Level I of the CFA® 2025 Exam

Study Notes - Ethics

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<u>Learning Module 1: Ethics and Trust in the Investment Profession</u>

LOS 1a: Ethics and Trust in the Investment Profession

Ethics Defined

Many professions define a code of ethics aimed at outlining cultural values within that profession. For the investment industry, ethics are defined as a standard of conduct valued by the financial sector. These can be expressed via concrete rules of behavior as defined by law, or through abstract concepts meant to define the spirit of organizational conduct. The Chartered Financial Analyst (CFA) Institute has outlined six components to its code of ethics. **Members of the CFA Institute must**:

1. Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.

2. Place the integrity of the investment profession and the interests of clients above their own personal interests.

3. Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

4. Practice and encourage others to practice professionally and ethically in a way that will reflect credit on themselves and the profession.

5. Promote the integrity of, and uphold the rules governing, capital market.

6. Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

Describe the Role of a Code of Ethics in Defining a Profession

The role of ethics within the investment profession is to promote the integrity and viability of global capital markets for the ultimate benefit of society. By learning and committing to that code of ethics, each professional contributes to a universal protocol of acceptable behavior. Within the financial sector, there are both Global Investment Practice Standards (GIPS), as well as CFA Institute Standards of Practice.

Ethics and Profession

A profession can be defined as the occupational group that is based on the unique education, specialist knowledge, and framework of practice and behavior that establishes community trust, respect, and recognition. A large proportion of professions outlines the importance of ethics, excellent service, and empathy when dealing with clients.

Diverse professions have developed over the years due to:

- Rise of new specialist areas of expertise which requires licensing and technical standards
- Pressure from the governments and regulators. These entities encourage the formation of strong ethical standards between professionals and society at large.
- Demand for a certain profession by the parties who see the merit of working as a professional and desire to work with professionals in specific fields.

Establishment of Trust by Professions

A credible profession is characterized by a strong trust from both the clients and the society at large. Profession builds through the following ways:

1. Provision of Community Service

The provision of community services creates confidence and professional pride and professional acceptance. Consequently, a trustworthy professional is substantially flexible and is independent of the government regulatory bodies when carrying its operations.

2. Making a Profession Client-based

The trust of a profession is built if it puts its integrity and the interest of clients above their interests. A client-focused profession is one that its actions portray a high level of care, skill, and diligence while making the interests of the clients' priority. In summary, a profession gains trust if it shows **fiduciary duty** a commitment to high-quality care when acting for the benefit of another party.

3. Normalizing of the Practitioner Behavior

A profession is trusted if it is grounded on codes and standards recognized by regulators and the government, under which the profession is established. The regulatory bodies should understand the profession's codes and standards and their enforcement.

4. Developing High Entry Standards for a Profession

A profession should develop an elaborate entry requirement into a profession since membership in a profession is a sign to the consumers that the professional will deliver high-quality service. Such requirements include expertise, knowledge, technical skills, and ethics.

5. Possessing Body of Expert Knowledge

Experienced and skilled practitioners should make available useful knowledge to their members to work resourcefully and ethically, based on best practice.

6. Continuous Education

Having qualified into a profession, there is a need for ongoing education to its members to accommodate the ever-changing knowledge and technical skills, technology, standards of ethical behavior, legal and business environment where professional services are needed. Most of the professional regulatory bodies make it mandatory for the members to undergo **continuing**

professional development -undergoing specified new learning each year.

7. Monitoring Professional Misconduct

Each professional found liable for professional misconduct should be held accountable. This is necessary to maintain the integrity and the reputation of the profession and hence trust.

8. Making a profession Collegial

Despite that members of a profession do compete, they should respect each other rights, autonomy, and dignity.

9. Establishing Profession Oversight Authorities

Although it is the responsibility of each professional to maintain a high level of professional standards and competency, an oversight body is established to make this happen. Moreover, the oversight body is mandated to provide continuous educational resources and information on professional changes as time goes by.

