. Conflict of interest can arise between hiring clients and plan beneficiaries. For example, perhaps a company whose pension is placed with an investment firm is the subject of a hostile takeover. Company leaders may urge the investment firm to use pension funds to purchase stock in the parent company to ward off the hostile investor. In this case, it is not corporate leadership to whom a member is obligated but the beneficiaries of the pension fund. Therefore, if the company's stock is overvalued, an investment professional must decline requests to purchase shares in that company.

"Soft commissions" are addressed under Standard III(A) – Loyalty, Prudence, and Care. These are commissions that aren't paid in dollars but on trade. For example, a trading brokerage may offer a third-party research firm the benefit of commission-free transactions in exchange for research reports. This allows the brokerage firm to show reduced expenses for research. Standard III(A) – Loyalty, Prudence, and Care cautions against soft commissions in cases that elevate the overall cost of this arrangement. Perhaps an actual expense paid in dollars would be less costly than a negotiated trade? In this case, the choice must be made to benefit one's client.

To maximize adherence to Standard III(A) – Loyalty, Prudence, and Care, the following are recommended:

1. Regular communication with clients, including written reports and up-to-date personal interaction.
2. Client approval in cases where a member is uncertain if an investment decision is matched with the client parameters.
3. Diversification of investments to limit the risk of loss. The exception to this is the case in which diversification runs counter to plan objectives.

4. Impartiality among clients. CFA members should not favor some clients over others.
5. Disclosure of potential conflicts of interests and compensation arrangements should be made available to clients so that they may evaluate that information.

Violation

Cases in which investment professionals do not practice due diligence as outlined in Standard I(A) – Knowledge of the Law, and Standard I(B) – Independence and Objectivity can be reviewed as a violation of Standard III(A) – Loyalty, Prudence, and Care.

An example of how Standard I(B) – Independence and Objectivity may relate to Standard III(A) – Loyalty, Prudence, and Care includes the undue influence of research and rating firms on investment decisions which could adversely affect client risk. Additionally, the question of soft commissions comes into play when an investment professional favors a brokerage firm with higher, non-dollar payment commissions over limiting costs to clients.

Question

The leadership team of Cracker Jack, Inc. has requested that Lisette Towle, portfolio manager for the company's pension fund, invest 45% of available funds in Cracker Jack. As a means of complying with Standard III(A) – Loyalty, Prudence, and Care, Towle may choose one of the following options:

I. Invest 45% of available funds in Cracker Jack, Inc. if Towle can show that it is prudent to do so within the overall scope of the market, as well as portfolio diversification.

II. Invest less than 45% of available funds into Cracker Jack, Inc. if Towle believes a lower percentage of investable funds will limit risk within the portfolio.

III. Invest no funds in Cracker Jack, Inc. if Towle can demonstrate that Cracker Jack, Inc. is not a sensible investment as compared with other market securities.

A. I or II, only

B. II or III, only

C. Any of the above

Solution

The correct answer is **C.**

Towle may choose any of the three provided options, so long as she practices loyalty, prudence, and care in determining which investment will result in a portfolio that is adequately diversified and limits the risk of losses for the plan's beneficiaries. In this instance, Lisette Towle owes her loyalty to the pension plan participant of Cracker Jack, Inc. rather than the company's leadership team.

LOS 3h: Standard III(B) - Fair dealing

Standard III(B) – Fair Dealing indicates that CFA members must take advice and/or take action with all clients in a reasonable and objective manner.

Compliance

Standard III(B) – Fair Dealing urges members to treat all parties fairly to uphold the profession's integrity. It is not uncommon for an investment advisor to favor one client over another. This may manifest itself in actions related to response time for advice or perhaps the quality of services provided.

The term "fair" implies that a member must not discriminate in relation to advice or action for individual clients. Although members may differentiate service to clients based on client parameters or individual needs, one is not to differentiate service in a way that will put any client at a disadvantage. For example, an analyst may disseminate an investment recommendation to a client (or group) while a firm is still reviewing the recommendation for accuracy. Even if it is assumed that the firm will approve an analyst's report/recommendation, the early distribution to some clients before others put the latter group at a potential disadvantage. Therefore, it is a violation of Standard III(B) – Fair Dealing.

Violation

To avoid violating Standard III(B) – Fair Dealing, a firm should make recommendations simultaneously to all clients who have expressed an interest in a particular type of security.

Furthermore, disclosure to clients of the process by which investments are allocated will allow clients to assess the fairness of said allocations. Similarly, disclosure of levels of service, fee-based or non-fee-based, should be made to all clients. Varying levels of service should not be offered to some clients but not others.

