Book 1 – Ethics and Quantitative Methods

WELCOME TO THE 2007 SCHWESER STUDY NOTES

Thanks for trusting Schweser to help you reach your goals. I am very pleased to be able to help you prepare for the Level I CFA Exam. In this introduction, I want to explain the resources we offer as part of the Study Notes package, suggest how you can best use them to prepare for the exam, and direct you toward other educational resources you may find helpful as you study for the exam. Finally, I have included a study schedule which divides the Level 1 curriculum by Study Session to help you plan your study effort over the coming months.

First, I want to explain what is included in the Study Notes package. Besides the Notes themselves, there are many resources and learning tools available online. Just login at schweser.com, using the individual username and password that you received when you purchased the Schweser Study Notes, and go to Online Access. All purchasers of our 2007 Level 1 Study Notes receive:

Study Notes - Five volumes that include complete coverage of all Study Sessions and LOS with examples, Concept Checker (multiple choice) questions for every topic review, and (more difficult) Comprehensive Problems for many topic reviews to help you master the material and check your progress.

Sample Exams - Book 6 of the Study Notes contains three full-length (6-hour) exams in a style and with a level of difficulty designed to match those of the actual Level I CFA exam. New for 2007: you can enter your answers by 3-hour exam segment and receive a complete evaluation of your performance by topic or study session, find out how your score compares with those of other Schweser students, and get detailed explanations of the answers to any questions you miss (or those you got right but might have guessed a bit on).

Schweser Library - I have created five videos for notes purchasers of approximately 30 to 60 minutes length, covering topics such as "Using Your Calculator," "Ethics Overview," and "Correlation and Regression Analysis." These are available using your Online Access at Schweser.com. Introductory information on topics such as Financial Statement Analysis, Economics, and Bonds is available in downloadable text files from the Schweser Library.

Faculty Office Hours - Get your questions about the curriculum answered in real time and see others' questions (and their answers) by joining "office hours," a text-based interactive chat with me, your Level 1 Professor. A complete schedule of times is available at Schweser.com. Join office hours using your Online Access.

Schweser Study Planner - Use your Online Access to tell us when you will start and what days of the week you can study. Study Planner will create a study plan just for you, breaking each study session into daily and weekly tasks to keep you on track and help you monitor your progress through the curriculum.

The Level I CFA exam is a formidable challenge and you must devote considerable time and effort to be properly prepared. There is no shortcut; you must learn the material, know the terminology and techniques, understand the concepts, and be able to answer questions quickly and correctly. 15-20 hours per week for 20 weeks is probably a good estimate of the study time required on average, but some candidates will need even more time depending on their individual background and experience. I suggest that you start early and strictly adhere to your study plan.

The Level I curriculum is quite broad and you are responsible for the knowledge contained in 79 readings and enumerated in over 450 Learning Outcome Statements. The writing in the Study Notes themselves is in a very concise style but also very precise in its construction. In many cases you will need to read it carefully and more than once to really understand and learn all the material.

You should begin by reading the Notes and doing all the Concept Checkers and Comprehensive problems. Go back and review the text and examples in any area where your answers are incorrect or incomplete. Once you have made it though all 18 Study Sessions in this manner you can turn your attention to the sample exams. Try to take these exams in minimum 3-hour sessions (one-half an exam), make sure you take the third one all in one day with only a lunch break, and time yourself strictly. Speed is definitely a factor in exam-day success. There are three more full exams in our Practice Exams book, and more available as online exams.

Plan to finish your initial study of the notes material at least two weeks before the exam to allow time for practice exams and for review of the Study Notes in those areas where you are the weakest. If at all possible, you should schedule the full week before the exam as vacation. Go through the Ethics material repeatedly during your months of study and once more the day before the exam.

While many candidates manage to stay motivated and learn the material from the Study Notes and Sample Exams, many cannot or find they simply prefer more of a college course approach to learning. I strongly urge you to enroll in my **16-week online class**, which meets for three hours each week. I will cover all the study sessions, include problem solving workshops with specially designed "learning" questions, and answer your questions during class in real time. Candidates enrolled in my class also receive the power point slides for each week's class and can download files with the Workshop questions (with answers provided the day after class). They also get access to archived video files for all classes in case they must miss class or simply want to see parts of it again (it does move at a pretty good pace). For those who must attend the archived class, there is a special email address where you can send me your questions any time, seven days a week.

If live classes work best for you, we have weekly classes in several cities and a variety of live seminar formats offered worldwide. Dr. Andrew Temte CFA, the President and co-founder of Schweser Study Programs, and I will both be teaching at Level I in our flagship week-long residence program in Windsor, Ontario (offered only in May). If you must study on airplanes or in the wilderness, we offer CDs with over 40 hours of video instruction.

For those who want more practice questions and want to be able to create quizzes and exams covering any LOS, reading, or topic, we offer an online database of thousands of up-to-date Level I questions and detailed answers. My full time job and current obsession is helping Schweser CFA candidates pass the exam. Work hard and stay motivated however you can. Tens of thousands have earned their CFA charter with Schweser's help, and so can you.

Best regards,

R. Douglas Van Eaton

R. Douglas Van Eaton, Ph.D., CFA
VP and Level I Manager, Schweser Study Program

Schedule for 16-Week Online Class

WEEK			*WEEK*		
1	Exam Intro and Ethics	SS #1	9	Financial Statement Analysis	SS #10
2	Quantitative Methods	SS #2	10	Corporate Finance	SS#11
3	Quantitative Methods	SS #3	11	Portfolio Mangmt & Sec Mkts	SS #12, #13
4	Economics	SS #4, #5	12	Equity Securities	SS #14
5	Economics	SS #5, #6	13	Fixed Income Securities	SS #15, #16
6	Financial Statement Analysis	SS #7	14	Fixed Income Securities	SS #16
7	Financial Statement Analysis	SS #8	15	Derivatives	SS #17
8	Financial Statement Analysis	SS #9	16	Portfolio Management	SS #18

READINGS AND LEARNING OUTCOME STATEMENTS

READINGS

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

STUDY SESSION 1

Reading Assignments
Ethical and Professional Standards and Quantitative Methods, Volume 1 (CFA Institute, 2007)

STUDY SESSION 2

Reading Assignments
Quantitative Methods for Investment Analysis, 2nd edition, Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle (CFA Institute, 2007)

STUDY SESSION 3

Reading Assignments
Quantitative Methods for Investment Analysis, 2nd edition, Richard A. DeFusco, Dennis W. McLeavey, Jerald E. Pinto, and David E. Runkle (CFA Institute, 2007)

Learning Outcome Statements (LOS)

Study Session 1

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

1. **Code of Ethics and Standards of Professional Conduct**

The candidate should be able to:

a. state the six components of the Code of Ethics and the seven Standards of Professional Conduct. (page 10)

b. explain the ethical responsibilities required by the Code and Standards, including the multiple subsections of each Standard. (page 11)

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

2. **"Guidance" for Standards I – VII**

The candidate should be able to:

a. demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by applying the Code and Standards to specific situations presenting multiple issues of questionable professional conduct. (page 14)

b. recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct. (page 14)

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

3. **Introduction to the Global Investment Performance Standards (GIPS®) and**

4. **Global Investment Performance Standards (GIPS®)**

The candidate should be able to:

a. explain why the GIPS standards were created, what parties the GIPS standards apply to and who is served by the standards. (page 61)

b. describe the key characteristics of the GIPS standards and the fundamentals of compliance. (page 61)

c. explain the construction and purpose of composites in performance reporting. (page 63)

d. describe the scope of the GIPS standards with respect to an investment firm's definition and historical performance record. (page 63)

e. explain how the GIPS standards are implemented in countries with existing standards for performance reporting and describe the appropriate response when the GIPS standards and local regulations are in conflict. (page 63)

f. name and characterize the eight major sections of the GIPS standards. (page 64)

g. explain the requirements for verification of compliance with GIPS standards. (page 64)