10. Engagement of the Professional Members

Professional members may help to protect the future of professional values by acting as educators to peers. They achieve this by volunteering to mentor and inspire other young professionals or even those who wish to join a certain profession to develop expertise and ethics. In the long term, the future trust of a profession is protected.

The Need for High Ethical Standards in the Investment Industry

In 2014 the investment industry accounted for more than $64 trillion in assets. Additionally, it is growing at eight percent a year. It can be theorized that with trillions in assets and billions of financial transactions each year, even a small percentage of unethical exchanges amount to a significant overall number.

A market collapse is devastating to faith and confidence in the investment industry. With each significant downfall, there is an increase in unemployment and a slump in the economy. The well-being of capital markets depends largely on consumer trust. Trust is earned through ethical conduct.

Professionalism in Investment Management

Investment management is an upcoming profession. This is evidenced by the following:

- The public understanding of its practice and codes are still growing.
- There is a lack of recognition by the regulators and the employers, which prevents the establishment of a profession in investment management.
- Not all participants in the investment management are professionals since the participants have not engaged in specified training or are members of any recognized authority. This makes it hard for investment management to gain trust.

However, some critical elements of investment management have developed over the years. Investment management, just like any other profession, meets a large proportion of the profession's expectations. Moreover, in most of the countries, some form of certification has been established, with no requirements to join a professional body. The investment management profession is trying to move with time. That is, it tries to cope with ever-changing demands.

Investment management is becoming global due to the increased opening of the capital markets internationally. Therefore, investment managers can offer their services in different countries or freely moving within the offices of multinational asset management firms. Several established bodies, such as actuarial societies, have investment management professionals as members.

Building Trust in Investment Management

The investment management profession has established itself to the level of other professions such as law and medicine, such that it is trusted to draw knowledge and utilize it with care and judgment. To maintain this trust, professionals should possess technical and financial expertise and understand the laws and regulations.

Investment management professionals should describe to the clients the charges, uncertainties, and conflicts that may arise in providing their investment services.

Investment management professionals should always adhere to codes of ethics and professional standards while their practices should be guided by care, transparency, and integrity.

Ethical Dilemmas

An ethical dilemma occurs whenever there are two or more choices. In this given circumstance there will always be the best choice, even when each option appears to have negative consequences.

Although the CFA Institute Code of Ethics aspires to drive behavior through high-level, moral principles, a dilemma can occur when two or more standards of conduct compete for primary preference. Major areas in which ethical dilemmas occur are (1) Misrepresentation, (2) Misconduct, (3) Fairness, (4) Loyalty prudence and care. Each will be discussed within a future LOS.

The Difference Between Ethical and Legal Standards

Often people equate ethical behavior with legal choices. However, there are numerous choices that may be legal but have no moral standing. It is important to remember that all laws stem from a place in which moral covenant has broken down. The means by which control is maintained in these circumstances is to set laws and stipulate punishment. Therefore, the law is reactive. By contrast, ethical conduct is proactive and the means by which standards of practice maintain a high level of morality beyond legality.

One may adhere to the letter of the law but ignore the spirit of the law. For example, IRS regulations repeatedly single out actions with “no legitimate business purpose.” If an investment professional makes choices with no legitimate business purpose in order to avoid short-term loss (i.e. taxation, fees) then you may be staying within parameters of what is legal, but with no purpose other than to get around the law.

Framework for Ethical Decision-Making

A framework for ethical decision-making is defined as a set of principles established to aid investment professionals in conducting business with integrity. The CFA Institute has outlined six tenets of ethical behavior as outlined in LOS 1a.

Beyond understanding the six ethical considerations established by CFA, one must apply these principles through ethical analysis. It is important to recognize that ethical dilemmas are a normal and predictable part of most jobs. This realization will help increase the likelihood that you will notice and act on ethical issues before they become destructive.

