CFA Institute®
CFA Program

PORTFOLIO MANAGEMENT, ETHICAL AND PROFESSIONAL STANDARDS

CFA® Program Curriculum
2023 • LEVEL 1 • VOLUME 6

Portfolio Management

SOLUTIONS

1. C is correct. Depending on circumstances, a written IPS or its equivalent may be required by law or regulation and a written IPS is certainly consistent with best practices. The mere fact that a written IPS is prepared for a client, however, does not *ensure* that risk and return objectives will in fact be achieved.

2. A is correct. A written IPS is best seen as a communication instrument allowing clients and portfolio managers to mutually establish investment objectives and constraints.

3. B is correct. A written IPS, to be successful, must incorporate a full understanding of the client's situation and requirements. As stated in the reading, "The IPS will be developed following a fact finding discussion with the client."

4. B is correct. The major components of an IPS are listed in Section 2 of the reading. *Investment Guidelines* are described as the section that provides information about how policy may be executed, including restrictions on the permissible use of leverage and derivatives and on specific types of assets excluded from investment, if any. *Statement of Duties and Responsibilities* "detail[s] the duties and responsibilities of the client, the custodian of the client's assets, the investment managers, and so forth." *Investment Objectives* is "a section explaining the client's objectives in investing."

5. C is correct. The major components of an IPS are listed in Section 2 of the reading. Strategic Asset Allocation (also known as the policy portfolio) and Rebalancing Policy are often included as appendices to the IPS. The *Statement of Duties and Responsibilities*, however, is an integral part of the IPS and is unlikely to be placed in an appendix.

6. B is correct. According to the reading, "The sections of an IPS that are most closely linked to the client's distinctive needs are those dealing with investment objectives and constraints." *Investment Guidelines* "[provide] information about how policy may be executed, including investment constraints." *Procedures* "[detail] the steps to be taken to keep the IPS current and the procedures to follow to respond to various contingencies." *Statement of Duties and Responsibilities* "detail[s] the duties and responsibilities of the client, the custodian of the client's assets, the investment managers, and so forth."

7. A is correct. Because the return objective specifies a target return *relative to* the FTSE 100 Index, the objective is best described as a relative return objective.

8. C is correct. Risk attitude is a subjective factor and measuring risk attitude is difficult. Oftentimes, investment managers use psychometric questionnaires, such as those developed by Grable and Joo (2004), to assess a client's willingness to take risk.

9. B is correct. The reference to the DAX marks this response as a relative risk objective. Value at risk establishes a minimum value of loss expected during a specified time period at a given level of probability. A statement of maximum allowed absolute loss (€2.5 million) is an absolute risk objective.

10. C is correct. Measuring willingness to take risk (risk tolerance, risk aversion) is an exercise in applied psychology. Instruments attempting to measure risk attitudes exist, but they are clearly less objective than measurements of ability to take risk. Ability to take risk is based on relatively objective traits such as expected income,

time horizon, and existing wealth relative to liabilities.

11. A is correct. The client's financial objectives are long term. Her stable employment indicates that her immediate liquidity needs are modest. The children will not go to college until 10 or more years later. Her time horizon is best described as being long term.

12. B is correct. The unpredictable nature of property and casualty (P&C) claims forces P&C insurers to allocate a substantial proportion of their investments into liquid, short maturity assets. This need for liquidity also forces P&C companies to accept investments with relatively low expected returns. Liquidity is of less concern to life insurance companies given the greater predictability of life insurance payouts.

13. B is correct. When a client has a restriction in trading, such as this obligation to refrain from trading, the IPS "should note this constraint so that the portfolio manager does not inadvertently trade the stock on the client's behalf."

14. A is correct. The volatility of the client's income and the significant support needs for his mother and himself suggest that the client has a low ability to take risk. The client's trading experience and his responses to the risk assessment questionnaire indicate that the client has an above average willingness to take risk.

15. B is correct. On the one hand, the client has a stable, high income and no dependents. On the other hand, she exhibits above average risk aversion. Her ability to take risk is high, but her willingness to take risk is low.

16. C is correct. Strategic asset allocation depends on several principles. As stated in the reading, "One principle is that a portfolio's systematic risk accounts for most of its change in value over the long run." A second principle is that, "the returns to groups of like assets… predictably reflect exposures to certain sets of systematic factors." This latter principle establishes that returns on asset classes primarily reflect the systematic risks of the classes.

17. A is correct. The correlation between US equities and Brazilian equities is 0.76. The correlations between US equities and East Asian equities and the correlation between US equities and European equities both exceed 0.76. Lower correlations indicate a greater degree of separation between asset classes. Therefore, using solely the data given in the table, returns on Brazilian equities are most sharply distinguished from returns on US equities.

18. C is correct. As the reading states, "an asset class should contain homogeneous assets… paired correlations of securities would be high within an asset class, but should be lower versus securities in other asset classes."

19. B is correct. Tactical asset allocation allows actual asset allocation to deviate from that of the strategic asset allocation (policy portfolio) of the IPS. Tactical asset allocation attempts to take advantage of temporary dislocations from the market conditions and assumptions that drove the policy portfolio decision.

SOLUTIONS

1. A is correct. Under-diversified portfolios are a consequence of both illusion of control and confirmation biases. Researchers have found that some investors prefer to invest in companies that they feel they have control over, such as the companies they work for, leading them to hold concentrated positions. Confirmation bias may lead to FMPs ignoring negative news, paying attention only to information confirming that a company is a good investment, which may result in large positions. Representativeness bias is not typically associated with under-diversified portfolios.

2. C is correct. This advice is specifically aimed at reducing self-attribution bias, a form of overconfidence bias. This bias may result in FMPs taking credit for investment success, as well as assigning responsibility to others for investment failures, when in reality the investment results reflect exogenous market forces.

3. C is correct. Both endowment bias and regret-aversion bias often result in indecision or inertia—a typical outcome of status quo bias, in which people prefer to not make changes even when changes are warranted.

4. C is correct. Endowment bias refers to people attributing additional, unwarranted value to things they possess versus things they do not. This bias is evident in FMPs that systematically and materially overvalue securities in their portfolio versus securities not in their portfolio. The question "Would you buy this security today at the current price?" turns the investor's attention to assessing the reasonableness of the current price as a buy price rather than solely as a selling price.

5. A is correct. Park is extrapolating his observation based on a narrow range of experience (working at a hedge fund that employs many CFA charterholders) to the entire population of CFA charterholders. Using a narrow range of experience is a form of availability bias.

6. C is correct. Conservatism bias results in maintain or only slowly updating views and forecasts despite the presence of new information. FMPs in the 1990s were reluctant to update forecasts, despite materially different new information for several years.

7. B is correct. Kai has segregated money into four different accounts based on the sources and uses of his funds. Although intuitively appealing, this approach is irrational because money is fungible across the four accounts. Nothing is stopping Kai from collapsing them into a single "account" with a holistic portfolio strategy.

8. B is correct. The most common consequence of mental accounting is neglecting opportunities to reduce risk by combining assets with low correlations, because each account's asset allocation is examined discretely. Offsetting positions across accounts, or an overall inefficient allocation with respect to risk, can lead to suboptimal aggregate performance.

9. C is correct. Aggregating mental accounts is a logical strategy to combat mental accounting. It is the opposite of disaggregating money into separate accounts.