Study Session 2

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

5. **The Time Value of Money**

The candidate should be able to:

a. explain an interest rate as the sum of a real risk-free rate, expected inflation, and premiums that compensate investors for distinct types of risk. (page 70)

b. calculate and interpret the effective annual rate, given the stated annual interest rate and the frequency of compounding, and solve time value of money problems when compounding periods are other than annual. (page 71)

c. calculate and interpret the FV and PV of a single sum of money, ordinary annuity, a perpetuity (PV only), an annuity due, or a series of uneven cash flows. (page 72)

d. draw a time line, specify a time index, and solve problems involving the time value of money as applied, for example, to mortgages and savings for college tuition or retirement. (page 84)

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

6. **Discounted Cash Flow Applications**

The candidate should be able to:

a. calculate and interpret the net present value (NPV) and the internal rate of return (IRR) of an investment, contrast the NPV rule to the IRR rule, and identify any problems associated with the IRR rule. (page 99)
b. define, calculate and interpret a holding period return (total return). (page 103)
c. calculate, interpret, and distinguish between the money-weighted and time-weighted rates of return of a portfolio and appraise the performance of portfolios based on these measures. (page 104)
d. calculate and interpret the bank discount yield, holding period yield, effective annual yield, and money market yield for a U.S. Treasury bill; and interpret and convert among holding period yields, money market yields, effective annual yields and the bond equivalent yields. (page 106)

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

7. **Statistical Concepts and Market Returns**

The candidate should be able to:

a. differentiate between descriptive statistics and inferential statistics, and between a population and a sample, and explain the differences among the types of measurement scales. (page 118)
b. explain the concepts of a parameter, a sample statistic, a frequency distribution, and relative versus cumulative relative frequency distributions. (page 119)
c. analyze and interpret a histogram or a frequency polygon by describing the properties of a dataset. (page 122)
d. define, calculate, and interpret measures of central tendency, including the population mean, sample mean, arithmetic mean, weighted average or mean (including a portfolio return viewed as a weighted mean), geometric mean, harmonic mean, median, and mode, quartiles, quintiles, deciles, and percentiles. (page 123)
e. define, calculate, and interpret 1) a range and mean absolute deviation, and 2) a sample and a population variance and standard deviation. (page 129)
f. contrast variance with semivariance and target semivariance. (page 132)
g. calculate and interpret the proportion of observations falling within a specified number of standard deviations of the mean, using Chebyshev's inequality. (page 132)
h. define, calculate, and interpret the coefficient of variation and the Sharpe ratio. (page 133)
i. define and interpret skew, explain the meaning of a positively or negatively skewed return distribution, and describe the relative locations of the mean, median, and mode for a nonsymmetrical distribution. (page 134)
j. define and interpret kurtosis, and measures of population and sample skew and kurtosis. (page 136)

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

8. **Probability Concepts**

The candidate should be able to:

a. define a random variable, an outcome, an event, mutually exclusive events, and exhaustive events. (page 150)
b. explain the two defining properties of probability, and distinguish among empirical, subjective, and a priori probabilities. (page 150)
c. state the probability of an event in terms of odds for or against the event. (page 151)
d. distinguish between unconditional and conditional probabilities. (page 151)
e. define joint probability and calculate and interpret 1) the joint probability of two events, 2) the probability that at least one of two events will occur, given the probability of each and the joint

probability of the two events, and 3) a joint probability of any number of independent events. (page 152)

f. distinguish between dependent and independent events. (page 154)
g. calculate, using the total probability rule, an unconditional probability. (page 155)
h. explain the use of conditional expectation in investment applications. (page 157)
i. diagram an investment problem, using a tree diagram. (page 158)
j. define, calculate and interpret covariance and correlation. (page 159)
k. calculate and interpret the expected value, variance, and standard deviation particularly for return on a portfolio. (page 161)
l. calculate covariance given a joint probability function. (page 163)
m. calculate and interpret an updated probability, using Bayes' formula. (page 165)
n. solve counting problems using the factorial, combination, and permutation notations, and identify which counting method is appropriate to solve a particular counting problem. (page 167)

STUDY SESSION 3

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

9. **Common Probability Distributions**

The candidate should be able to:

a. define and explain a probability distribution and distinguish between discrete and continuous random variables. (page 182)
b. describe the set of possible outcomes of a specified discrete random variable. (page 182)
c. define and interpret a probability function, a probability density function, and a cumulative distribution function, and calculate and interpret probabilities for a random variable, given its cumulative distribution function. (page 183)
d. define a discrete uniform random variable and a binomial random variable, calculate and interpret probabilities given the discrete uniform and the binomial distribution functions, and construct a binomial tree to describe stock pricemovement. (page 184)
e. describe the continuous uniform distribution, and calculate and interpret probabilities, given a continuous uniform probability distribution. (page 188)
f. explain the key properties of the normal distribution, distinguish between a univariate and a multivariate distribution, and explain the role of correlation in the multivariate normal distribution. (page 189)
g. construct and explain confidence intervals for a normally distributed random variable, and interpret the probability that a normally distributed random variable takes its value inside the constructed confidence interval. (page 190)
h. define the standard normal distribution, explain how to standardize a random variable, and calculate and interpret probabilities using the standard normal distribution. (page 191)
i. define shortfall risk, calculate the safety-first ratio and select an optimal portfolio using Roy's safety-first criterion. (page 197)
j. explain the relationship between the lognormal and normal distributions and explain and interpret the use of the lognormal distribution in modeling asset prices. (page 199)
k. distinguish between discretely and continuously compounded rates of return; and calculate and interpret the continuously compounded rate of return, given a specific holding period return. (page 200)
l. explain Monte Carlo simulation and historical simulation and describe their major applications and limitations. (page 201)

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

10. **Sampling and Estimation**

The candidate should be able to:

a. define simple random sampling, sampling error, and a sampling distribution, and interpret sampling error. (page 213)
b. distinguish between simple random and stratified random sampling. (page 214)
c. distinguish between time-series and cross-sectional data. (page 214)
d. interpret the central limit theorem and describe its importance. (page 214)
e. calculate and interpret the standard error of the sample mean. (page 215)
f. distinguish between a point estimate and a confidence interval estimate of a population parameter. (page 217)
g. identify and describe the desirable properties of an estimator. (page 217)
h. explain the construction of confidence intervals. (page 217)
i. describe the properties of Student's *t*-distribution and calculate and interpret its degrees of freedom. (page 218)
j. calculate and interpret a confidence interval for a population mean when sampling from a normal distribution with 1) a known population variance, 2) an unknown population variance, or 3) with an unknown variance and the sample size is large. (page 218)
k. discuss the issues regarding selection of the appropriate sample size, data-mining bias, sample selection bias, survivorship bias, look-ahead bias, and time-period bias. (page 221)