Question 1

The credibility of a profession is deeply dependent on the trust of both the clients and the community at large. Which of the following is *least likely* to be a way of building trust by professions?

A. *Members' engagement to nurture future professionalism*
B. *Antagonistic competition among the members of a profession*
C. *Continuous provision of educational resources to the members of a profession*

Solution

The correct answer is **B.**

Competition is healthy in any other industry, but members of a profession do compete; they should respect each other rights, autonomy, and dignity. By doing this, the reputation of a profession is maintained.

Learning Module 2: Code of Ethics and Standards of Professional Conduct

LOS 2a: Code of Ethics and Standards of Professional Conduct

CFA Institute Professional Conduct Program and the Process for Enforcement of Code and Standards

Violations of the CFA codes and standards are reviewed through the CFA Institute's Professional Standards and Policy Committee (PSPC). This committee is authorized to conduct investigations and impose penalties. Within the PSPC, there are two subcommittees. First, the Disciplinary Review Committee (DRC) is charged with reviewing potential violations and enforcing the Code of Ethics. Second, the Standards of Practice Council (SPC) is charged with editing, deleting, or adding standards and distributing updated information to CFA members.

Causes for an investigation

CFA Institute members may be investigated based on:

1. Violation of the CFA Institute Articles of Incorporation, Bylaws, Code of Ethics, Standards of Professional Conduct, or Rules of Procedure or other applicable rules

2. Sanction or injunction imposed by a government or judicial agency, or public or private self-regulatory organization with jurisdiction over investment-related activities

3. Conviction of a felony, or (if the jurisdiction does not define a felony) any crime punishable by more than one year in prison

4. Ban or restriction (permanently or indefinitely) from registration under a jurisdiction's securities laws or any restriction related to any investment-related professional activity

5. Failure to complete, sign and return the Professional Conduct Statement

6. Falsifying information on a candidate or society membership application

7. Failure to cooperate with the CFA Institute's inquiry and investigation into one's own conduct or the conduct of another member

8. Any other good cause

Consequences

If found to be in violation of codes and standards, members are subject to censure, suspension, or revocation of membership. Candidates can also be penalized by revoking the right to sit for CFA examinations, thereby becoming ineligible for membership.

Ethics and the Investment Industry

Efficient markets rely on trust and transparency. Ethical conduct ensures fair markets, fostering investor confidence. While laws and regulations are crucial, they aren't enough. A culture of integrity, where ethical principles like honesty and fairness guide behavior, is essential for sustaining global capital markets. Unethical behavior erodes trust and harms market sustainability. Thus, ethics play a vital role in maintaining robust financial markets and benefiting society as a whole.

Ethics, Society and Markets

CFA Institute's mission includes "for the ultimate benefit of society," emphasizing the importance of stable, efficient global capital markets. These markets allocate resources effectively, fostering innovation, job creation, and improved living standards. Trust is crucial; if investors distrust market fairness, they invest less, demanding higher risk premiums, harming the economy. Universal ethics promote trust and integrity across all regions, supporting the industry's efficiency and values. Global standards should align with fundamental ethical principles to maintain a vibrant investment environment.

Capital Market Sustainability and the Actions of One

Investment professionals and firms should consider the broader impact of their actions on the global investment community. As finance becomes more interconnected, market sustainability is crucial. Isolated decisions can collectively cause crises, so awareness of global effects is essential. Ethical behavior, risk management, and product development should prioritize market health. Compensation strategies must avoid incentivizing unethical conduct. Protecting client interests above all remains a fundamental principle.

The Relationship between Ethics and Regulations

Some equate ethical behavior with legal compliance, but ethics often go beyond the law. Laws guide appropriate behavior but don't cover all unethical acts. Legal behavior is what’s required; ethical behavior is doing what’s morally right. Since regulators may lack resources to enforce all rules, relying solely on legal compliance is insufficient for ensuring ethical conduct in the investment industry. Strong ethical principles at individual and firm levels are crucial to limit abuses and ensure ethical decision-making.