10. A is correct. The overconfidence and excessive trading that contribute to a bubble are linked to self-attribution bias, a form of overconfidence. In a rising market, sales of stocks from a portfolio will typically be profitable, even if winners are being sold too soon, and FMPs will attribute profits and strong performance to

their investment acumen and subsequently underestimate risks.

11. B is correct. Representativeness refers to the tendency to adopt a view or forecast based on individual information or a small sample, as well to use simple classifications. The halo effect is an example of representativeness, because FMPs extend an overall favorable evaluation to an investment (e.g., a "good company") based on one or few characteristics (e.g., a "visionary CEO").

12. C is correct. Bubbles and crashes are well-known and well-documented phenomena yet represent market anomalies.

13. B is correct. Investment managers' incentives—or perhaps more accurately, their perception of their incentives—for short-term performance were named as considerations in the technology and real estate bubbles. Not participating in the bubble presented certain FMPs with commercial or career risk.

14. B is correct. Home bias refers to FMPs preferentially investing in domestic securities, likely reflecting perceived relative informational advantages, a greater feeling of comfort with the access to company executives that proximity brings (either personal or through a local brokerage), or a psychological desire to invest in a local community. Momentum, on the other hand, has been documented in a range of markets around the world, in a time-dependent manner, and reflects some FMPs' availability bias, manifested as a belief that stocks will continue to rise because recently they have only risen, as well as regret aversion by those who invest in past winners because they regret not investing in them in the past.

15. B is correct. This choice describes the halo effect, which does offer a behavioral explanation for the poor performance of growth stocks versus value stocks. Growth stocks are mispriced relative to their risk characteristics, because FMPs focusing on just a few properties, such as a high historical revenue growth rate, while neglecting other characteristics.

SOLUTIONS

1. B is correct. For individuals, risk management concerns maximizing utility while taking risk consistent with individual's level of risk tolerance.

2. A is correct. Many decision makers focus on return, which is not something that is easily controlled, as opposed to risk, or exposure to risk, which may actually be managed or controlled

3. C is correct. Risks need to be defined and measured so as to be consistent with the organization's chosen level of risk tolerance and target for returns or other outcomes.

4. C is correct. While risk infrastructure, which a risk management framework must address, refers to the people and systems required to track risk exposures, there is no requirement to actually name the responsible individuals.

5. C is correct. *Risk infrastructure* refers to the people and systems required to track risk exposures and perform most of the quantitative risk analysis to allow an assessment of the organization's risk profile. The risk management infrastructure identifies, measures, and monitors risks (among other things).

6. A is correct. Risk governance is the top-down process that defines risk tolerance, provides risk oversight and guidance to align risk with enterprise goals.

7. C is correct. Risk governance is not about specifying methods to mitigate risk at the business line level. Rather, it is about establishing an appropriate level of risk for the entire enterprise. Specifics of dealing with risk fall under risk management and the risk infrastructure framework.

8. A is correct. The risk management committee is a part of the risk governance structure at the operational level—as such, it does not approve the governing body's policies.

9. B is correct. When risk tolerance has been determined, the risk framework should be geared toward measuring, managing, and complying with the risk tolerance, or aligning risk exposure with risk tolerance. The risk tolerance decision begins by looking at what shortfalls within an organization would cause it to fail to achieve some critical goals and what are the organization's risk drivers.

10. C is correct. If a company has the ability to adapt quickly to adverse events may allow for a higher risk tolerance. There are other factors, such as beliefs of board members and a stable market environment, which may but should not affect risk tolerance.

11. A is correct. In establishing a risk management system, determining risk tolerance must happen before specific risks can be accepted or reduced. Risk tolerance defines the appetite for risk. Risk budgeting determine how or where the risk is taken and quantifies the tolerable risk by specific metrics. Risk exposures can then be measured and compared against the acceptable risk.

12. A is correct. Risk budgeting does not include determining the target return. Risk budgeting quantifies and allocates the tolerable risk by specific metrics.

13. A is correct. The process of risk budgeting forces the firm to consider risk tradeoffs. As a result, the firm should choose to invest where the return per unit

of risk is the highest.

14. A is correct. A financial risk originates from the financial markets. Credit risk is one of three financial risks identified in the reading: Credit risk is the chance of loss due to an outside party defaulting on an obligation. Solvency risk depends at least in part on factors internal to the organization and operational risk is an *internal* risk arising from the people and processes within the organization.

15. B is correct. Liquidity risk is also called transaction cost risk. When the bid–ask spread widens, purchase and sale transactions become increasingly costly. The risk arises from the uncertainty of the spread.

16. C is correct. Settlement risk is related to default risk but deals with the timing of payments rather than the risk of default.

17. A is correct. The VaR measure indicates the probability of a loss of at least a certain level in a time period.

18. C is correct. Risk acceptance is similar to self-insurance. An organization choosing to self-insure may set up a reserve fund to cover losses. Buying insurance is a form of risk transfer and using derivatives is a form of risk-shifting, not risk acceptance.

19. C is correct. Among the risk-modification methods of risk avoidance, risk acceptance, risk transfer, and risk shifting none has a clear advantage. One must weigh benefits and costs in light of the firm's risk tolerance when choosing the method to use.

SOLUTIONS

1. A is correct. Almost all technical analysis relies on these data inputs.

2. A is correct. Technical analysis works because markets are *not* efficient and rational and because human beings tend to behave similarly in similar circumstances. The result is market trends and patterns that repeat themselves and are somewhat predictable.

3. A is correct. Trends generally must be in place for some time before they are recognizable. Thus, some time may be needed for a change in trend to be identified.

4. A is correct. Commodities and currencies do not have underlying financial statements or an income stream; thus, fundamental analysis is useless in determining theoretical values for them or whether they are over- or undervalued.

5. A is correct. The underlying logic of technical analysis is that past price action can be useful to anticipate and project potential future prices with charts and other technical tools

6. B is correct. According to technical analysts, market psychology leads to repetition of price movements. Because investor behavior repeats itself, price movement patterns can be charted out, allowing technicians to recognize patterns.

7. C is correct. The top and bottom of the bars indicate the highs and lows for the day; the line on the left indicates the opening price and the line on the right indicates the closing price.

8. C is correct. Dark and light shading is a unique feature of candlestick charts.

9. C is correct. A shaded candlestick body indicates that the price of the security closed down from its opening price, whereas a clear body indicates that the price closed up from its opening price. Thus, a shaded candlestick body indicates that the opening price was higher than the closing price.

10. B is correct. A line chart has one data point per time interval, with price on the vertical axis and unit of time on the horizontal axis.

11. A is correct. The price of gold in nominal dollars was several orders of magnitude cheaper 100 years ago than it is today (roughly US$20 then versus US$1,100 today). Such a wide range of prices lends itself well to being graphically displayed on a logarithmic scale.

12. B is correct. A linearly scaled (rather than a logarithmically scaled) chart is better suited for analysis of short-term price movements. A linear scale plots price against a vertical axis with an equal distance between prices, whereas with a logarithmic scale, equal vertical distances correspond to an equal percentage change. The difference between a logarithmic price chart and an arithmetic (linear) price chart can be small when analyzing a chart in the short term. However, major differences are apparent when analyzing longer-term charts (more than two years of price data).