Question

David Roberts just received approval from his firm to publish a report on Okala, Inc. in which he recommends a strong "sell" based on current reporting and projected product releases. Roberts sends an email to his clients indicating he recommends the sale of Okala. He attaches his analysis to back up the message and requests that clients call him should they have a need for further information. After sending the email, Roberts calls a handful of major clients to personally discuss Okala, Inc. According to Standard III(B) – Fair Dealing:

A. Roberts is in violation of Standard III(B) – Fair Dealing because he called some but not all clients.
B. Roberts is in violation of Standard I(B) – Independence and Objectivity based on his partiality toward some clients over others.
C. Roberts is not in violation of the Code of Standards.

Solution

The correct answer is **C.**

Roberts is not in violation because he publicized information to all clients simultaneously via email. It is ethical to provide premium services (i.e., personalized advice via telephone contact) for a fee. Violation of Standard I(B) – Independence and Objectivity is irrelevant to this situation because it discusses the objectivity of analysis and recommendation rather than the objectivity of client contacts.

Reading 3 LOS 3a

demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity

Reading 3 LOS 3b

distinguish between conduct that conforms to the Code and Standards and conduct that violates the Code and Standards

Reading 3 LOS 3c

recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct

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Ethics and Professional Standards - Learning Sessions

Seven Standards of Professional Conduct

LOS 3i: Standard III(C) - Suitability

Standard III(C) – Suitability refers to providing recommendations and transactions that align with a client’s willingness and ability.

Compliance

The essence of Standard III(C) – Suitability lies in the notion that a client’s objectives and financial circumstances are unique. For example, some may favor higher risk with the prospect of higher gains, while others desire to preserve what they have with moderate gains.

CFA members are compelled to carefully consider each client's needs and financial circumstances before making decisions on their behalf. The key to determining suitability is obtaining knowledge related to clients’ experience with investments and their objectives.

At the start of a client relationship, an investment professional collects information such as financial circumstances, age, profession, and attitudes toward risk. This information should be translated into a written investment policy statement (IPS) that outlines risk assessment, timeline, tax considerations, and unique circumstances.

Each IPS should be updated annually, if not more frequently. Changes to an individual client’s IPS may include increased or decreased income, change in the number of dependents, or adjusted attitude toward risk. Examples of IPS updates for institutional clients might be the number of unfunded liabilities in a pension fund, changes in withdrawal policies for employees, or adjustment to credit rating.

Categories:

1. Client Identification - Ex: type of clients, profession, list of individual beneficiaries
2. Investor Objectives - Ex: investment objectives, risk tolerance
3. Investor Constraints - Ex: liquidity needs, expected cash flows, time horizon, tax consideration, legal circumstances, investor preferences, proxy guidance
4. Performance measurement benchmarks

Note. Adapted from *2017 CFA Curriculum (p. 135)* by CFA Institute, New York: 2017

Generally speaking, diversification within client portfolios is the most suitable means of investment. Risks associated with individual security are limited when that security is bundled with other similar investments.

Also related to risk assessment, a client may request a transaction outside the recommendation of an agreed-upon IPS. In these cases, a CFA member has the responsibility to explain risks associated with this investment and balance the portfolio to maintain client parameters.

Violation

An increase in legally required suitability tests should indicate that CFA members are obligated to adopt suitability policies. Beyond the analysis of possible return on investment, a member should investigate the impact of an investment on the overall portfolio diversification and the alignment of an investment with clients' risk tolerance.

As an example of a possible violation, a manager of a high-income mutual fund should not invest in zero-dividend stock even if s/he believes it to be undervalued unless the stock is within the excepted fund's mandate as made available within its disclosures.

Question

Abdul Mahjeed manages the portfolio of Anna Papazian, a wealthy client with whom he's had a professional relationship for more than a decade. Ms. Papazian receives regular communication from Mahjeed's firm indicating that she should contact her investment professional if there is a change in "life-status." Papazian has not contacted the firm, and Mahjeed has not spoken with her in more than two years. Has Mahjeed fulfilled his obligation with respect to Standard III(C) – Suitability?

A. Mahjeed's long-standing relationship with Papazian makes him ideally suited to make relevant changes in his client's investment policy. Therefore, he is not in violation of Standard III(C) – Suitability.

B. Mahjeed's firm has maintained communication with Papazian, requesting information related to any change in life-status that may impact her portfolio. Therefore, the firm's burden of responsibility has been met.

C. Mahjeed is in violation of Standard III(C) – Suitability by not regularly assessing knowledge related to his client's current circumstances and objectives.

Solution

The correct answer is **C.**

Standard III(C) – Suitability dictates that CFA members must update clients' IPS information at least every 12 months. Although Mahjeed has a long-standing client relationship with Papazian, he is not exempt from this duty. Furthermore, it is not incumbent upon the firm to ensure that clients communicate changes. Therefore, Mahjeed is in violation of Standard III(C) – Suitability.