Applying an Ethical Framework

Laws, regulations, and professional standards guide ethical behavior, but individual judgment is crucial for principled choices. Without a solid ethical framework, decisions can lead to fraud and loss of public trust. Investment professionals should use a decision-making framework to balance profit with ethical considerations, ensuring their actions meet high standards. This framework helps analyze decisions in context, supporting ethical conduct and fulfilling professional responsibilities effectively.

Commitment to Ethics by Firms

A firm’s code of ethics must be deeply integrated into its culture to be effective. Investment professionals need a framework that brings ethical principles to life, making them central to the firm's operations. Building a culture of integrity, led by senior management, reinforces the desire to "do the right thing." Regular practice of ethical decision-making helps employees make sound choices despite conflicts of interest. This approach benefits businesses, individuals, firms, the industry, markets, and society by promoting ethical conduct in investment management.

Ethical Commitment of CFA Institute

CFA Institute aims to uphold the highest ethical standards in the investment industry through its Code of Ethics and Standards of Professional Conduct. These guidelines ensure fair and ethical practices for members and candidates. Over 60 years, the Code and Standards have evolved to stay relevant. The Standards of Practice Handbook addresses key ethical principles, covering professionalism, responsibilities, and conflicts of interest. Despite the complexity of modern finance, distinguishing right from wrong remains essential. CFA Institute provides resources to help members and candidates apply these ethical principles effectively.

Code of Ethics

The CFA Institute has outlined six components to its ***Code of Ethics***. Members of the CFA Institute must:

1. Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the global capital markets.

2. Place the integrity of the investment profession and clients' interests above their own personal interests.

3. Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

4. Practice and encourage others to practice professionally and ethically to reflect credit on themselves and the profession.

5. Promote the integrity of, and uphold the rules governing, capital markets.

6. Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

Standards of Conduct

With regard to ***Standards of Conduct***, there are seven areas by which one must be held accountable. They are as follows:

1. Professionalism

- Knowledge of the law
- Independence and objectivity
- Misrepresentation
- Misconduct

2. Integrity of Capital Markets

- Material non-public information
- Market manipulation

3. Duties to Clients and Prospective Clients

- Loyalty and prudence
- Fair dealing
- Suitability
- Performance presentation
- Preservation of confidentiality

4. Duties to Employers

- Loyalty
- Additional compensation arrangements
- Responsibilities of supervisors

5. Investment Analysis, Recommendations, and Action

- Diligence and Reasonable Basis
- Communication with clients and prospective clients
- Records retention

6. Conflicts of Interest

- Disclosure of conflicts
- Priority of transactions
- Referral fees

7. Responsibilities as a CFA Institute Member or CFA Candidate

- Conduct as participants in CFA Institute programs
- Reference to CFA Institute, CFA designation, and CFA program

Ethical Responsibilities Required by the Code and Standards

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. In addition, it specifies that investment professionals must have a working knowledge of laws and a framework for resolving ethical dilemmas.

II. Integrity of Capital Markets

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

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.

IV. Duties to Employers

Standard IV outlines basic responsibilities by investment professionals for their employers. Language includes the premise of "do no harm" toward an employer, bearing that there can occasionally be a conflict of loyalty between personal and agency interests. There are also specific instances outlined in which an investment professional may be considered in violation of duties to employers, including unfair competition and sharing of confidential information. Whistleblowing, or reporting unethical employers, is also addressed in this section.

V. Investment Analysis, Recommendations, and Action

Standard V outlines the responsibility of investment professionals regarding due diligence before making recommendations to clients. The intent is to prevent conjecture in the form of a "hot tip" but rather provides that recommendations be made based on a firm's independent research or the quantitative research of other reputable sources.

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.

VII. Responsibilities as a CFA Institute Member or CFA Candidate

Finally, Standard VII indicates that members and candidates must not risk the integrity of the CFA Institute or the CFA designation through unethical action. This standard also addresses cheating on CFA exams.