13. B is correct. In relative strength analysis, the analyst typically prepares a line chart of the ratio of the two assets' prices, with the asset under analysis as the numerator and with the benchmark or other security as the denominator. With

this single line chart, the analyst can readily visualize relative performance by the positive or negative slope of the line. A rising line shows the asset is performing better than the index or other stock; a declining line shows the opposite.

14. C is correct. Rising volume shows conviction by many market participants, which is likely to lead to a continuation of the trend.

15. B is correct. A downtrend line is constructed by drawing a line connecting the highs of the price chart.

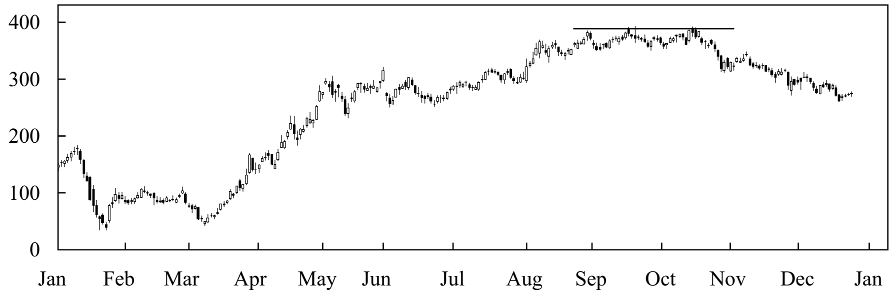
16. B is correct. It is demonstrated in the following chart:

Exhibit 1: Candlestick Chart: ABC Co., Ltd. Price Data, November–September (Price Measured in RMB × 10)

17. B is correct.

18. C is correct. As shown in the following chart, XYZ Co. shares traded up to 390p on three occasions, each several weeks apart, and declined thereafter each time.

Exhibit 2: Candlestick Chart: XYZ Co. Price Data, January–January (Price Measured in British Pence)



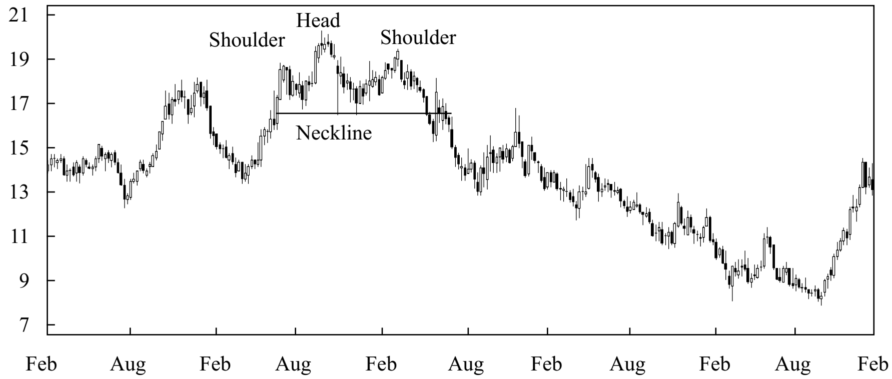
19. C is correct. In technical analysis, when a security is not trending, it is considered to be in consolidation. A consolidation phase is characterized by a fairly narrow trading range in which the price moves sideways (indicative of relative supply/demand balance) without much upward or downward movement. The key to technical analysis is the ability to differentiate between a consolidation and a trend phase.

20. A is correct. When a previously downtrending price breaks out of its consolidation range on the downside, it suggests that the price will enter a new downtrend phase.

21. A is correct. According to the change in polarity principle, once a support level is breached, it becomes a level of resistance. Likewise, when a resistance level is breached, it becomes a level of support.

22. C is correct. The left shoulder formed at around US$18.50, the head formed at around US$20.50, and the second shoulder formed at around US$19.

Exhibit 3: Candlestick Chart: DGF Company, five years, February–February



23. A is correct. In the ascending triangle pattern, irrespective of where the ascending triangle is identified, it should be considered as a consolidation with bullish

implications.

24. C is correct. Target = Neckline + (Neckline − Head): €100 + (€100 − €75) = €125

25. B is correct. A head and shoulders pattern is a reversal pattern that signals the end of an uptrend in price. Once a head and shoulders pattern has been formed, the expectation is that the price will decline through the neckline price of the formation.

26. B is correct. An inverse head and shoulders is a reversal pattern for a downtrend that preceded the formation of the pattern. An inverse head and shoulders is also referred to as a head and shoulders bottom and signals a potential reversal from the preceding downtrend to an uptrend. An inverse head and shoulders is the opposite of a head and shoulders pattern that signals a reversal from a preceding uptrend to a downtrend.

27. B is correct. A head and shoulders formation is a sell indicator that signals a reversal of a preceding uptrend. Once the head and shoulders pattern forms, the expectation is that the price will decline through the neckline price, setting the stage for a downtrend phase.

28. A is correct. When attempting to profit from a head and shoulders formation, a technician will often use the price difference between the head and neckline to set a price target below the neckline. The price target is therefore set as follows: Price target = Neckline − (Head − Neckline).

29. B is correct. With a "healthy correction," a type of continuation pattern, the long-term price trend does not change as supply and demand remains in balance while ownership transitions from one investor group to another.

30. A is correct. Triangles are one of several continuation patterns.

31. C is correct. It is one of several reversal patterns.

32. A is correct. Volume is necessary to confirm the various market rallies and reversals during the formation of the head and shoulders pattern.

33. A is correct. When the short-term moving average crosses above the long-term moving average, it can be viewed as a bullish buy signal. For example, a 5-day short-term moving average (a proxy for short-term momentum) breaking up through a 60-day longer-term moving average (an indicator of intermediate trend) can be used as a buy signal.

34. A is correct. A widely followed moving average crossover signal is the one that takes place between the 50-day moving average and the 200-day moving average. When the short-term (50-day) moving average crosses below the long-term (200-day) moving average, it is called a death cross and is a bearish signal.

35. C is correct. Bollinger Bands consist of a moving average and a higher line representing the moving average plus a set number of standard deviations from average price (for the same number of periods as used to calculate the moving average) and a lower line that is a moving average minus the same number of standard deviations.

36. B is correct. A Bollinger Band "squeeze" occurs when volatility falls to a very low level, as evidenced by the narrowing bands.

37. C is correct. Bollinger Bands are price-based indicators, *not* momentum oscil-

lators, which are constructed so that they oscillate between a high and a low or around 0 or 100.

38. C is correct. Intermarket analysis is a field within technical analysis that combines analysis of major categories of securities, industries, benchmarks, and geographies to identify intermarket relationships, trends, and possible inflections in a trend. To identify these intermarket relationships and trends, a commonly used tool is relative strength analysis, which charts the ratio of the price of two assets.

39. C is correct. Securities that break out from low-volatility conditions are likely to experience high volatility, and high volatility in the direction of an existing trend will usually help the trend pick up momentum. Breakouts from consolidation periods in an uptrend or entering an uptrend are usually followed by a continuation of the existing trend.

SOLUTIONS

1. A is correct. Drivers of fintech include extremely rapid growth in data (including their quantity, types, sources, and quality) and technological advances enabling the capture and extraction of information from it.

2. B is correct. Big Data is collected from many different sources and is in a variety of formats, including structured data (e.g., SQL tables or CSV files), semi-structured data (e.g., HTML code), and unstructured data (e.g., video messages).