LOS 3j: Standard III(D) - Performance presentation

Standard III(D) – Performance Presentation obliges CFA members to make sure communication about investment performance is fair, accurate, and complete.

Compliance

Similar to Standard I(C) – Misrepresentation, Standard III(D) – Performance Presentation insists that information provided by investment professionals be representative of factual information and as complete as possible. Standard III(D) – Performance Presentation, of course, is concerned primarily with duties to clients.

This standard prohibits inflation of yields for past investment, as well as projections for current recommendations. The illusions of inflated performance by limiting discussion of risks are also barred.

To comply with Standard III(D) – Performance Presentation, a firm should consider the level of financial sophistication of its clients, making sure to include as much explanation as needed. It is also beneficial to include the performance of a composite of similar portfolios rather than a single account. Finally, all disclosures related to tax, fees, and prior performance should be included in the presentation of recommendations.

Violation

It may be tempting for a fund manager to publicize exceptional earnings for a previous year. However, to infer that similar performances can be expected, particularly when a fund's performance is lower when averaged over a multi-year timeframe, would violate Standard III(D) – Performance Presentation. Should the fund manager guarantee a specific result, then Standard I(C) – Misrepresentation would also be in violation.

Question

Haruka Lin manages a fund for which 65% of the financial assets are held in 10 of the 120 stocks. The performance of that 65% of the fund outperformed the average index of similar indexes. Lin analyzes the year-over-year performance for those 10 major stocks and issues an email statement to current and prospective clients publicizing performance with an announcement that "current year results are likely to outperform popular index results." In how many ways has Lin violated Standard III(D) – Performance Presentation?

I. Lin did not perform a complete analysis of her fund.
II. The analysis of a single-year performance is limited.
III. Fund managers must not guarantee specific results based on past performance.

A. I & II, only
B. II & III, only
C. All of the above

Solution

The correct answer is **C.**

Haruka Lin has violated Standard III(D) – Performance Presentation in many ways. First, Lin did not perform a complete analysis of her fund because although 65% of a fund composes a majority of holdings, 10 of 120 stocks result in incomplete information. Furthermore, an analysis of a single-year performance is limited in nature and therefore contributes to an incomplete analysis.

LOS 3k: Standard IV(A) - Loyalty

IV. Duties to Employers

Standard IV outlines basic responsibilities by investment professionals for their employers.

Standard IV(A) – Loyalty

Standard IV(A) – Loyalty requires CFA members from behaving in a way that would negatively impact their employer's reputation or deprive it of profit.

Compliance

Members must always be loyal to clients first; however, they have a responsibility to act in a way that sustains the integrity of their firm. Members are obligated to comply with employer policies and procedures to the extent that they are lawful. Employers are not obligated to comply with the CFA Institute Code and Standards. However, to the extent that they expect to recruit and retain quality employees, employers should not develop policies that conflict with these codes.

In all cases, CFA members must refrain from independent activity that conflicts with the best interest of employers. Should an investment professional wish to engage in an independent activity, his/her employer should be notified and permitted to evaluate potential conflicts.

A special mention related to the separation of employment specifies that some aspects of employment cannot be left behind or forgotten, such as learned skills; simple information that can be recalled from memory; and names of former clients; the departing employee should not exploit confidential documents and intellectual property belonging to an employer.

It may be tempting for departing employees to take clients' lists, recommended lists of securities, and the like. However, even if a CFA member is very careful not to alert current clients about a separation from the employer before the departure, taking any documents from an employer violates Standard IV(A) – Loyalty. This extends to documents prepared for an employer by the departing employee.

Violation

Activities that could conflict with loyalty to an employer include misuse of proprietary information, sharing of confidential material, behaving in one's own interest rather than an employer, and misappropriation of client lists.

Related to ethical violations by employers, a CFA member's loyalty to employers must be secondary to that of protecting the integrity of capital markets and duty to clients. In cases of conflict with laws and the Code of Standards, it may be acceptable for a member to act in a way that is counter to an employer's policies. Additionally, rather than commit a violation of the Code of Standards, members are encouraged to inquire with the CFA Institute's Professional Standards and Policy Committee (PSPC).

Question

Maria Wells resigned from Tru-tech Corporation as a market analyst. She has accepted a position with a company overseas who operates in a different industry, not directly competing with Tru-tech. When packing up her office, she found a bound copy of an analytical sector report that she’s particularly proud of. Wells knows that to take the electronic version of this information would be a violation of Standard IV(A) – Loyalty since it is proprietary to Tru-tech. However, Wells takes a single hard-copy to satisfy her nostalgia. Wells is:

A. Not in violation of Standard IV(A) – Loyalty since she didn’t take the electronic root document, and only a single hard-copy of the completed analysis.