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

11. **Hypothesis Testing**

The candidate should be able to:

a. define a hypothesis, describe the steps of hypothesis testing; define and interpret the null hypothesis and alternative hypothesis, discuss the choice of the null and the alternative hypotheses, and distinguish between one-tailed and two-tailed tests of hypotheses. (page 232)
b. define and interpret a test statistic, a Type I and a Type II error, and a significance level, and explain how significance levels are used in hypothesis testing. (page 237)
c. define and interpret a decision rule and the power of a test, and explain the relation between confidence intervals and hypothesis tests. (page 238)
d. identify the appropriate test statistic and interpret the results for a hypothesis test concerning 1) the population mean of a normally distributed population with a) known or b) unknown variance; 2) the equality of the population means of two normally distributed populations, based on independent random samples with a) equal or b) unequal assumed variances; and 3) the mean difference of two normally distributed populations (paired comparisons test). (page 242)
e. identify the appropriate test statistic and interpret the results for a hypothesis test concerning 1) the variance of a normally distributed population; and 2) the equality of the variances of two normally distributed populations, based on two independent random samples. (page 252)
f. distinguish between parametric and nonparametric tests and describe the situations in which the use of nonparametric tests may be appropriate. (page 257)

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

12. **Correlation and Regression**

The candidate should be able to:

a. construct and interpret a scatter plot. (page 268)
b. calculate and interpret a sample covariance and a sample correlation coefficient. (page 269)
c. formulate a test of the hypothesis that the population correlation coefficient equals zero and determine whether the hypothesis is rejected at a given level of significance. (page 272)
d. differentiate between the dependent and independent variables in a linear regression and explain the assumptions underlying linear regression. (page 273)
e. interpret a regression coefficient. (page 274)
f. define, calculate, and interpret the standard error of estimate and the coefficient of determination. (page 276)

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

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

Study Session 1

Exam Focus

In addition to reading this review of the ethics material, we strongly recommend that all candidates for the CFA® examination *purchase* their own copy of the *Standards of Practice Handbook 9th Edition* (2005) and read it multiple times. As a registered candidate, it is your responsibility to own an original copy of the *Code and Standards* and to comply with the *Code and Standards.*

CFA Institute Code of Ethics and Standards of Professional Conduct

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

Code of Ethics

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

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

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The Standards of Professional Conduct

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

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

Standards of Professional Conduct[2]

I. PROFESSIONALISM

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

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

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

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

II. INTEGRITY OF CAPITAL MARKETS

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

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

III. DUTIES TO CLIENTS

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

2. Ibid.

relationships with clients, Members and Candidates must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed.

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

C. Suitability.

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

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

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

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

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

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

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

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

2. Disclosure is required by law, or

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

IV. DUTIES TO EMPLOYERS

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

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

C. **Responsibilities of Supervisors.** Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTION

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

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.
2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

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

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.
3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

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

VI. CONFLICTS OF INTEREST

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

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

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

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

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

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

GUIDANCE FOR STANDARDS I–VII.

LOS 2.a, b: Demonstrate a thorough knowledge of the Code of Ethics and Standards of Professional Conduct by applying the Code and Standards to specific situations presenting multiple issues of questionable professional conduct, and recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.

I Professionalism

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

I(A) **Knowledge of the Law.** Members must understand and comply with laws, rules, regulations, and Code and Standards of any authority governing their activities. In the event of a conflict, follow the more strict law, rule, or regulation. Do not knowingly participate or assist in violations, and *dissociate from any known violation.*

Guidance—Code and Standards vs. Local Law

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

Guidance—Participation or Association with Violations by Others

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

Recommended Procedures for Compliance—Members

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

Recommended Procedures for Compliance—Firms

Members should encourage their firms to:

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

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

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

I(B) Independence and Objectivity. Use reasonable care to exercise independence and objectivity in professional activities. Members and Candidates are not to offer, solicit, or accept any gift, benefit, compensation, or consideration that would compromise either their own or someone else's independence and objectivity.

Guidance

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

Guidance—Investment-Banking Relationships

Do not be pressured by sell-side firms to issue favorable research on current or prospective investment-banking clients. It is appropriate to have analysts work with investment bankers in "road shows" only when the conflicts

3. Ibid.

are adequately and effectively managed and disclosed. Be sure there are effective "firewalls" between research/investment management and investment banking activities.

Guidance—Public Companies

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

Guidance—Buy-Side Clients

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

Guidance—Issuer-Paid Research

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

Recommended Procedures for Compliance

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

Application of Standard I(B) Independence and Objectivity

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Example 3:

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

Comment:

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

I(C) **Misrepresentation.** Do not misrepresent facts regarding investment analysis, recommendations, actions, or other professional activities.

Guidance

Trust is a foundation in the investment profession. Do not make any misrepresentations or give false impressions. This includes oral and electronic communications. Misrepresentations include guaranteeing investment performance and plagiarism. Plagiarism encompasses using someone else's work (reports, forecasts, charts, graphs, and spreadsheet models) without giving them credit.

Recommended Procedures for Compliance

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

Application of Standard I(C) Misrepresentations

Example 1:

Allison Rogers is a partner in the firm of Rogers and Black, a small firm offering investment advisory services. She assures a prospective client who has just inherited $1 million that "we can perform all the financial and investment services you need." Rogers and Black is well equipped to provide investment advice but, in fact, cannot provide asset allocation assistance or a full array of financial and investment services.

Comment:

Rogers has violated Standard I(C) by orally misrepresenting the services her firm can perform for the prospective client. She must limit herself to describing the range of investment advisory services Rogers and Black can provide and offer to help the client obtain elsewhere the financial and investment services that her firm cannot provide.

Example 2:

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

Comment:

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

Example 3:

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

Comment:

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

Example 4:

Gary Ostrowski runs a small, two-person investment management firm. Ostrowski's firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged as in-house research from smaller firms. Ostrowski's firm distributes these reports to clients as its own work.

Comment:

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

I(D) **Misconduct.** Do not engage in any professional conduct which involves dishonesty, fraud, or deceit. Do not do anything that reflects poorly on your integrity, good reputation, trustworthiness, or professional competence.

Guidance

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

Recommended Procedures for Compliance

Firms are encouraged to adopt these policies and procedures:

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

Application of Standard I(D) Misconduct

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

II Integrity of Capital Markets

II(A) Material Nonpublic Information. Members and Candidates in possession of nonpublic information that could affect an investment's value must not act or induce someone else to act on the information.

Guidance

Information is "material" if its disclosure would impact the price of a security or if reasonable investors would want the information before making an investment decision. Ambiguous information, as far as its likely effect on price, may not be considered material. Information is "non-public" until it has been made available to the marketplace. An analyst conference call is not public disclosure. Selectively disclosing information by corporations creates the potential for insider-trading violations.

Guidance—Mosaic Theory

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

Recommended Procedures for Compliance

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

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

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

Application of Standard II(A) Material Nonpublic Information

Example 1:

Josephine Walsh is riding an elevator up to her office when she overhears the chief financial officer (CFO) for the Swan Furniture Company tell the president of Swan that he has just calculated the company's earnings for the past quarter and they have unexpectedly and significantly dropped. The CFO adds that this drop will not be released to the public until next week. Walsh immediately calls her broker and tells him to sell her Swan stock.

Comment:

Walsh has sufficient information to determine that the information is both material and nonpublic. By trading on the inside information, she has violated Standard II(A).

Example 2:

Samuel Peter, an analyst with Scotland and Pierce Incorporated, is assisting his firm with a secondary offering for Bright Ideas Lamp Company. Peter participates, via telephone conference call, in a meeting with Scotland and Pierce investment-banking employees and Bright Ideas' CEO. Peter is advised that the company's earnings projections for the next year have significantly dropped. Throughout the telephone conference call, several Scotland and Pierce salespeople and portfolio managers walk in and out of Peter's office, where the telephone call is taking place. As a result, they are aware of the drop in projected earnings for Bright Ideas. Before the conference call is concluded, the salespeople trade the stock of the company on behalf of the firm's clients and other firm personnel trade the stock in a firm proprietary account and in employee personal accounts.