3. C is correct. Overfitting occurs when the ML model learns the input and target dataset too precisely. In this case, the model has been "over trained" on the data and is treating noise in the data as true parameters. An ML model that has been overfitted is not able to accurately predict outcomes using a different dataset and might be too complex.

4. A is correct. Through the text analytics application of NLP, models using NLP analysis might incorporate non-traditional information to evaluate what people are saying—via their preferences, opinions, likes, or dislikes—in the attempt to identify trends and short-term indicators about a company, a stock, or an economic event that might have a bearing on future performance.

5. B is correct. Research suggests that robo-advisers tend to offer fairly conservative advice, providing a cost-effective and easily accessible form of financial guidance to underserved populations, such as the mass affluent and mass market segments.

6. C is correct. Interest is increasing in monitoring risk in real time. To do so, relevant data must be taken by a firm, mapped to known risks, and identified while moving within the firm. Data could be aggregated for reporting purposes or used as inputs to risk models.

7. C is correct. Global financial markets have undergone substantial change as markets have fragmented into multiple trading destinations consisting of electronic exchanges, alternative trading systems, and so-called dark pools. In such an environment, when markets are continuously reflecting real-time information and continuously changing conditions, algorithmic trading has been viewed as an important tool.

8. C is correct. DLT has the potential to streamline the existing, often complex and labor-intensive post-trade processes in securities markets by providing close to real-time trade verification, reconciliation, and settlement, thereby reducing related complexity, time, and costs.

9. A is correct. Through tokenization—the process of representing ownership rights to physical assets on a blockchain or distributed ledger—DLT has the potential to streamline this rights process by creating a single, digital record of ownership with which to verify ownership title and authenticity, including all historical activity.

Ethical and Professional Standards

SOLUTIONS

1. C is correct. Standards of conduct are applied to specific communities or societal groups and identify specific behaviors required of community members. These standards of conduct serve as benchmarks for the minimally acceptable behavior of community members. Codes of ethics serve as a general guide for how community members should act; they communicate the organization's values and overall expectations regarding member behavior, but they do not identify specific behaviors required of community members. Laws and regulations are rules of conduct defined by governments and related entities about obligatory and forbidden conduct broadly applicable for individuals and entities under their jurisdiction.

2. B is correct. A profession has several characteristics that distinguish it from an occupation or vocation, such as specialized knowledge and skills, service to others, and a code of ethics shared by its members. A profession is the ultimate evolution of an occupation, resulting from excellence in practice, a mastery mindest, and expected adherence to a code of ethics and standards of practice.

3. C is correct. Unethical behavior ultimately harms investment firms. Clients are not attracted if they suspect unethical behavior, leading to less business and lower revenues. Investment firms may also experience higher relative costs because regulators are more likely to have cause to initiate costly investigations.

4. C is correct. High ethical standards distinguish professions from the craft guilds or trade bodies. Unlike trade bodies, professional bodies also typically have a mission to serve society and enforce professional conduct rules for practitioners.

5. B is correct. Fiduciary duty is an obligation to deliver a high standard of care when acting for the benefit of another party. Professionals must act in the best interest of the client, exercising a reasonable level of care, skill, and diligence. Other entities—including employers, regulators, trade associations, and not-for-profit bodies—may also support an industry but are not the same as professional bodies. Unlike professions, these other entities generally do not exist to set and maintain professional standards.

6. A is correct. An overconfidence bias can lead individuals to put too much importance on internal traits and intrinsic motivations, such as their own perceptions of personal honesty, that can lead to faulty decision making. Loyalty to an employer and promise of money or prestige are situational influences that can lead to faulty decision making.

7. B is correct. Consciously considering long-term consequences will help offset situational influences. We more easily recognize and consider short-term situational influences than longer-term considerations because longer-term considerations have fewer immediate consequences than situational influences do. When decision making is too narrowly focused on short-term factors, we tend to ignore longer-term risks and consequences, and the likelihood of poor ethical decision making increases. A strong compliance policy is a good first step toward developing an ethical culture; a focus on rules adherence may not be sufficient. Emphasis on compliance may not encourage decision makers to consider the larger picture and can oversimplify decision making. Taken to the extreme, a strong compliance culture can become another situational influence that blinds employees to other important considerations. An overconfidence bias can place too much importance on internal traits and intrinsic motivations, such as "I'm honest and would

not lie," even though studies have shown that internal traits are generally not the main determinant of whether or not someone will behave ethically in a given situation.

8. B is correct. A compliance approach can oversimplify decision making and may not encourage decision makers to consider the larger picture. A strong compliance culture may be a good start in developing an ethical culture but can become another situational influence that may result in employees failing to consider other important factors.

9. C is correct. The investment management profession and investment firms must be interdependent to maintain trust. Employers and regulators have their own standards and practices, which may differ from regulations and standards set by professional bodies.

10. B is correct. The investment industry has examples of conduct that may be legal but that CFA Institute considers unethical. Trading while in possession of material nonpublic information is not prohibited by law worldwide and can, therefore, be legal, but CFA Institute considers such trading unethical.

11. C is correct. Using an ethical decision-making framework consistently will help you develop sound judgment and decision-making skills and avoid making decisions that have unanticipated ethical consequences. The decision-making process is often iterative, and the decision maker may move between phases of the framework. A decision maker should consider more than confirmable facts and relationships; for example, the decision maker should consider situational influences and personal biases.

12. C is correct. When a dilemma occurs, raising an issue internally with a senior employee is often a good starting place and creates an opportunity for an independent internal review. Protecting the client and the firm may take priority over the position of an individual professional raising a concern.

SOLUTIONS

1. B is correct. The *Standards of Practice Handbook* provides guidance to which CFA Institute members and candidates are required to adhere.

   A is incorrect because the *Handbook* provides guidance in understanding the interconnectedness of the aspirational and practical principles (not regarding penalties for violations) of the Code of Ethics and Standards of Conduct.

   C is incorrect because although the *Standards of Practice Handbook* provides hypothetical but factual situations, the explanatory material and examples are not intended to be all inclusive.

2. C is correct. When an inquiry is initiated, the Professional Conduct staff conducts an investigation that may include requesting a written explanation from the member or candidate.

   A is incorrect because Professional Conduct inquiries can be initiated in response to information provided by the media. CFA Institute staff may become aware of questionable conduct by a member or candidate through the media, regulatory notices, or another public source.

   B is incorrect because although the Disciplinary Review Committee (DRC) is responsible for enforcement of the Code and Standards in conjunction with the Professional Conduct Program (PCP), only in the event that a member or candidate does not accept the charges and proposed sanction is the matter referred to a panel composed of DRC members.

3. C is correct. One of the principles in the Code of Ethics was updated to reflect the role that the capital markets have in society as a whole.

   A is incorrect because it is incomplete, missing the additional language to reflect the role that the capital markets have in society as a whole.

   B is incorrect because this is the old principle as written in the Code of Ethics, which was recently updated to reflect the role of the capital markets in society as a whole.

4. C is correct. Given the constant development of new and exotic financial instruments and strategies, the standard regarding communicating with clients now includes an implicit requirement to discuss the risks and limitations of recommendations being made to clients.

   A is incorrect because the updated standard for members and candidates with supervision or authority over others within their firms stresses broader compliance expectations, which include the detection and prevention aspects of the original version that was the prior focus.

   B is incorrect because the updated standard not only maintains the integrity of the CFA Program but also expands the same (not separate) ethical considerations when members or candidates participate in such programs as the CIPM Program and the Investment Foundations Certificate.