B. In violation of Standard IV(A) – Loyalty because taking proprietary documents from an employer is prohibited.

C. Not in violation of Standard IV(A) – Loyalty because the work was compiled by her; therefore, it is her property.

Solution

The correct answer is **B.**

Wells is in violation of Standard IV(A) – Loyalty, which prohibits CFA members from taking any form of documentation from an employer at time of separation, even when that document has been prepared by the CFA member in question.

LOS 3l: Standard IV(B) - Additional compensation arrangements

Standard IV(B) – Additional Compensation Arrangements obliges members not to accept gifts, additional compensation, or consideration that competes with the interests of an employer.

Compliance

Standard IV(B) – Additional Compensation Arrangements requires members to obtain written permission before accepting gifts or additional compensation from third parties. This consent is to limit the possibility of a conflict of loyalty between employees and employers.

Clients may offer a bonus contingent upon stated return on investment, over and beyond an investment professional's salary, or an employer-based bonus program. The nature of that client-paid contingency can result in unfair client service (see Standard III(B) – Fair Dealing). Therefore, this offer must be disclosed to an employer for evaluation and approval.

Violation

To prevent the violation of this standard, firms are encouraged to develop well-defined, written policies related to the acceptance of gifts or extraordinary compensation by third parties. Policies should outline the risk of conflict of loyalty, as well as the need to preserve Standard I(B) – Independence and Objectivity, and Standard III(B) – Fair Dealing.

Question

Hernan Martinez, a CFA member, serves Dinero Asset Management as an analyst. In his free time, he helps a friend make investment decisions by reviewing her portfolio. He accepts no fee or favor for this work. He has not told his employer about the help he gives his friend. With regard to Standard IV(A) – Loyalty:

A. Martinez is in violation of Standard IV(A) – Loyalty because the standard prohibits CFA members from giving advice without disclosure to one's employer

B. Martinez is in violation of Standard IV(A) – Loyalty because he is not accepting money for his time

C. Martinez is not in violation of Standard IV(A) – Loyalty

Solution

The correct answer is **C.**

Martinez is not in violation of Standard IV(A) – Loyalty because he is not assisting his friend for a fee. Therefore, there is no conflict in terms of loyalty to his employer over himself. Additionally, if he is doing this work during off-hours, then there is no conflict in terms of time-loyalty.

LOS 3m: Standard IV(C) - Responsibilities of supervisors

Standard IV(C) – Responsibilities of Supervisors indicates that supervisors must make every effort to ensure subordinates comply with appropriate laws, firm policies, and the Code of Standards.

Compliance

This standard relates to employees within immediate supervision (i.e., direct reports). Supervisors with many employees must make it clear to direct reports that secondary or distant subordinates are expected to uphold the strictest law and ethical standards.

Standard IV(C) – Responsibilities of Supervisors encourage supervisors to establish compliance systems such as policies and procedures, ethics training, and/or incentive structure to commend ethical conduct.

Additionally, it is incumbent upon supervisors to anticipate policies and informal behavior that may result in ethical violations. For example, if an officer of the firm is partially compensated on the volume of trades within a firm, that officer may not fully investigate large trades of ethical dubiousness. Therefore, this compensation policy directly conflicts with the promotion of fitting behavior.

Suspected ethics violations by employees should be investigated, documented, and communicated by supervisors to individual employees. Additionally, discussing the consequences of further abuse of laws, policies, or the Code of Standards should be part of this discussion.

Violation

Clear policies and supervision of subordinate activities can prevent a violation of Standard IV(C) – Responsibilities of supervisors. Furthermore, accurate and complete record-keeping related to subordinate actions to prevent or detect code violations is a critical aspect of supervisory responsibility. Finally, failure to establish and encourage ethical action within a firm is a violation of Standard IV(C) – Responsibilities of supervisors.

Question

Which of the following is not an appropriate action under the tenets of Standard IV(C) – Responsibilities of supervisors?

A. Supervisors are expected to address inadequate compliance systems with a firm's leadership, as well as make recommendations for repairing inadequacies.

B. Supervisors are permitted to delegate compliance enforcement responsibilities to another member of a firm, thereby relieving them of their oversight obligations.

C. Supervisors are to fully understand the CFA Code of Standards and enforce said standards within their organizations.

Solution

The correct answer is **B.**

Supervisors may partially delegate responsibility for compliance enforcement to another member of their organization. However, this does not relieve a supervisor from being ultimately responsible for his organization's compliance.

LOS 3n: Standard V(A) - Diligence and Reasonable basis

V. Investment Analysis, Recommendations, and Action

Standard V outlines the responsibility of investment professionals regarding the performance of due diligence before making recommendations to clients.