Comment:

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

Example 3:

Elizabeth Levenson is based in Taipei and covers the Taiwanese market for her firm, which is based in Singapore. She is invited to meet the finance director of a manufacturing company along with the other 10 largest shareholders of the company. During the meeting, the finance director states that the company expects its workforce to strike next Friday, which will cripple productivity and distribution. Can Levenson use this information as a basis to change her rating on the company from "buy" to "sell"?

Comment:

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

Example 4:

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

Comment:

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

II(B) Market **Manipulation.** Do not engage in any practices intended to mislead market participants through distorted prices or artificially inflated trading volume.

Guidance

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

Application of Standard II(B) Market Manipulation

Example 1:

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

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

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

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

Comment:

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

Example 2:

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

Comment:

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

III Duties to Clients and Prospective Clients

III(A) Loyalty, Prudence, and Care. Members must always act for the benefit of clients and place clients' interests before their employer's or their own interests. Members must be loyal to clients, use reasonable care, exercise prudent judgment, and determine and comply with their applicable fiduciary duty to clients.

Guidance

Client interests always come first.

- Exercise the prudence, care, skill, and diligence under the circumstances that a person acting in a like capacity and familiar with such matters would use.
- Manage pools of client assets in accordance with the terms of the governing documents, such as trust documents or investment management agreements.
- Make investment decisions in the context of the total portfolio.
- Vote proxies in an informed and responsible manner. Due to cost benefit considerations, it may not be necessary to vote all proxies.
- Client brokerage, or "soft dollars" or "soft commissions" must be used to benefit the client.

Recommended Procedures of Compliance

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

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

- Follow applicable rules and laws.
- Establish investment objectives of client. Consider suitability of portfolio relative to client's needs and circumstances, the investment's basic characteristics, or the basic characteristics of the total portfolio.
- Diversify.
- Deal fairly with all clients in regards to investment actions.
- Disclose conflicts.
- Disclose compensation arrangements.
- Vote proxies in the best interest of clients and ultimate beneficiaries.
- Maintain confidentiality.
- Seek best execution.
- Place client interests first.

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

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

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

Guidance

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

Guidance—Investment Recommendations

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

Guidance—Investment Actions

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

Recommended Procedures for Compliance

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

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

Application of Standard III(B) Fair Dealing

Example 1:

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

Comment:

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

Example 2:

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

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

Comment:

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

III(C) Suitability

1. When in an advisory relationship with client or prospect, Members and Candidates must:
   a. Make reasonable inquiry into clients' investment experience, risk and return objectives, and constraints prior to making any recommendations or taking investment action. Reassess information and update regularly.
   b. Be sure investments are suitable to a client's financial situation and consistent with client objectives before making recommendation or taking investment action.
   c. Make sure investments are suitable in the context of a client's total portfolio.
2. When managing a portfolio, investment recommendations and actions must be consistent with stated portfolio objectives and constraints.

Guidance

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

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

Recommended Procedures for Compliance

Members should:

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

Application of Standard III(C) Suitability

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

III(D)Performance Presentation. Presentations of investment performance information must be fair, accurate, and complete.

Guidance

Members must avoid misstating performance or misleading clients/prospects about investment performance of themselves or their firms, should not misrepresent past performance or reasonably expected performance, and should not state or imply the ability to achieve a rate of return similar to that achieved in the past.

Recommended Procedures for Compliance

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

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

Application of Standard III(D) Performance Presentation

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

III(E) **Preservation of Confidentiality.** All information about current and former clients and prospects must be kept confidential unless it pertains to illegal activities, disclosure is required by law, or the client or prospect gives permission for the information to be disclosed.

Guidance

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

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

Recommended Procedures for Compliance

Members should avoid disclosing information received from a client except to authorized co-workers who are also working for the client.

Application of Standard III(E) Preservation of Confidentiality

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

IV Duties to Employers

IV(A) Loyalty. Members and Candidates must place their employer's interest before their own and must not deprive their employer of their skills and abilities, divulge confidential information, or otherwise harm their employer.

Guidance

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

Guidance—Independent Practice

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

Guidance—Leaving an Employer

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

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

Once an employee has left a firm, simple knowledge of names and existence of former clients is generally not confidential. Also there is no prohibition on the use of experience or knowledge gained while with a former employer.

Guidance—Whistleblowing

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

Guidance—Nature of Employment

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

Application of Standard IV(A) Loyalty

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

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

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

Example 3:

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

Comment:

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

IV(B) **Additional Compensation Arrangements.** No gifts, benefits, compensation or consideration are to be accepted which may create a conflict of interest with the employer's interest unless written consent is received from all parties.

Guidance

Compensation includes direct and indirect compensation from a client and other benefits received from third parties. Written consent from a member's employer includes email communication.

Recommended Procedures for Compliance

Make an immediate written report to employer detailing proposed compensation and services, if additional to that provided by employer.

Application of Standard IV(B) Additional Compensation Arrangements

Example 1:

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

Comment:

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

IV(C) **Responsibilities of Supervisors.** All Members and Candidates must make reasonable efforts to detect and prevent violations of laws, rules, regulations, and the Code and Standards by any person under their supervision, or authority.

Guidance

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

Guidance—Compliance Procedures

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

Recommended Procedures for Compliance

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

Adequate compliance procedures should:

- Be clearly written.
- Be easy to understand.
- Designate a compliance officer with authority clearly defined.
- Have a system of checks and balances.
- Outline the scope of procedures.
- Outline what conduct is permitted.
- Contain procedures for reporting violations and sanctions.

Once the compliance program is instituted, the supervisor should:

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

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

Application of Standard IV(C) Responsibilities of Supervisors

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

V Investment Analysis, Recommendations, and Action

V(A) Diligence and Reasonable Basis

1. When analyzing investments, making recommendations, and taking investment actions use diligence, independence, and thoroughness.
2. Investment analysis, recommendations, and actions should have a reasonable and adequate basis, supported by research and investigation.

Guidance

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

Guidance—Using Secondary or Third-Party Research

See that the research is sound. Examples of criteria to use to evaluate:

- Review assumptions used.
- How rigorous was the analysis?
- How timely is the research?
- Evaluate objectivity and independence of the recommendations.

Guidance—Group Research and Decision Making

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

Recommended Procedures for Compliance

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

- Have a policy requiring that research reports and recommendations have a basis that can be substantiated as reasonable and adequate.
- Have detailed, written guidance for proper research and due diligence.
- Have measurable criteria for judging the quality of research, and base analyst compensation on such criteria.

Application of Standard V(A) Diligence and Reasonable Basis

Example 1:

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

Comment:

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

Example 2:

Evelyn Mastakis is a junior analyst asked by her firm to write a research report predicting the expected interest rate for residential mortgages over the next six months. Mastakis submits her report to the fixed-income investment committee of her firm for review, as required by firm procedures. Although some committee members support Mastakis's conclusion, the majority of the committee disagrees with her conclusion and the report is significantly changed to indicate that interest rates are likely to increase more than originally predicted by Mastakis.

Comment:

The results of research are not always clear, and different people may have different opinions based on the same factual evidence. In this case, the majority of the committee may have valid reasons for issuing a report that differs from the analyst's original research. The firm can issue a report different from the original report of the analyst as long as there is a reasonable or adequate basis for its conclusions. Generally, analysts must write research reports that reflect their own opinion and can ask the firm not to put their name on reports that ultimately differ from that opinion. When the work is a group effort, however, not all members of the team may agree with all aspects of the report. Ultimately, members and candidates can ask to have their names removed from the report, but if they are satisfied that the process has produced results or conclusions that have a reasonable or adequate basis, members or candidates do not have to dissociate from the report even when they do not agree with its contents. The member or candidate should document the difference of opinion and any request to remove his or her name from the report.