5. B is correct. Members of CFA Institute and candidates for the CFA designation must place the integrity of the investment profession and the interests of clients above their own personal interests.

   A is incorrect because members of CFA Institute and candidates for the CFA designation must maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals. The exercise of independent professional judgment is associated with using reasonable care.

C is incorrect because members of CFA Institute and candidates for the CFA designation must practice and encourage others to practice in a professional and ethical manner that will reflect credibly on themselves and the profession. Members are supposed to act with integrity, competence, diligence, and respect and in an ethical manner with the public, clients, and other market participants.

6. B is correct. The current Standards of Professional Conduct requires members and candidates to promptly disclose any changes that might materially affect investment processes.

   A is incorrect because under Standard III.C.2 Suitability, when members and candidates are responsible for managing a portfolio according to a specific mandate, they must take only investment actions that are consistent with the stated objectives of the portfolio. The "fair, accurate, and complete" criterion relates to the Standard III D Performance Presentation.

   C is incorrect because under Standard III.E.1, 2, 3 Preservation of Confidentiality, members and candidates must keep information about current clients confidential unless the information concerns illegal activities on the part of the client, disclosure is required by law, or the client permits disclosure. No decisions on confidentiality are required, with the "reasonable and adequate basis" criterion related to Standard V.A.2 Diligence and Reasonable Basis.

7. A is correct. Within the Standards of Practice Handbook, CFA Institute addresses ethical principles for the profession in the following Standards: individual professionalism; integrity in capital markets; responsibilities to clients, responsibilities to employers; ethics involved in investment analysis, recommendations, and actions; and possible conflicts of interest. B is incorrect because it represents, and combines, two ethical principles, those relating to the Standards "Duties to Clients" and "Duties to Employers." C is incorrect because the ethical principle (and Standard) relating to ethics in investment analysis and recommendations also includes actions.

8. B is correct. Under Standard II.A Material Nonpublic Information, members having material nonpublic information that could affect the value of an investment must not cause others to act on the information.

   A is incorrect because price distortion is mentioned in the Standard II.B Market Manipulation, not Standard II.A Material Nonpublic Information.

   C is incorrect because the maintenance of appropriate records to support investment analyses is noted in Standard V.C Record Retention, not Standard II.A Material Nonpublic Information.

9. B is correct. Standard III.C.1c Suitability states that when members and candidates are in an advisory relationship with a client, they must judge the suitability of investments in the context of the client's total portfolio.

   A is incorrect because this is a requirement addressed under Standard III.A Loyalty, Prudence, and Care, not Standard III.C.1c Suitability.

   C is incorrect because this is a requirement addressed under Standard I.C Misrepresentation, not Standard III.C.1c Suitability.

10. C is correct. Under the III.B Fair Dealing section of the Duty to Clients standard, members and candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

    A is incorrect because under Standard III.C.1a Suitability, a section of Duties to Clients, members and candidates in an advisory relationship must make a reasonable inquiry into a client's financial constraints prior to (not after) taking investment action and must reassess and update this regularly.

B is incorrect because under Standard III.A Loyalty, Prudence, and Care, members and candidates must act for the benefit of their clients and place their clients' interests before (not maintain an equal balance with) their employer's or their own interests.

11. B is correct. The IV.A Loyalty section of the Duties to Employers standard states that members and candidates cannot deprive their employer of the advantage of their skills and abilities in matters related to their employment.

    A is incorrect because accepting gifts that might compromise a member or candidate's independence and objectivity is addressed by Standard I.B Independence and Objectivity, a section of Professionalism, not under Standard IV Duties to Employers.

    C is incorrect because IV.B Additional Compensation Arrangements, part of the Duties to Employers standard, permits members and candidates to accept compensation that competes with their employer's interest if they obtain written consent from all parties involved.

12. C is correct. The V.B.4 Communications with Clients and Prospective Clients section of the Investment Analysis, Recommendations, and Actions standard states that members and candidates must distinguish between fact and opinion in the presentation of investment analysis and recommendations.

    A is incorrect because this standard is discussed in the III.C.1b Suitability section of the Duties to Clients standard.

    B is incorrect because performance presentation is discussed in the III.D Performance Presentation section of the Duties to Clients standard.

13. B is correct. The VI.C Referral Fees section of the Conflicts of Interest standard requires members and candidates to disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

    A is incorrect because the VI.A Disclosure of Conflicts section of the Conflicts of Interest standard requires members and candidates to make full and fair disclosure of all matters (not limited to legal requirements) that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer.

    C is incorrect because the VI.B Priority of Transactions section of the Conflicts of Interest standard requires members and candidates to give priority to investment transactions for clients and employers versus those in which a member or candidate is the beneficial owner. This requirement is not waived by an employer's approval.

14. C is correct. The VII.B Reference to CFA Institute, the CFA Designation, and the CFA Program section of the Responsibilities as a CFA Institute Member or CFA Candidate standard explicitly states the appropriate manner to make reference to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program.

    A is incorrect because Standard VII Responsibilities as a CFA Institute Member or CFA Candidate standard does not refer to loyalty. Loyalty is addressed in two other standards, Standard III.A Loyalty, Prudence, and Care and Standard IV.A Loyalty.

    B is incorrect because Standard VII Responsibilities as a CFA Institute Member or CFA Candidate standard does not refer to the responsibility of supervisors. The responsibility of supervisors is addressed in Standard IV.C Responsibility of Supervisors.

SOLUTIONS

1. The correct answer is B. This question involves Standard III(B)–Fair Dealing. Smith disseminated a change in the stock recommendation to his clients but then received a request contrary to that recommendation from a client who probably had not yet received the recommendation. Prior to executing the order, Smith should take additional steps to ensure that the customer has received the change of recommendation. Answer A is incorrect because the client placed the order prior to receiving the recommendation and, therefore, does not have the benefit of Smith's most recent recommendation. Answer C is also incorrect; simply because the client request is contrary to the firm's recommendation does not mean a member can override a direct request by a client. After Smith contacts the client to ensure that the client has received the changed recommendation, if the client still wants to place a buy order for the shares, Smith is obligated to comply with the client's directive.

2. The correct answer is C. This question involves Standard III(A)–Loyalty, Prudence, and Care and the specific topic of soft dollars or soft commissions. Answer C is the correct choice because client brokerage commissions may not be directed to pay for the investment manager's operating expenses. Answer B describes how members and candidates should determine how to use brokerage commissions—that is, if the use is in the best interests of clients and is commensurate with the value of the services provided. Answer A describes a practice that is commonly referred to as "directed brokerage." Because brokerage is an asset of the client and is used to benefit the client, not the manager, such practice does not violate a duty of loyalty to the client. Members and candidates are obligated in all situations to disclose to clients their practices in the use of client brokerage commissions.

3. The correct answer is C. This question involves Standard VI(A)–Disclosure of Conflicts. The question establishes a conflict of interest in which an analyst, Jamison, is asked to write a research report on a company that is a client of the analyst's employer. In addition, two directors of the company are senior officers of Jamison's employer. Both facts establish that there are conflicts of interest that must be disclosed by Jamison in her research report. Answer B is incorrect because an analyst is not prevented from writing a report simply because of the special relationship the analyst's employer has with the company as long as that relationship is disclosed. Answer A is incorrect because whether or not Jamison expresses any opinions in the report is irrelevant to her duty to disclose a conflict of interest. Not expressing opinions does not relieve the analyst of the responsibility to disclose the special relationships between the two companies.