Standard V(A)

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

Compliance

A reasonable basis is formed through the balanced use of quantitative study, third-party research, and company reports. Due diligence assumes a thorough study of numerous reputable sources of information before making recommendations. The intent of Standard V(A) – Diligence and Reasonable Basis are to prevent conjecture in the form of a "hot tip."

A partial list of examples of reasonable sources to be studied before making an investment recommendation include the following:

1. Global, regional, and national economic conditions
2. A company's operating and financial history
3. Current conditions within an industry or sector.
4. Mutual funds' fee structure and management history
5. Results and limitations of quantitative models
6. Quality of assets within a security
7. Fitness of chosen peer-group comparisons

When considering any source of research, it is necessary to consider limitations and assumptions made by the author and potential biases. For example, with the popularity of social media, it may be tempting to utilize investment blogs as research tools for making recommendations. Even if a blogger is a CFA member, investment professionals are obliged to consider the limitations of references cited within a blog and the impact of incorporating this information on overall advice.

With regard to choosing an external advisor to manage certain asset classes or diversification strategies, the member must use reasonable care and diligence in choosing advisors. This includes reviewing external partners' code of ethics and compliance procedures. It should also include a review of the quality of partners' published information and its consistency of investment strategy.

Violation

To prevent a violation, firms should require that research reports, recommendations, and ratings have a basis that can be referenced as extensive and acceptable. This may be done by creating measurable parameters for establishing compliance with Standard V(A) – Diligence and Reasonable Basis.

Additionally, firms should have a policy for evaluating external advisors' credentials before contracting with these partners. A periodic review of the quality of the information provided by the firm will encourage the accuracy and thoroughness of the information provided over time.

Question

Michael Dade and Ron Gad, both CFA members, are financial advisors at Centerville Investments. Dade recommends that one of his clients buy Z-Co based on research conducted by his firm. Chavis recommends that one of her clients sell Z-Co based on research conducted by a different brokerage firm for general distribution.

Both recommendations are consistent with each client's investment objectives and within the context of their entire portfolios. Neither Dade nor Gad has a reason to suspect that any information contained in the research reports from these two sources is inaccurate or inadequately supported. According to Standard V(A) – Diligence and Reasonable Basis, do Dade and Gad have a reasonable basis for making their investment recommendations?

A. Both of these advisors have a reasonable basis for their recommendations.

B. Only one of these advisors has a reasonable basis for his or her recommendation.

C. Neither of these advisors has a reasonable basis for their recommendations.

Solution

The correct answer is **A.**

Both Dade and Gad have practiced due diligence and made reasonable recommendations, in accordance with Standard V(A) – Diligence and Reasonable Basis so long as their reports are believed to be inclusive of accurate and adequate information, and investment recommendations are made in alliance with clients' objectives.

LOS 3o:Standard V(B) - Communication with clients and prospective clients

Standard V(B) – Communication with Clients and Prospective Clients specifies that members must disclose the limitations and risks associated with investment recommendations and activities.

Compliance

Related to Standard III – Duties to Clients, Standard V(B) – Communication with Clients and Prospective Clients outlines the need for investment professionals to develop clear, frequent, and thorough communication practices. When clients and prospective clients understand the investment process and the actions of CFA members, they can make well-informed decisions.

To this end, members are obliged to explain the process by which recommendations are made. This includes assumptions, limitations, and risks associated with these methods. For example, if an individual stock accounts for 40% of an investment portfolio, fluctuations in that security will have a much greater impact than if it made up only 2% of a diversified portfolio.

Additionally, investment professionals are expected to outline risks associated with recommendations. Of course, as with any investment, there are inherent risks. That said, economic conditions, corporate liquidity, or volatility within an industry are specific risks that should be communicated to clients and prospective clients.

The length of communication should be appropriate to the recommendation. For example, an electronic communication that says little more than “buy” or “sell” should also include a reference to more detailed information available as a basis for making that recommendation. This allows clients to evaluate specifics should they desire to be more informed of the analysis behind a recommendation.

Violation

Violations often occur when thorough communication is not provided and when members fail to separate facts from opinions. Research-based on past circumstances can be verified as fact. However, projections of future performances are the basis of opinions. For example, an analyst may extrapolate the quantity of a natural resource-based on a limited sample (i.e., an overall reserve of platinum in a mine as inferred from core samples). This type of deduction cannot be proven as fact until the entire mine is quarried. Therefore, the extrapolation must be labeled as an opinion.

Appropriate designation of each type of communication will prevent violation of Standard V(B) – Communication to Clients and Prospective Clients.

Question

Johnna Black is composing a communique to be sent to her clients. The subject of her writing is Tall Boys Grocer, whose earnings have increased each of the past four years by an average of 9.3%. Based on current research, Ms. Black projects that Tall Boys' earnings will increase by 10.6% in each of the next two years.