<u>**Learning Module 3: Guidance for Standards I-VII**</u>

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.

Learning Module 4: Introduction to the Global Investment Performance Standards (GIPS)

LOS 4a: explain why the GIPS standards were created, what parties the GIPS standards apply to, and who is benefitted by the standards

The Global Investment Performance Standards establish a standardized set of ethical practices that guide practitioners in analyzing and presenting historical data as a basis for the comparison of investment results.

Why GIPS were Created?

These GIPS standards provide a basis for including all relevant data, as well as avoiding misrepresentations. Prior to GIPS creation, like-for-like performance comparison was a challenge because of the presence of the following misleading practices:

- **Representative Accounts**: Firms use the top-performing portfolio as a representative of the firm's overall investment results.
- **Survivorship Bias**: Firms exclude poor performing portfolios in presenting their performance and present an "average" performance history.
- **Varying Time Periods**: Firms "hand-pick" only the time periods during which the mandate outperformed the specified benchmark.

The **objectives** of the GIPS standards:

1. Promote investor interests and instill investor confidence.
2. Ensure accurate and consistent data.
3. Obtain worldwide acceptance of a single standard for calculating and presenting performance.
4. Promote fair, global competition among investment firms.
5. Promote industry self-regulation on a global basis.

Source: CFA® Program Curriculum

Who can Claim Compliance?

Any investment firm can choose to comply with the Global Investment Performance Standards, and observance is voluntary. However, only management firms that manage assets can claim compliance.

Parties that cannot claim compliance are as follows:

- Plan sponsors.
- Consultants who do not manage assets.
- Software developers.
- Software vendors.

Additionally, to claim compliance, a firm must comply with all Global Investment Performance Standards. Simple compliance with one or a limited portion of parameters is insufficient.

Who Benefits from Compliance?

Clients and prospective clients can have a degree of confidence in the numbers they are using to compare managers that the numbers are representative of the actual experience of those managers and not conveniently crafted records that distort what actually happened.

Investment management firms in compliance with GIPS requirements enjoy a greater level of credibility in the hands of investors. Compliance is seen as proof that the firm upholds a high level of ethical behavior. By adopting GIPS, firms in countries with few-to-no standards can compete with countries whose standards are more developed.

Benefits of compliance with GIPS Standards are as follow:

- GIPS primarily benefits investment firms and the clients of those firms. Compliance with GIPS ensures that a firm’s historical results are presented consistently and fairly.

- Conformity allows GIPS-compliant firms to bid against other GIPS-compliant firms throughout the world. Investors can easily compare the results of compliant firms, thereby adding credibility to GIPS-compliant performance data.
- Compliance with the GIPS standards strengthens the firm’s internal controls over performance-related processes and procedures.
- Compliance with the GIPS standards enhances the credibility of investment management firms.

Question 1

Which of the following parties can *most likely* claim compliance with GIPS?

A. Plan sponsors.
B. Firms that do manage assets.
C. Both plan sponsors and firms that do manage assets.

Solution

The correct answer is **B**.

Only investment firms that manage assets can claim compliance with GIPS.

Parties that cannot claim compliance are as follows:

- Plan sponsors.
- Consultants who do not manage assets.
- Software developers.
- Software vendors.

Question 2

Which of the following is *least likely* a key objective of GIPS?

A. Obtain global acceptance of a single standard for calculation and presentation of investment performance based upon fair representation and investor confidence.
B. Promote the use of accurate and consistent performance data.
C. Encourage fair, global competition among investment firms by creating barriers to entry.

Solution

The correct answer is **C**.

The correct statement would be “Encourage fair, global competition among investment firms ***without*** creating barriers to entry.”

A and B are incorrect. Those two statements are key objectives of GIPS.