V(B) Communication With Clients and Prospective Clients

1. Disclose to clients and prospects basic format and general principles of investment processes used to analyze and select securities and construct portfolios. Promptly disclose any process changes.

2. Use reasonable judgment in identifying relevant factors important to investment analyses, recommendations, or actions, and include factors when communicating with clients and prospects.

3. Investment analyses and recommendations should clearly differentiate facts from opinions.

Guidance

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

Members must illustrate to clients and prospects the investment decision-making process utilized. The suitability of each investment is important in the context of the entire portfolio.

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

Recommended Procedures for Compliance

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

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

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Example 3:

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

Comment:

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

Example 4:

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

Comment:

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

V(C) **Record Retention.** Maintain all records supporting analysis, recommendations, actions, and all other investment-related communications with clients and prospects.

Guidance

Members must maintain research records that support the reasons for the analyst's conclusions and any investment actions taken. Such records are the property of the firm. If no other regulatory standards are in place, CFA Institute recommends at least a 7-year holding period.

Recommended Procedures for Compliance

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

Application of Standard V(C) Record Retention

Example 1:

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

Comment:

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

VI Conflicts of Interest

VI(A) **Disclosure of Conflicts.** Members and Candidates must make full and fair disclosure of all matters which may impair their independence or objectivity or interfere with their duties to employer, clients and prospects. Disclosures must be prominent, in plain language, and effectively communicate the information.

Guidance

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

Guidance—Disclosure to Clients

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

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

Guidance—Disclosure of Conflicts to Employers

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

Recommended Procedures of Compliance

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

Application of Standard VI(A) Disclosure of Conflicts

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Example 3:

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

Comment:

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

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

Guidance

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

Recommended Procedures for Compliance

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

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

Application of Standard VI(B) Priority of Transactions

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

VI(C) Referral Fees. Members and Candidates must disclose to their employers, clients, and prospects any compensation consideration or benefit received by, or paid to, others for recommendations of products and services.

Guidance

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

Application of Standard VI(C) Referral Fees

Example 1:

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment counseling firm. Under this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral account to Brady Securities. Willard White, a partner in Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities amount to $20,000 annually. Referrals from Brady Securities last year resulted in fee income of $200,000, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of $10,000.

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

Comment:

White violated Standard VI(C) by failing to inform the prospective customer of the referral fee payable in services and commissions for an indefinite period to Brady Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

Example 2:

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

Comment:

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

Example 3:

Yeshao Wen is a portfolio manager for a bank. He receives additional monetary compensation from his employer when he is successful in assisting in the sales process and generation of assets under management. The assets in question will be invested in proprietary product offerings such as affiliate company mutual funds.

Comment:

Standard VI(C) is meant to address instances where the investment advice provided by a member or candidate appears to be objective and independent but in fact is influenced by an unseen referral arrangement. It is not meant to cover compensation by employers to employees for generating new business when it would be obvious to potential clients that the employees are "referring" potential clients to the services of their employers.

If Wen is selling the bank's investment management services in general, he does not need to disclose to potential clients that he will receive a bonus for finding new clients and acquiring new assets under management for the bank. Potential clients are likely aware that it would be financially beneficial both to the portfolio manager and the manager's firm for the portfolio manager to sell the services of the firm and attract new clients. Therefore, sales efforts attempting to attract new investment management clients need not disclose this fact.

However, in this example, the assets will be managed in "proprietary product offerings" of the manager's company (for example, an in-house mutual fund) and Wen will receive additional compensation for selling firm products. Some sophisticated investors may realize that it would be financially beneficial to the portfolio manager and the manager's firm if the investor buys the product offerings of the firm.

Best practice, however, dictates that the portfolio manager must disclose to clients that they are compensated for referring clients to firm products. Such discloser will meet the purpose of Standard VI(C), which is to allow investors to determine whether there is any partiality on the part of the portfolio manager when making investment advice.

VII Responsibilities as a CFA Institute Member or CFA Candidate

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

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

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

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

Members and candidates are not precluded from expressing their opinions regarding the exam program or CFA Institute.

Application of Standard VII(A) Conduct as Members and Candidates in the CFA Program

Example 1:

Ashlie Hocking is writing Level II of the CFA examination in London. After completing the exam, she immediately attempts to contact her friend in Sydney, Australia, to tip him off to specific questions on the exam.

Comment:

Hocking has violated Standard VII(A) by attempting to give her friend an unfair advantage, thereby compromising the integrity of the CFA examination process.

Example 2:

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

Comment:

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

VII(B) **Reference to CFA Institute, the CFA designation, and the CFA Program.** Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the program.

Guidance

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

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

Guidance—CFA Institute Membership

Members must satisfy these requirements to maintain membership:

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

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

Guidance—Using the CFA Designation

Do not misrepresent or exaggerate the meaning of the designation.

Guidance—Referencing Candidacy in the CFA Program

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

Guidance—Proper Usage of the CFA Marks

The Chartered Financial Analyst and CFA marks must always be used either after a charterholder's name or as adjectives, but not as nouns, in written and oral communications.

Recommended Procedures for Compliance

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

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

Example 1:

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

Comment:

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

Example 2:

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

Comment:

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

Concept Checkers: Standards of Practice Handbook

1. Jamie Hutchins, CFA, is a portfolio manager for CNV Investments Inc. Over the years, Hutchins has made several poor personal investments that have led to financial-distress and personal bankruptcy. Hutchins feels that her business partner, John Smith, is mostly to blame for her situation since "he did not invest enough money in her investment opportunities and caused them to fail." Hutchins reports Smith to CFA Institute claiming Smith violated the Code and Standards relating to misconduct. Which of the following statements is correct?
   A. Neither Hutchins nor Smith violated the Code and Standards.
   B. By reporting Smith to CFA Institute, Hutchins has misused the Professional Conduct Program, thus violating the Code and Standards.
   C. Hutchins' bankruptcy reflects poorly on her professional reputation and thus violates the Code and Standards.
   D. Smith's lack of investment in Hutchin's opportunities violated the priority of transactions, and he was appropriately reported to CFA Institute.

2. While working on a new underwriting project, Jean Brayman, CFA, has just received information from her client that leads her to believe that the firm's financial statements in the registration statement overstate the firm's financial position. Brayman should:
   A. report her finding to the appropriate governmental regulatory authority.
   B. immediately dissociate herself from the underwriting in writing to the client.
   C. seek advice from her firm's compliance department as to the appropriate action to take.
   D. inform the client of the problem and issue a press release correcting the statements.

3. Karen Jones, CFA, is an outside director for Valley Manufacturing. At a director's meeting, Jones finds out that Mfg. Corp. has made several contributions to foreign politicians that she suspects were illegal. Jones checks with her firm's legal counsel and determines that the contributions were indeed illegal. At the next board meeting Jones urges the board to disclose the contributions. The board, however, votes not to make a disclosure. Jones should:
   A. protest the board's actions in writing to the executive officer of Valley.
   B. resign from the board and seek legal counsel as to her legal disclosure requirements.
   C. inform her supervisor of their discovery and cease attending meetings until the matter is resolved.
   D. resign form the board, sell any stock she owns in the firm, and issue a press release explaining her actions.