4. The correct answer is C. This question asks about compliance procedures relating to personal investments of members and candidates. The statement in answer C clearly conflicts with the recommended procedures in the *Standards of Practice Handbook*. Employers should compare personal transactions of employees with those of clients on a regular basis regardless of the existence of a requirement by any regulatory organization. Such comparisons ensure that employees' personal trades do not conflict with their duty to their clients, and the comparisons can be conducted in a confidential manner. The statement in answer A does not conflict with the procedures in the *Handbook*. Disclosure of such policies will give full information to clients regarding potential conflicts of interest on the part of those entrusted to manage their money. Answer B is incorrect because firms are encouraged to establish policies whereby employees clear their personal holdings

and transactions with their employers.

5. The correct answer is B. This question relates to Standard III(A)–Loyalty, Prudence, and Care and Standard III(E)–Preservation of Confidentiality. In this case, the member manages funds of a private endowment. Clients, who are, in this case, the trustees of the fund, must place some trust in members and candidates. Bronson cannot disclose confidential financial information to anyone without the permission of the fund, regardless of whether the disclosure may benefit the fund. Therefore, answer A is incorrect. Answer C is incorrect because Bronson must notify the fund and obtain the fund's permission before publicizing the information.

6. The correct answer is B. This question relates to Standard V(A)–Diligence and Reasonable Basis. The opinion of another financial analyst is not an adequate basis for Willier's action in changing the recommendation. Answer C is thus incorrect. So is answer A because, although it is true that members and candidates must distinguish between facts and opinions in recommendations, the question does not illustrate a violation of that nature. If the opinion overheard by Willier had sparked him to conduct additional research and investigation that justified a change of opinion, then a changed recommendation would be appropriate.

7. The correct answer is B. This question relates to Standard I(B)–Independence and Objectivity. When asked to change a recommendation on a company stock to gain business for the firm, the head of the brokerage unit must refuse in order to maintain his independence and objectivity in making recommendations. He must not yield to pressure by the firm's investment banking department. To avoid the appearance of a conflict of interest, the firm should discontinue issuing recommendations about the company. Answer A is incorrect; changing the recommendation in any manner that is contrary to the analyst's opinion violates the duty to maintain independence and objectivity. Answer C is incorrect because merely assigning a new analyst to decide whether the stock deserves a higher rating will not address the conflict of interest.

8. The correct answer is A. Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program is the subject of this question. The reference on Albert's business card implies that there is a "CFA Level II" designation; Tye merely indicates in promotional material that he is participating in the CFA Program and has completed Levels I and II. Candidates may not imply that there is some sort of partial designation earned after passing a level of the CFA exam. Therefore, Albert has violated Standard VII(B). Candidates may communicate that they are participating in the CFA Program, however, and may state the levels that they have completed. Therefore, Tye has not violated Standard VII(B).

9. The correct answer is B. This question relates to Standard V(B)–Communication with Clients and Prospective Clients. Scott has issued a research report stating that he expects the price of Walkton Industries stock to rise by US$8 a share "because the dividend will increase" by US$1.50 per share. He has made this statement knowing that the dividend will increase only if Congress enacts certain legislation, an uncertain prospect. By stating that the dividend will increase, Scott failed to separate fact from opinion.

   The information regarding passage of legislation is not material nonpublic information because it is conjecture, and the question does not state whether the US representative gave Scott her opinion on the passage of the legislation in confidence. She could have been offering this opinion to anyone who asked. Therefore, statement A is incorrect. It may be acceptable to base a recommendation, in part, on an expectation of future events, even though they may be uncertain. Therefore, answer C is incorrect.

10. The correct answer is C. This question, which relates to Standard III(B)–Fair Dealing, tests the knowledge of the procedures that will assist members and candidates in treating clients fairly when making investment recommendations. The step listed in C will help ensure the fair treatment of clients. Answer A may have negative effects on the fair treatment of clients. The more people who know about a pending change, the greater the chance that someone will inform some clients before the information's release. The firm should establish policies that limit the number of people who are aware in advance that a recommendation is to be disseminated. Answer B, distributing recommendations to institutional clients before distributing them to individual accounts, discriminates among clients on the basis of size and class of assets and is a violation of Standard III(B).

11. The correct answer is B. This question deals with Standard II(A)–Material Nonpublic Information. The mosaic theory states that an analyst may use material public information and nonmaterial nonpublic information in creating a larger picture than shown by any individual piece of information and the conclusions the analyst reaches become material only after the pieces are assembled. Answers A and C are accurate statements relating to the Code and Standards but do not describe the mosaic theory.

12. The correct answer is C. This question involves Standard IV(B)–Additional Compensation Arrangements. The arrangement described in the question—whereby Jurgen would be compensated beyond the compensation provided by her firm, on the basis of an account's performance—is not a violation of the Standards as long as Jurgen discloses the arrangement in writing to her employer and obtains permission from her employer prior to entering into the arrangement. Answers A and B are incorrect; although the private compensation arrangement could conflict with the interests of other clients and lead to short-term performance pressures, members and candidates may enter into such agreements as long as they have disclosed the arrangements to their employer and obtained permission for the arrangement from their employer.

13. The correct answer is B. This question relates to Standard III(A)–Loyalty, Prudence, and Care—specifically, a member's or candidate's responsibility for voting proxies and the use of client brokerage. According to the facts stated in the question, Farnsworth did not violate Standard III(A). Although the company president asked Farnsworth to vote the shares of the Jones Corporation profit-sharing plan a certain way, Farnsworth investigated the issue and concluded, independently, the best way to vote. Therefore, even though his decision coincided with the wishes of the company president, Farnsworth is not in violation of his responsibility to be loyal and to provide care to his clients. In this case, the participants and the beneficiaries of the profit-sharing plan are the clients, not the company's management. Had Farnsworth not investigated the issue or had he yielded to the president's wishes and voted for a slate of directors that he had determined was not in the best interest of the company, Farnsworth would have violated his responsibilities to the beneficiaries of the plan. In addition, because the brokerage firm provides the lowest commissions and best execution for securities transactions, Farnsworth has met his obligations to the client in using this brokerage firm. It does not matter that the brokerage firm also provides research information that is not useful for the account generating the commission because Farnsworth is not paying extra money of the client's for that information.

14. The correct answer is A. In this question, Brown is providing investment recommendations before making inquiries about the client's financial situation, investment experience, or investment objectives. Brown is thus violating Standard

III(C)–Suitability. Answers B and C provide examples of information members and candidates should discuss with their clients at the outset of the relationship, but these answers do not constitute a complete list of those factors. Answer A is the best answer.

15. The correct answer is C. This question involves Standard I(C)–Misrepresentation. Statement I is a factual statement that discloses to clients and prospects accurate information about the terms of the investment instrument. Statement II, which guarantees a specific rate of return for a mutual fund, is an opinion stated as a fact and, therefore, violates Standard I(C). If statement II were rephrased to include a qualifying statement, such as "in my opinion, investors may earn . . ., " it would not be in violation of the Standards.