Black will violate Standard V(B) – Communication with Clients and Prospective Clients if she states the following:

I. Tall Boys Grocer’s earnings will grow 10.6% in each of the next two years

II. Tall Boys earning have been compounding at approximately 9.3% annually

III. I expect the earnings of Tall Boys Grocer to increase by 10.6% each year for the next two years.

A. I only

B. I & II only

C. I & III only

Solution

The correct answer is **A.**

Johnna Black’s projection of growth is opinion vs. fact. Therefore, it must be stated as such. If she makes a simple statement of “Tall Boys Grocer’s earnings will grow 10.6% in each of the next two years” then she is guaranteeing a growth outcome and is in violation of Standard V(B) – Communication with Clients and Prospective Clients.

LOS 3p: Standard V(C) - Records retention

Standard V(C) – Record Retention indicates that CFA members must develop a method for maintaining records for analysis, recommendations, and actions.

Compliance

Responsibility to maintain records typically falls upon a firm rather than an individual. That said, each member must keep accurate records that support investment-related communications. These records can be electronic or hard-copy.

Local regulations may specify a timeframe for which a firm must hold specific categories of information. Firms must implement policies to comply with regulations to maintain investment records and client communication. In the absence of local regulation, CFA recommends retaining records for seven years.

Violation

Although the bulk of responsibility for Standard V(C) – Record Retention falls to a firm, individual members must maintain client records to avoid violating this standard. For example, clients' IPS, documents related to discussions of risk and limitations, and periodic updates must be retained.

Question

Nigella Reese enjoys lunch with a client whose portfolio she manages. During lunch, Reese recommends to the client that he reduce his stock holding in ABC Enterprises due to loss of patent protection on their most popular product. To comply with Standard V(C) – Record Retention, Reese should do the following when she returns to her office after lunch?

A. Discuss her lunch conversation with her boss.

B. Document the investment recommendation made over lunch with Reese’s client.

C. Identify other clients for whom ABC Enterprises may be a suitable investment.

Solution

The correct answer is **B.**

Standard V(C) – Record Retention requires that investment professionals maintain record of all investment recommendations and actions. Reese should immediately record details of the recommendations made to her client regarding ABC Enterprises, as well as any client decisions made during their time together.

LOS 3q:Standard VI(A) - Disclosure of conflicts

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 IV(A) – Loyalty?

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

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

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

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 IV(A) – Disclosure of Conflicts if his work for Wealth Assets continues three months later.

LOS 3r: Standard VI(B) - Priority of transactions

Standard VI(B) – Priority of Transactions specifies that investment transactions for clients or employers must take precedence over investment transactions for a CFA member.

Compliance

Reinforcing loyalty to clients, Standard VI(B) – Priority of Transactions clearly indicates that the order of transaction priority is (1) clients, (2) employer, and (3) member.

Nothing is inherently wrong with an investment professional making money from investments, so long as a client is not put at a disadvantage by a trade or an investment professional does not benefit personally from transactions undertaken for clients. This includes not making recommendations to clients or employers because a member wants to benefit personally from an investment.

A conflict may also arise when holding an account in the name of a family member. For example, perhaps an investment professional is tempted to make trades for a short issue, thereby preventing clients from investing in the same issue. For this reason, a member's interests are extended to direct family, as well as any account in which a member may have a pecuniary interest.

Violation

To prevent the violation, a firm should adopt a policy that includes the following elements:

1. Limit personal investment in IPOs.
2. Put restrictions on private placements (i.e., venture capitalist deals).
3. Establish black-out periods in which investment professionals cannot transact for their personal portfolios, thereby ensuring transactions are first placed on behalf of clients and/or employers.
4. Require reporting by personnel of securities holdings and transaction timelines. This may

also include requiring brokers to provide to employers duplicate receipts for all transactions.

Question

An allocation of shares from an oversubscribed IPO are made to Todd Blanco. He plans to distribute the shares evenly among his clients, one of which is his sister-in-law. Blanco allocates shares to his sister-in-law first 24 hours before he distributes shares to the rest of his clients. Which statement is most likely true about Blanco?

A. He is in violation of Standard VI(B) – Priority of Transactions because he favored one client over others.

B. He is not in violation of Standard VI(B) – Priority of Transactions because he eventually made an equal distribution of shares for the oversubscribed IPO to all clients.

C. He is not in violation of Standard VI(B) – Priority of Transactions because his sister-in-law is not a blood-relative.

Solution

The correct answer is **A.**

Blanco is in violation of Standard VI(B) – Priority of Transactions by acting in a way that may benefit himself over clients. Nothing is inherently wrong, so long as a client is not put at a disadvantage by a trade or an investment professional does not benefit personally from transactions undertaken for clients. In this case, we can assume his actions have an indirect benefit to himself. The timeline of a 24 hours lag in investment for other clients may lead to a disadvantage to them.