4. Carrie Carlson, CFA, is a citizen of Emerging Market Country (EMC) with no securities laws governing the use of inside information. Carlson has clients in Emerging Market Country and in Neighboring Country (NC), which has a few poorly defined laws governing the use of inside information. Should Carlson have inside information on a publicly traded security, she:
   A. can inform her clients in EMC, but not NC.
   B. can only trade for her own account when she has inside information.
   C. can use the information for her NC clients to the extent permitted by the laws of NC.
   D. cannot use the information to trade in either EMC or NC.

5. In order to dispel the myth that emerging market stocks are illiquid investments, Green Brothers, a "long only" emerging market fund manager, has two of its subsidiaries simultaneously buy and sell emerging market stocks. In its marketing literature, Green Brothers cites the overall emerging market volume as evidence of the market's liquidity. As a result of its actions, more investors participate in the emerging markets fund. Which of the following is TRUE? Green Brothers:
A. did not violate the Code and Standards.
B. violated the Code and Standards by failing to consider the suitability of emerging market investments.
C. violated the Code and Standards by manipulating the volume in the emerging securities markets.
D. would not have violated the Code and Standards if the subsidiaries only traded stocks not included in the fund.

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

7. Which of the following statements is **FALSE**? A member or candidate:
A. can participate or assist in a violation simply by having knowledge of the violation and not taking action to stop it.
B. is held responsible for participating in illegal acts in instances where violation of the law is evident to those who know or should know the law.
C. when confronted with potentially illegal activities, should consult with her supervisor and her employer's counsel.
D. must report evidence of legal violations to the appropriate governmental or regulatory organization.

8. Paula Osgood, CFA is promoting her new money management firm by issuing an advertisement. Which of these items is NOT *in conflict* with the professional designation Standard? The advertisement states that:
A. she passed three exams covering ethics, financial statement analysis, asset valuation, and portfolio management and that she is a member of the local society. Osgood signs the advertisement followed by the letters CFA in oversized and bold strike letters.
B. she passed three exams totaling over 18 hours over the minimum period of one and a half years. Knowledge tested included ethics, financial statement analysis, asset valuation, and portfolio management. In addition, she is a member of the local society.
C. because of her extensive CFA training she will be able to achieve better investment results than non-CFA managers since she is one of very few professionals to have been awarded this designation.
D. she is one of very few professionals to have been awarded this designation and that she is a member of the local society. She signs the advertisement followed by the letters CFA in oversized and bold strike letters.

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

10. In which of the following has the analyst NOT committed plagiarism?
   A. Julie Long takes performance projections and charts from a company she is researching, combines them with her own analysis, and publishes them under her own name.
   B. Bill Cooper finds a statistical table in the Federal Reserve Bulletin that supports the work he has done in his industry analysis and has his secretary include the table as part of his report without citing the source.
   C. Jan Niedfeldt gets a call from one of her fellow analysts stating that the analyst's research shows that XYZ Company is a buy. Niedfeldt calls up her major clients and tells them that her research shows XYZ is a buy.
   D. To speed up an acquisition project, Jim Zijacek's boss gives him a report from another firm also working on the project and tells Zijacek to print the report on company letterhead, sign it, and mail it out to the stockholders.

11. Jessica Ellis, CFA, manages an international stock portfolio for a group of wealthy investors with similar investment objectives. According to the investment policy statement, the portfolio is to pursue an aggressive growth strategy while maintaining sufficient international diversification. The fund is prohibited from using leverage. Ellis has just received a request from all of the group of investors to purchase a large position in German bonds which they believe to be significantly undervalued. Which of the following actions should Ellis take to avoid violating the Code and Standards?
   A. Purchase the bonds since it was requested by the clients to whom Ellis has a fiduciary duty.
   B. Inform the investors that she is unable to make the purchase since it is inconsistent with the international stock portfolio's investment mandate.
   C. Purchase the bonds only after receiving a written consent statement signed by each portfolio investor that states they are aware that the investment is not suitable for the portfolio.
   D. Change the investment policy statement to reflect an investment strategy that would allow the bond purchase and then purchase the undervalued bonds for the portfolio.

12. In a marketing brochure, DNR Asset Managers presents the performance of several composite portfolios managed according to similar investment strategies. In constructing composites, the firm excludes individual portfolios with less than $1 million in assets, excludes terminated portfolios, and includes simulated results. DNR includes the following disclosure in the brochure: "Past performance is no guarantee of future results. Composites exclude portfolios under $1 million in assets and include results from simulated model portfolios with similar strategies." DNR's brochure:
   A. does not violate the Code and Standards.
   B. violates the Code and Standards by failing to include terminated portfolios in the performance presentation.
   C. violates the Code and Standards by excluding portfolios under $1 million from the composite performance presentations.
   D. violates the Code and Standards by including simulated results of model portfolios even with a disclosure in the presentation.

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

14. Which of the following statements about an investment supervisor's responsibilities is **FALSE**? A supervisor:
   A. is expected to know what constitutes an adequate compliance system.
   B. should bring an inadequate compliance system to the attention of management and recommend corrective action.
   C. is responsible for instructing those to whom he has delegated authority about methods to detect and prevent violations of the law and standards.
   D. need only report employee violations of the Code and Standards to upper management and provide a written warning to the employee to cease such activities.

15. Robert Blair, CFA, Director of Research, has had an ongoing battle with management about the adequacy of the firm's compliance system. Recently, it has come to Blair's attention that the firm's compliance procedures are inadequate in that they are not being monitored and not carefully followed. What should Blair do?
   A. Resign from the firm unless the compliance system is strengthened and followed.
   B. Send his superior a memo outlining the problem. This will discharge his obligation under the Code.
   C. Take no action since his job is supervision and not policy making.
   D. Decline in writing to continue to accept supervisory responsibility until reasonable compliance procedures are adopted.

16. Ahmed Jamal, CFA, head of research for Valley Brokers, decided it was time to change his recommendation on D&R Company from buy to sell. He orally announced his decision during the Monday staff meeting and said his written report would be finished and disseminated to Valley's customers by the middle of next week. As a result of this announcement, Doris Smith, one of Jamal's subordinates, immediately sold her personal shares in D&R, and Martin Temple told his largest institutional customers of the change the following day. Which Standards have been ***violated?***
   A. Jamal violated Standard IV(C), Responsibilities of Supervisors; and Smith violated Standard II(A), Material Nonpublic Information.
   B. Jamal violated Standard IV(C), Responsibilities of Supervisors; Smith violated Standard II(A), Material Nonpublic Information; and Temple violated Standard VI(B), Priority of Transactions.
   C. Jamal violated Standard IV(C), Responsibilities of Supervisors; Smith violated Standard VI(B), Priority Transactions; and Temple violated Standard III(B), Fair Dealing.
   D. Smith violated Standard VI(B), Priority of Transactions; and Temple violated Standard III(B), Fair Dealing.

17. Jack Schleifer, CFA, is an analyst for Brown Investment Managers (BIM). Schleifer has recently accepted an invitation to visit the facilities of ChemCo, a producer of chemical compounds used in a variety of industries. ChemCo offers to pay for Schleifer's accommodations in a penthouse suite at a luxury hotel and allow Schleifer to use the firm's private jet to travel to its three facilities located in New York, Hong Kong, and London. In addition, ChemCo offers two tickets to a formal high-society dinner in New York and a small desk clock with the ChemCo logo. Schleifer declines to use ChemCo's corporate jet and allow for the firm to pay for his accommodations but accepts the clock and the tickets to the dinner (which he discloses to his employer) since he will be able to market his firm's mutual funds to other guests at the dinner. Has Schleifer violated any CFA Institute Standards of Professional Conduct?
   A. Yes.
   B. No, since he is using the gifts accepted to benefit his employer's interests.
   C. No, since the gifts he accepted were fully disclosed in writing to his employer.
   D. No, since the gifts that he accepted were of nominal value and he declined to accept the hotel accommodations and the use of ChemCo's jet.