16. The correct answer is A. This question involves three of the Standards. Anderb, the portfolio manager, has been obtaining more favorable prices for her personal securities transactions than she gets for her clients, which is a breach of Standard III(A)–Loyalty, Prudence, and Care. In addition, she violated Standard I(D)–Misconduct by failing to adhere to company policy and by hiding her personal transactions from her firm. Anderb's supervisor, Bates, violated Standard IV(C)–Responsibilities of Supervisors; although the company had requirements for reporting personal trading, Bates failed to adequately enforce those requirements. Answer B does not represent a violation because Standard VI(B)–Priority of Transactions requires that personal trading in a security be conducted after the trading in that security of clients and the employer. The Code and Standards do not prohibit owning such investments, although firms may establish policies that limit the investment opportunities of members and candidates. Answer C does not represent a violation because the Code and Standards do not contain a prohibition against employees using the same broker for their personal accounts that they use for their client accounts. This arrangement should be disclosed to the employer so that the employer may determine whether a conflict of interest exists.

17. The correct answer is A because this question relates to Standard I(A)–Knowledge of the Law—specifically, global application of the Code and Standards. Members and candidates who practice in multiple jurisdictions may be subject to various securities laws and regulations. If applicable law is more strict than the requirements of the Code and Standards, members and candidates must adhere to applicable law; otherwise, members and candidates must adhere to the Code and Standards. Therefore, answer A is correct. Answer B is incorrect because members and candidates must adhere to the higher standard set by the Code and Standards if local applicable law is less strict. Answer C is incorrect because when no applicable law exists, members and candidates are required to adhere to the Code and Standards, and the Code and Standards prohibit the use of material nonpublic information.

18. The correct answer is B. The best course of action under Standard I(B)–Independence and Objectivity is to avoid a conflict of interest whenever possible. Therefore, for Ward to pay for all his expenses is the correct answer. Answer C details a course of action in which the conflict would be disclosed, but the solution is not as appropriate as avoiding the conflict of interest. Answer A would not be the best course because it would not remove the appearance of a conflict of interest; even though the report would not be affected by the reimbursement of expenses, it could appear to be.

19. The correct answer is B. Under Standard IV(A)–Loyalty, members and candidates may undertake independent practice that may result in compensation or other benefit in competition with their employer as long as they obtain consent

from their employer. Answer C is not consistent with the Standards because the Standards allow members and candidates to make arrangements or preparations to go into competitive business as long as those arrangements do not interfere with their duty to their current employer. Answer A is not consistent with the Standards because the Standards do not include a complete prohibition against undertaking independent practice.

20. The correct answer is B. This question involves Standard VI(A)–Disclosure of Conflicts—specifically, the holdings of an analyst's employer in company stock. Answers A and C do not describe conflicts of interest that Smith would have to disclose. Answer A describes the use of a firm's products, which would not be a required disclosure. In answer C, the relationship between the analyst and the company through a relative is so tangential that it does not create a conflict of interest necessitating disclosure.

21. The correct answer is C. This question relates to Standard I(C)–Misrepresentation. Although Michelieu's statement about the total return of his clients' accounts on average may be technically true, it is misleading because the majority of the gain resulted from one client's large position taken against Michelieu's advice. Therefore, this statement misrepresents the investment performance the member is responsible for. He has not taken steps to present a fair, accurate, and complete presentation of performance. Answer B is thus incorrect. Answer A is incorrect because although Michelieu is not guaranteeing future results, his words are still a misrepresentation of his performance history.

22. The correct answer is B. The best policy to prevent violation of Standard II(A)–Material Nonpublic Information is the establishment of firewalls in a firm to prevent exchange of insider information. The physical and informational barrier of a firewall between the investment banking department and the brokerage operation prevents the investment banking department from providing information to analysts on the brokerage side who may be writing recommendations on a company stock. Prohibiting recommendations of the stock of companies that are clients of the investment banking department is an alternative, but answer A states that this prohibition would be permanent, which is not the best answer. Once an offering is complete and the material nonpublic information obtained by the investment banking department becomes public, resuming publishing recommendations on the stock is not a violation of the Code and Standards because the information of the investment banking department no longer gives the brokerage operation an advantage in writing the report. Answer C is incorrect because no exchange of information should be occurring between the investment banking department and the brokerage operation, so monitoring of such exchanges is not an effective compliance procedure for preventing the use of material nonpublic information.

23. The correct answer is B. Under Standard III(A)–Loyalty, Prudence, and Care, members and candidates who manage a company's pension fund owe these duties to the participants and beneficiaries of the pension plan, not the management of the company or the company's shareholders.

24. The correct answer is B. Answer B gives one of the two primary reasons listed in the *Handbook* for disclosing referral fees to clients under Standard VI(C)–Referral Fees. (The other is to allow clients and employers to evaluate the full cost of the services.) Answer A is incorrect because Standard VI(C) does not require members or candidates to discount their fees when they receive referral fees. Answer C is inconsistent with Standard VI(C) because disclosure of referral fees, to be effective, should be made to prospective clients before entering into a formal

client relationship with them.

25. The correct answer is B. Standard VI(B)–Priority of Transactions does not limit transactions of company employees that differ from current recommendations as long as the sale does not disadvantage current clients. Thus, answer A is incorrect. Answer C is incorrect because the Standard does not require the matching of personal and client trades.

26. Answer C is correct. Standard IV(A)–Loyalty discusses activities permissible to members and candidates when they are leaving their current employer; soliciting clients is strictly prohibited. Thus, answer A is inconsistent with the Code and Standards even with the required disclosure. Answer B is incorrect because the offer does not directly violate the Code and Standards. There may be out-of-work members and candidates who can arrange the necessary commitments without violating the Code and Standards.

27. Answer A is correct. The question relates to Standard III(A)–Loyalty, Prudence, and Care. Carter believes the broker offers effective execution at a fee that is comparable with those of other brokers, so he is free to use the broker for all accounts. Answer B is incorrect because the accounts that prohibit soft dollar arrangements do not want to fund the purchase of research by Carter. The new trading scheme does not incur additional commissions from clients, so it would not go against the prohibitions. Answer C is incorrect because Carter should not incur unnecessary or excessive "churning" of the portfolios (excessive trading) for the purpose of meeting the brokerage commitments of soft dollar arrangements.

28. Answer B is correct according to Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program. CFA Program candidates do not receive their actual scores on the exam. Topic and subtopic results are grouped into three broad categories, and the exam is graded only as "pass" or "fail." Although a candidate may have achieved a topical score of "above 70%," she or he cannot factually state that she or he received the highest possible score because that information is not reported. Thus, answer C is incorrect. Answer A is incorrect as long as the member or candidate actually completed the exams consecutively. Standard VII(B) does not prohibit the communication of factual information about completing the CFA Program in three consecutive years.

29. Answer C is correct. According to Standard III(A)–Loyalty, Prudence, and Care, the CFA Program would be considered a personal or firm expense and should not be paid for with the fund's brokerage commissions. Soft dollar accounts should be used only to purchase research services that directly assist the investment manager in the investment decision-making process, not to assist the management of the firm or to further education. Thus, answer A is incorrect. Answer B is incorrect because the reasonableness of how the money is used is not an issue; the issue is that educational expense is not research.