LOS 3s: Standard VI(C) - Referral fees

Standard VI(C) – Referral Fees requires CFA members to report to employers and clients any sums received from or paid to recommendations of products or services.

Compliance

Appropriate disclosure means communicating *before* an investment professional enters into a contract with a client or a prospective client. The reporting of referral fees includes the type (i.e., flat fee, percentage of the business) and estimated value. This should be done in writing, with both parties signing a written agreement.

Disclosure of fees received from or paid to recommendations of products or services allows employers and clients to evaluate any potential bias that may arise from referral fees.

Violation

A firm should adopt a clear policy related to the acceptance and disclosure of referral fees to avoid violations. This may include a complete restriction of such fees.

Individual members must be clear on what constitutes a referral and that the exchange of dollars is not required to qualify as such. For example, if a company refers its tax-exempt accounts to a member's firm in exchange for a regular investment recommendation and research report, the member has entered into a referral arrangement. Therefore, this information must be disclosed to avoid violation of sums received from or paid to product or service recommendations.

Question

Zoe Mattieu makes it clear to all clients that she pays a flat fee of $500 for referrals to her firm. She prefers to make this information known to clients and prospective clients via verbal announcement during their first face-to-face meeting. Beyond this, there is no other communication regarding a referral policy made by Mattieu. Her firm has not seen fit to change this policy, as it receives a high number of referrals each year. Which of the following statements is most likely correct?

A. Mattieu is in violation of Standard VI(C) – Referral Fees.

B. Mattieu has not violated any Standard.

C. Mattieu has violated Standard III(C) – Loyalty and prudence.

Solution

The correct answer is **A.**

Zoe Mattieu is in violation of Standard VI(C) – Referral Fees because, although she communicates her firm's referral program to clients, she does so verbally instead of via written communication. Standard VI(C) – Referral Fees indicates that information related to referral fees is required to be written, and signed by both parties.

LOS 3t: Standard VII(A) - Conduct as participants in CFA Institute programs

Standard VII – Responsibilities as a CFA Institute Member or CFA Candidate

Standard VII outlines the responsibilities of CFA members or Candidates regarding their profession and the CFA Institute.

Standard VII(A) – Guidance

Standard VII(A) – Guidance designates that members and candidates must not risk the integrity of the CFA Institute.

Compliance

Standard VII(A) – Guidance designates that members and candidates must not risk the integrity of the CFA Institute or the CFA designation through unethical action associated with exams.

All members and candidates must behave congruently with attaining a level of achievement based on merit. This includes refraining from cheating on exams, providing confidential program information to the public, improperly using affiliation with CFA Institute as a means of self-promotion, misrepresenting information on the Professional Conduct Statement.

Related to confidential program information, this includes specific questions used in a CFA exam or formulas used in exam questions. This information is not to be made public for use by other members or candidates.

Sample CFA Testing Policies - Candidate Pledge

- As a candidate in the CFA Institute, I am obliged to follow Standard VII(A) of the CFA Code of Standards, which states that members and candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute; the CFA designation; or the integrity, security, and validity of the CFA exam.

- Before this exam, I have not been given or received information regarding the content of this exam. During the exam, I will not give or receive any information regarding the content of this exam.
- After this exam, I will not disclose any portion of this exam, and I will not remove any exam materials from the testing room in original or copied form. I understand that all exam materials, including my answers, are the property of CFA Institute and will not be returned to me in any form.
- I will follow all rules of the CFA Program as stated on the CFA Institute website and the back cover of the exam book. My violation of any rule of the CFA Program will result in the CFA institute voiding my exam results. It may lead to suspension or termination of my candidacy in the CFA Program.

Note. Adapted from *2017 CFA Curriculum (p. 209)* by CFA Institute, New York: 2017

Violation

CFA program rules and policies clearly indicate actions permitted by exam takers. These include but aren't limited to calculator use, personal possessions, and adherence to the Candidate Pledge. Behaving in a manner that runs counter to said rules violates Standard VII – Responsibilities as a CFA Institute Member or CFA Candidate.

Expressing personal opinions about CFA Institute is not considered a violation, so long as the expression does not include divulging confidential content-specific information.

LOS 3u: Standard III(E) - Preservation of confidentiality

Standard III(E) – Preservation of Confidentiality requires CFA members to maintain the confidentiality of current, former, and prospective clients under most circumstance

Compliance

Due to the relationship between investment professionals and clients, it is common to obtain private information (i.e., financial, familial) required in providing due care of a client's resources. CFA members and candidates are obliged to withhold personal information communicated by clients. This preservation of confidentiality extends to current clients and persons who once were but are no longer clients.