18. Based on the Standards of Professional Conduct, a financial analyst is required to do all the following EXCEPT:
   A. disclose the fact that his firm is the underwriter for securities issued by a company he covers.
   B. report to his employer the receipt of gifts and additional compensation from clients.
   C. pay for chartered transportation and lodging while visiting a company's remotely located facilities.
   D. pay for commercial transportation and lodging while visiting a company's headquarters.

19. Beth Anderson, CFA, is a portfolio manager for several wealthy clients including Reuben Carlyle. Anderson manages Carlyle's personal portfolio of stock and bond investments. Carlyle recently told Anderson that he is under investigation by the IRS for tax evasion related to his business, Carlyle Concrete (CC). After learning about the investigation, Anderson proceeds to inform a friend at a local investment bank so that they may withdraw their proposal to take CC public. Which of the following is TRUE? Anderson:
   A. violated the Code and Standards by failing to immediately terminate the client relationship with Carlyle.
   B. violated the Code and Standards by failing to maintain the confidentiality of her client's information.
   C. violated the Code and Standards by failing to detect and report the tax evasion to the proper authorities.
   D. did not violate the Code and Standards since the information she conveyed pertained to illegal activities on the part of her client.

20. Gail Stefano, CFA, an analyst for a U.S. brokerage firm that serves U.S. investors, researches public utilities in South American emerging markets. Stefano makes the following statement in a recent report: "Based on the fact that the South American utilities sector has seen rapid growth in new service orders, we expect that most companies in the sector will be able to convert the revenue increases into significant profits. We also believe the trend will continue for the next three to five years." The report goes on to describe the major risks of investing in this market, in particular the political and exchange rate instability associated with South American countries. Stefano's report:
    - A. has not violated the Code and Standards.
    - B. violated the Code and Standards by failing to properly distinguish factual information from opinions.
    - C. violated the Code and Standards by recommending an investment which would not be suitable for all of its clients.
    - D. violated the Code and Standards by failing to properly identify details related to the operations of South American utilities.

21. All of the following violate Standard III(B), Fair Dealing, EXCEPT:
    - A. before disseminating a change in the analyst's buy recommendation, the analyst calls his best clients and tells them about the change.
    - B. a firm makes investment recommendations and also manages a mutual fund. The firm routinely begins trading for the fund's account ten minutes before announcing recommendation changes to client accounts.
    - C. after releasing the general recommendation to all clients, an analyst calls the firm's largest institutional clients to discuss the recommendation in more detail.
    - D. a portfolio manager allocates IPO shares to her brother's fee-based retirement account only after allocating shares to all other accounts.

22. Which of the following does NOT constitute a violation of Standard VI(B), Priority of Transactions?
    - A. Failure by an analyst to make or change a recommendation until he trades for his own account.
    - B. An analyst trades for her son's trust account on the same day her firm changes its buy/sell recommendation.
    - C. An analyst takes a position in a stock she recommended one week after the recommendation was made public.
    - D. An analyst trades for the firm's account before handling client trades.

23. Jamie Olson, CFA, has just started work as a trainee with Neuvo Management Corp., a small regional money management firm started six months ago. She has been told to make a few cold calls and round up some new clients. In which of the following statements has Olson NOT violated the Standards of Practice?
    - A. "Sure, we can perform all the financial and investment services you need. We've consistently outperformed the market indexes and will continue to do so under our current management."
    - B. "Sure, we can assist you with all the financial and investment services you need. If we don't provide the service in-house, we have arrangements with other full-service firms that I would be happy to tell you about."
    - C. "Believe me, I've been at this game long enough to know what I'm talking about. I personally guarantee this investment. It's a sure winner."
    - D. "Our firm has a long history of successful performance for our clients. While we can't guarantee future results, we do believe we will continue to benefit our clients."

24. Mary Herbst, CFA, a pension fund manager at GBH Investments, is reviewing some of FreeTime, Inc.'s pension fund activities over the past years. Which of the following actions related to FreeTime, Inc.'s pension fund is *least likely* to be a breach of her fiduciary duties?
    A. Paying higher-than-average brokerage fees to obtain research materials used in the management of other funds by the investment.group.
    B. Trading with selected brokers so that the brokers will recommend GBH's managers to potential clients.
    C. Substantially increasing the risk of the fund in order to minimize FreeTime, Inc.'s future contributions.
    D. Selectively choosing brokers for the quality of research provided for managing FreeTime's pension.

25. Kevin Minter is an investment analyst at Bradley & Company, a small money management firm. Minter keeps detailed records and documentation of relevant research pertaining to his investment recommendations. Because of the limited physical and electronic storage space, however, three days after issuing a recommendation, Minter shreds hard copy documentation and deletes all electronic files except for the recommendation itself. There is no regulatory requirement to maintain records for any specified time period. Which of the following statements is TRUE? Minter:
    A. has not violated the Code and Standards.
    B. violated the Code and Standards because he did not maintain hard copy and electronic documentation supporting all of his current recommendations.
    C. violated the Code and Standards because he did not maintain hard copy or electronic documentation supporting his recommendations for seven years.
    D. violated the Code and Standards because he did not maintain hard copy and electronic documentation supporting all of his recommendations.

26. Eugene Nieder, CFA, has just accepted a new job as a quantitative analyst for Paschal Investments, LLP. Nieder developed a complex model while working for his previous employer and plans to recreate the model for Paschal. Nieder did not make copies of the model or any supporting documents since his employer refused to grant him permission to do so. Nieder will recreate the model from memory. Which of the following statements is TRUE?
    A. Nieder can recreate the model without violating the Code and Standards as long as he also generates supporting documentation.
    B. Nieder can recreate the model without violating the Code and Standards as long as he obtains permission to do so from his former employer.
    C. Nieder can recreate the model without violating the Code and Standards without documentation if the model is modified from its original form.
    D. Nieder cannot recreate the model without violating the Code and Standards because it is the property of his former employer.

27. As part of an agreement with Baker Brokerage, Hern Investment Company, a money manager for individual clients, provides monthly emerging market overviews in exchange for prospective client referrals and European equity research from Baker. Clients and prospects of Hern are not made aware of the agreement, but clients unanimously rave about the high quality of the research provided by Baker. As a result of the research, many non-discretionary clients have earned substantial returns on their portfolios. Managers at Hern have also used the research to earn outstanding returns for the firm's discretionary portfolios. Which of the following statements is TRUE? Hern:
    A. has not violated the Code and Standards.
    B. has violated the Code and Standards by using third-party research in discretionary accounts.
    C. has violated the Code and Standards by failing to disclose the referrals made by Baker.
    D. has violated the Code and Standards by failing to communicate the basic investment characteristics to discretionary clients.

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

29. Before joining Mitsui Ltd. as an analyst covering the electrical equipment manufacturing industry, Pam Servais, CFA, worked for Internet Security Systems (ISS) where she had access to nonpublic information. While at ISS, Servais learned of a severe environmental problem at two firms handling boron-based components. It is common knowledge that seven firms in the industry worldwide use the same boron handling technique. The two firms for which Servais has knowledge announced the problem last week and had immediate stock price declines of 11 and 17%, respectively. The other five firms have not made an announcement. Servais issues a report recommending Mitsui clients sell shares of the remaining five firms. Servais' issuance of this recommendation:
A. is not a violation of CFA Institute Standards.
B. is a violation of CFA Institute Standards insofar as it fails to have adequate basis in fact.
C. is a violation of CFA Institute Standards insofar as it fails to distinguish between opinion and fact.
D. constitutes a violation of the Standard pertaining to the use of material nonpublic information.