30. Answer A is correct. Standard I(B)–Independence and Objectivity emphasizes the need for members and candidates to maintain their independence and objectivity. Best practices dictate that firms adopt a strict policy not to accept compensation for travel arrangements. At times, however, accepting paid travel would not compromise one's independence and objectivity. Answers B and C are incorrect because the added benefits—free conference admission for additional staff members and an exclusive golf retreat for the speaker—could be viewed as inducements related to the firm's working arrangements and not solely related to the speaking engagement. Should Long wish to bring other team members or participate in the golf outing, he or his firm should be responsible for the associ-

ated fees.

31. Answer C is correct. The guidance to Standard II(A)–Material Nonpublic Information recommends adding securities to the firm's restricted list when the firm has or may have material nonpublic information. By adding these securities to this list, Andrews would uphold this standard. Because waiting until the next day will not ensure that news of the merger is made public, answer A is incorrect. Negotiations may take much longer between the two companies, and the merger may never happen. Andrews must wait until the information is disseminated to the market before he trades on that information. Answer B is incorrect because Andrews should not disclose the information to other managers; no trading is allowed on material nonpublic information.

32. Answer B is correct. Through placing a personal purchase order that is significantly greater than the average volume, Pietro is violating Standard IIB–Market Manipulation. He is attempting to manipulate an increase in the share price and thus bring a buyer to the negotiating table. The news of a possible merger and confirmation of the firm's earnings guidance may also have positive effects on the price of Local Bank, but Pietro's actions in instructing the release of the information does not represent a violation through market manipulation. Announcements of this nature are common and practical to keep investors informed. Thus, answers A and C are incorrect.

33. Answer C is correct. Cupp violated Standard III(D)–Performance Presentations when he deviated from the firm's stated policies solely to capture the gain from the holding being acquired. Answer A is incorrect because the firm does not claim GIPS compliance and the GIPS standards require external cash flows to be treated in a consistent manner with the firm's documented policies. Answer B is incorrect because the firm does not state that it is updating its composite policies. If such a change were to occur, all cash flows for the month would have to be reviewed to ensure their consistent treatment under the new policy.

34. Answer A is correct. According to Standard V(C)–Record Retention, Cannan needed the permission of her employer to maintain the files at home after her employment ended. Without that permission, she should have deleted the files. All files created as part of a member's or candidate's professional activity are the property of the firm, even those created outside normal work hours. Thus, answer B is incorrect. Answer C is incorrect because the Code and Standards do not prohibit using one's personal computer to complete work for one's employer.

35. Answer B is correct. According to Standard VII(B)–Reference to CFA Institute, the CFA Designation, and the CFA Program, Quinn cannot claim to have finished the CFA Program or be eligible for the CFA charter until he officially learns that he has passed the Level III exam. Until the results for the most recent exam are released, those who sat for the exam should continue to refer to themselves as "candidates." Thus, answer C is incorrect. Answer A is incorrect because members and candidates may discuss areas of practice in which they believe the CFA Program improved their personal skills.

36. Answer A is correct. Hart's decision to invest in the retail fund appears directly correlated with Rodriguez's statement about the successful quarter of Mega Retail and thus violates Standard II(A)–Material Nonpublic Information. Rodriguez's information would be considered material because it would influence the share price of Mega Retail and probably influence the price of the entire exchange-traded retail fund. Thus, answer B is incorrect. Answer C is also incorrect because Rodriguez shared information that was both material and nonpublic. Company officers regularly have such knowledge about their firms, which is

not a violation. The sharing of such information, however, even in a conversation between friends, does violate Standard II(A).

37. Answer C is correct. Standard VII(A)–Conduct as Members and Candidates in the CFA Program prohibits providing information to candidates or the public that is considered confidential to the CFA Program. In revealing that questions related to the analysis of inventories and analysis of taxes were on the exam, Park has violated this standard. Answer B is incorrect because the guidance for the standard explicitly acknowledges that members and candidates are allowed to offer their opinions about the CFA Program. Answer A is incorrect because candidates are not prohibited from using outside resources.

38. Answer B is correct. Paper has violated Standard III(D)–Performance Presentation by not disclosing that he was part of a team of managers that achieved the results shown. If he had also included the return of the portion he directly managed, he would not have violated the standard. Thus, answer A is incorrect. Answer C is incorrect because Paper received written permission from his prior employer to include the results.

39. Answer A is correct. Townsend has not provided any information about her clients to the leaders or managers of the golf program; thus, she has not violated Standard III(E)–Preservation of Confidentiality. Providing contact information about her clients for a direct-mail solicitation would have been a violation. Answer B is incorrect because the notice in the newsletter does not violate Standard III(E). Answer C is incorrect because the golf program's fund-raising campaign had already begun, so discussing the opportunity to donate was appropriate.

SOLUTIONS

1. B is correct. Selecting a top-performing portfolio to represent a firm's overall investment results for a specific mandate, also known as using representative accounts, is a misleading practice that is not allowed under the GIPS standards. A is incorrect because including terminated portfolios is consistent with the GIPS standards. If the firm instead presented a performance history that excludes terminated portfolios, however, such a practice would be misleading and not allowed under the GIPS standards. C is incorrect because presenting performance for its mandate covering all periods since the firm's inception is consistent with the GIPS standards. If the firm instead presented performance for a selected period during which it produced excellent returns or outperformed its benchmark, however, such a practice would be misleading and not allowed under the GIPS standards.

2. A is correct. Asset owners can claim compliance if they manage actual assets for which they are making a claim of compliance. B is incorrect because software (and the vendors that supply software) cannot be GIPS compliant. Software can assist firms in achieving compliance with the GIPS standards, but only a firm that manages actual assets can claim compliance. C is incorrect because a firm has only two options regarding compliance with the GIPS standards: fully comply with all applicable requirements of the GIPS standards and claim compliance through the use of the GIPS Compliance Statement; or not comply with all requirements of the GIPS standards and not claim compliance with, or make any reference to, the GIPS standards.

3. C is correct. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. For example, if a GIPS-compliant firm presents performance for a global equity composite (the composite), the composite must include portfolios that are managed, or have historically been managed, according to the firm's global equity strategy. A is incorrect because a composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective, or strategy. A composite may consist of a single portfolio when it is the only portfolio managed according to a particular investment mandate. B is incorrect because the determination of which portfolio(s) to include in a composite should be done according to pre-established criteria (*ex ante* basis), not after the fact (*ex post* basis).

4. A is correct. Verification is performed with respect to an entire firm, not on specific composites. B is incorrect because verification must be performed by an independent third party. C is incorrect because verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis; it does not ensure the accuracy of a specific composite presentation.

5. B is correct. Only investment management firms and asset owners (including pension funds, whether public or private) that manage actual assets may claim compliance with the GIPS standards. Software vendors and other intermediaries cannot claim compliance.

6. C is correct. The GIPS standards require performance to be presented for consis-

tent, standardized time periods.

7. A is correct. Verification is the process of testing a firm or asset owner that claims compliance with the GIPS standards, in accordance with the required verification procedures of the GIPS standards.

8. C is correct. Firms are not required to be verified in order to claim compliance with the GIPS standards, although verification is recommended and viewed as best practice.

9. B is correct. Compliance with the GIPS standards is not typically required by regulators, nor are the GIPS standards intended to cover all regulatory requirements.

10. B is correct. Firms are encouraged to adopt the broadest, most meaningful definition possible of the firm.

11. B is correct. Composites must be defined based on investment mandate, objective, or strategy. Composites can include only discretionary portfolios.