An exception Standard III(E) – Preservation of Confidentiality, are cases in which sharing personal information reveals an illegal nature of client activity. In certain circumstances, a CFA member may be required to report illegal activities to appropriate authorities. It is expected that investment professionals will comply with applicable laws associated with maintaining the client's confidentiality. Therefore, if a member obtains information connected to illegal activity, then s/he is encouraged to consult an attorney or compliance officer for advice regarding disclosure.

Due to the electronic nature of current business practices, CFA members must take added precautions to preserve client privacy. Stricter data security regulations have been passed in recent years to prevent accidental breaches of confidentiality. Although it is not expected that CFA members become experts in data security, they should ensure they have proper training related to their respective firms' policies.

Violation

To prevent a violation of Standard III(E) – Preservation of Confidentiality, one must become familiar with the context of legal vs. illegal client activity in the eyes of local laws.

Additionally, according to the CFA Code of Ethics, all members and candidates are required to "maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals." This extends to maintaining up-to-date training on client loyalty and confidentiality, including data security.

Ultimately, when induced to share client information, one should consider whether that disclosure is work-related and done to benefit the client. Will sharing that information allow a member to provide a better service? If the answer to this question is "no," then one should reconsider betraying client confidence.

Question

James Heckman, the owner of HGI Construction, is aware that Elgrow Corporation is in need of capital improvements to a number of its facilities. Prior to approaching Elgrow, he wants to know if it's worth the substantial amount of time to prepare a building proposal. His neighbor is an investment analyst for Smith Capital, who manages investments for Elgrow Corp. During a weekend barbecue at his home, Heckman approaches the analyst to ask a few questions about Elgrow's financial position, sharing his plans to approach the company with a building proposal. Related to Standard III(E) – Preservation of Confidentiality, the investment analyst should:

A. Share what she knows in order to help Elgrow Corporation get the best proposal possible.
B. Not disclose private information because it could be a violation of Standard III(E) – Preservation of Confidentiality.
C. Not share information because she thinks HGI Construction is engaged in illegal activities.

Solution

The correct answer is **B.**

Client loyalty is owed to Elgrow Corp. Therefore, the investment analyst must maintain client confidentiality related to Elgrow's financial position, and any recommendations related to capital improvements. Sharing private information is likely a violation of Standard III(E) – Preservation of Confidentiality.

LOS 3v: Standard VII(B) - Reference to CFA Institute, CFA designation, and CFA program

Standard VII(B) – Reference to CFA Institute, the CFA Designation, and CFA Program discusses the use of CFA Institute name and logo by individuals and firms.

Compliance

Caution must be taken not to exaggerate the meaning of the CFA Institute or its programs when used by members and candidates. Factual statements concerning the benefits of CFA Program membership are permitted. However, inflammatory statements regarding the superior performance of CFA charterholders are prohibited. Additionally, promising certain results of CFA Program members versus non-members is not allowed.

Any statement that cannot be referenced to historical fact must be framed as an opinion by the statement-maker. This includes communication via any medium, including electronic, speech, and print.

Additionally, to refer to oneself as a CFA charterholder, it is necessary to submit a complete Professional Conduct Statement each year that recommits the industry professional to requirements of the Standards of Conduct of and CFA Institute Professional Conduct program. Furthermore, members must be up-to-date with their CFA Institute membership dues. Failure to comply with either of these provisions will nullify one’s membership and disallow the professional from utilizing the CFA Program membership status.

Before becoming a full member, CFA Program candidates may indicate that they have been accepted into a CFA Insitute program so long as the term *candidate* is clearly used. In addition to being accepted to the CFA Institute program, a candidate must have sat for a particular CFA exam. The use of “candidate” may be used even if an exam has been taken, but no results have been issued. The term “partial designation” or any similar term may not be used by a candidate who has passed one or more levels. Additionally, candidates may not communicate an expected CFA Institute completion date.

CFA Institute marks are legally registered and recognized globally. However, an individual charterholder can only use the mark. It is not to be used by a firm or organization. CFA and the term Chartered Financial Analyst are to be capitalized and used as adjectives, not nouns.

Violation

CFA Institute recognizes its designation and marks are often misused by uninformed firms. Therefore, members and candidates should provide information related to Standard VII(B) – Reference to CFA Institute, the CFA Designation, and CFA Program to appropriate legal, compliance, and public relations contacts within their respective organizations.

Question

Which of the following is an incorrect use of the CFA designation?

I. John Doe, CFA

II. John Doe, C.F.A.

III. John Doe, Chartered Financial Analyst

IV. John Doe, CFA (2018)

A. II and III

B. II and IV

C. III and IV

Solution

The correct answer is **B.**

There are to be no periods between the letters "CFA." Additionally, a date of charter or expected charter cannot be used in conjunction with the CFA designation.