LOS 4b: describe the key concepts of the GIPS standards for firms

The following are the key concepts of the GIPS standards that apply to firms:

1. GIPS are ethical standards for an investment performance presentation to ensure fair representation and full disclosure of investment performance. In order to claim compliance, firms must adhere to the requirements included in the GIPS standards.
2. Meeting the objectives of fair representation and full disclosure is likely to require more than simply adhering to the minimum requirements of the GIPS standards. Firms should also adhere to the recommendations to achieve best practices in the calculation and presentation of performance.
3. The GIPS standards require firms to include all actual, discretionary, fee-paying portfolios in at least one composite defined by investment mandate, objective, or strategy to prevent firms from cherry-picking their best performance.
4. GIPS relies on the integrity of input data. The accuracy of input data is critical to the accuracy of the performance presentation. The underlying valuations of portfolio holdings drive the portfolio's performance. These and other inputs need to be accurate. GIPS standards require firms to adhere to certain calculation methodologies and make specific disclosures and the firm's performance.
5. Firms must comply with all requirements of the GIPS standards, including any updates, guidance statements, interpretations, questions & answers (Q&As), and clarifications published by CFA Institute and the GIPS Executive Committee, which are available on the GIPS website (gipsstandards.org) as well as in the GIPS Handbook.

As noted, GIPS compliance is voluntary and self-regulated. Due to the nature of this setup, a strong commitment to ethical integrity is required to maintain GIPS compliance. The GIPS Executive Committee encourages firms to recognize the benefit of self-regulation and consider taking action against firms that falsely claim compliance with GIPS.

LOS 4c: explain the construction and purpose of composites in performance reporting

A primary aspect of GIPS is to require composites, which are aggregate portfolios managed with a similar investment approach. Therefore, if a firm presents its record for a particular equity classification, all portfolios meeting pre-established criteria for that class must be represented. A firm cannot include some and exclude others at will.

In addition, composite guidelines prevent firms from using only their best-performing portfolios, thereby skewing presentation results.

Non-discretionary portfolios must not be included in a firm's composites. A discretionary portfolio is one in which buy and sell decisions are made by a portfolio manager. On the other hand, the manager of a non-discretionary portfolio does not have full discretion over how the money is invested.

LOS 4d: describe the fundamentals of compliance, including the recommendations of the GIPS Standards with respect to the definition of the firm and the firm's definition of discretion.

The GIPS standards must be applied on a firm-wide basis. There are two important issues that must be considered by a firm when it complies with the GIPS standards:

i. Definition of the firm.
ii. Definition of discretionary.

Definition of Firm under GIPS

The GIPS standards state "The firm should adopt the broadest, most meaningful definition of the firm. The scope of this definition should include all geographical (country, regional, etc.) offices operating under the same brand name, regardless of the actual name of the individual investment management company."

This implies that:

- Firms must be defined as an investment firm, subsidiary, or division held out to clients or prospective clients as a distinct business entity.
- Total firm assets must be the aggregate of the fair value of all discretionary and non-discretionary assets under management within the defined firm.
- Firms must include the performance of assets assigned to a sub-advisor in a composite, provided that the firm has discretion over the selection of the sub-advisor.
- Changes in a firm's organization are not sufficient grounds for alternation of historical composite results.

Definition of Discretionary under GIPS

The GIPS standards state “If documented client-imposed restrictions interfere with the implementation of the intended strategy to the extent that the portfolio is no longer representative of the strategy, the firm may determine that the portfolio is non-discretionary.”

Non-discretionary portfolios must not be included in a firm’s composites.

LOS 4e: describe the concept of independent verification

Verification refers to the process by which a firm claiming compliance with GIPS requirements hires an independent third party to evaluate its processes and corroborate the firm's assertions. Despite the fact that verification is a recommendation rather than a requirement for firms to claim compliance, it increases investor confidence.

Verification must include an entire firm's practices, not just a small grouping of composites. Authentication should include information related to the proper formulation of composite information and company policies established to calculate and present GIPS-compliant performance. Verification does not validate specific results of historical data.

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).