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

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

32. Julia Green, CFA, has friends from her previous employer who have suggested that she agree to receive non-public information anonymously from them via an Internet chat room. In this way, she receives news about an exciting new product being developed by a firm in Singapore that has the potential to double the firm's revenue. The firm has not previously revealed any information regarding the product to the public. According to the Code and Standards, this information is:
   A. not material and may be traded upon.
   B. both material and nonpublic and may not be traded upon in Singapore, but may be traded on elsewhere.
   C. both material and nonpublic and may not be traded upon in any jurisdiction.
   D. public by virtue of its release in the chat room and may be traded upon.

33. Sally Albright, CFA, works full-time for Frank & Company, an investment management firm, as a fixed-income security analyst. Albright has been asked by a business contact at KDG Enterprises to accept some analytical work from KDG on a consulting basis. The work would entail investigating potential distressed debt investments in the small-cap market. Albright should:
   A. accept the work as long as she obtains consent to all the terms of the engagement from Frank & Company.
   B. not accept the work as it violates the Code and Standards by creating a conflict of interest.
   C. accept the work so long as she obtains written consent from KDG.
   D. not accept the work since this will likely expose her to material nonpublic information in violation of the Code and Standards.

34. William Bixby, CFA, oversees a mid-cap fund that is required to invest in a minimum of 40 and a maximum of 60 different issues. Bixby uses a quantitative approach to actively manage the assets. In promotional materials, he states that "through our complex quantitative approach, securities are selected that have similar exposures to a number of risk factors that are found in the S&P 500 Index. Thus the fund is designed to track the performance of the S&P 500 Index but will receive a return premium of between 2 and 4% according to our model's risk-return measures." This statement is:
   A. permissible since the assertion is supported by modern portfolio theory and estimates from the firms' model.
   B. not permissible since Bixby is misrepresenting the services that she and/or her firm are capable of performing.
   C. not permissible since Bixby is misrepresenting the investment performance she and/or her firm can reasonably expect to achieve.
   D. permissible since the statement describes the basic characteristics of the fund's risk and return objectives.

35. Josef Karloff, CFA, acts as liaison between Pinnacle Financial (an investment management firm) and Summit Inc. (an investment banking boutique specializing in penny stocks). When Summit underwrites an IPO, Karloff routinely has Pinnacle issue vague statements implying that the firm has cash flows, financial resources, and growth prospects that are far better than is the case in reality. This action is:
   A. permissible under CFA Institute Standards.
   B. a violation of the Standard concerning fair dealing.
   C. a violation of the Standard concerning responsibilities of supervisors.
   D. a violation of the Standard concerning professional misconduct.

36. Shane Matthews, CFA, is a principal at Carlson Brothers, a leading regional investment bank specializing in initial public offerings of small to mid-sized biotech firms. Just before many of the IPOs are offered to the general public, Matthews arranges for 10% of the shares of the firm going public to be distributed to management at 75% of the expected IPO price. This action is:
A. permissible under CFA Institute Standards.
B. a violation of the Standard concerning professionalism.
C. a violation of the Standard concerning disclosure of conflicts of interest.
D. a violation of the Standard concerning suitability.

37. Will Hunter, CFA, is a portfolio manager at NV Asset Managers in Baltimore, which specializes in managing labor union pension fund accounts. A friend of Hunter's who is an investment banker asks Hunter to purchase shares in their new IPOs in order to support the price long enough for insiders to liquidate their holdings. Hunter realizes that the price of the shares will almost certainly fall dramatically after his buying support ceases. NV management "strongly suggests" that Hunter "not rock the boat" and honor the investment banker's request since NV has had a long-standing relationship with the investment bank. Hunter agrees to make the purchases. Hunter has:
A. not violated the Code and Standards.
B violated the Code and Standards by failing to report fair, accurate, and complete data to his clients.
C. violated the Code and Standards by attempting to distort natural market forces.
D. violated the Code and Standards by failing to place orders in the appropriate transaction priority.

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

39. Fred Johnson, CFA, a financial analyst and avid windsurfer, has begun an investment survey of the water sports leisure industry. His brother sells windsurfing gear in Tampa and tells him that Swordfish9 is the "hottest windsurfing rig on the market and will be highly profitable for Swordfish Enterprises." Johnson had never heard of Swordfish previously but after testing the board himself became very excited about the Swordfish9 and issued an investment recommendation of "buy" on Swordfish Enterprises. As a result of issuing the recommendation, Johnson has:
A. not violated the Code and Standards.
B. violated the Code and Standards by failing to establish a reasonable and adequate basis.
C. violated the Code and Standards concerning professionalism by placing recreational interests ahead of his fiduciary duty to his clients.
D. violated the Code and Standards by failing to consider the suitability of the investment for his clients.

40. Daniel Lyons, CFA, is an analyst for a French firm that sells investment research to European companies. Lyons' aunt owns 30,000 shares of French National Bank (FNB). She informs Lyons that as a part of her estate planning she has created a trust in his name into which she has placed 2,000 shares of FNB. The trust is structured so that Lyons will not receive control of the assets for two years, at which time his aunt will also gift her current home to Lyons and move into a retirement community. Lyons is due to update his research coverage of FNB next week. Lyons should:
    A. advise his superiors that he is no longer able to issue research recommendations on FNB.
    B. update the report without notification since the shares are held in trust and are beyond his direct control.
    C. disclose the situation to his employer and, if then asked to prepare a report, also disclose the situation in the report.
    D. disclose the situation to his employer and then prepare the report with no disclosure.

41. Which of the following is *not* one of the recommendations included in the Standards of Practice Handbook with regard to Performance Presentation?
    A. Include terminated accounts in past performance history.
    B. Present the performance of a representative account rather than an average of similar portfolios.
    C. Maintain a record of the data used to calculate performance.
    D. Consider the level of financial knowledge of the audience to whom the performance is presented.

42. All of the following are recommended procedures included in the Standard regarding Fair Dealing *except:*
    A. Maintain a list of clients and their holdings.
    B. Develop written procedures for trade allocation.
    C. Disseminate initial recommendations to all clients.
    D. Review accounts systematically to ensure that no client is given preferred treatment.

43. Which of the following actions is *a required, rather than recommended, action* under the Standard regarding diligence and a reasonable basis for a firm's research?
    A. Have a policy requiring that research reports and recommendations have a basis that can be substantiated as reasonable and adequate.
    B. Have detailed *written* guidance for proper research and due diligence.
    C. Compensate analysts based on measurable criteria to assess the quality of their research.
    D. Review the assumptions used and evaluate the objectivity of externally generated research reports.

44. Should you agree or disagree with the following two statements:

    Sally states, "The Standards recommend, but do not require, that members and candidates should not participate in initial public offerings."

    Ralph states, "The Standards recommend that trades for accounts of family members must always be made after those for other clients, but before those for the account of the members and candidates responsible for executing the transactions."

	Sally	Ralph
A.	Agree	Agree
B.	Agree	Disagree
C.	Disagree	Disagree
D.	Disagree	Agree

Answers – Concept Checkers: Standards of Practice Handbook

1. B Hutchins' personal bankruptcy may reflect poorly on her professional reputation if it resulted from fraudulent or deceitful business activities. There is no indication of this, however, and the bankruptcy is thus not a violation. Smith has not violated the Code and Standards by refusing to invest with Hutchins in what turned out to be bad investment opportunities. By reporting Smith to CFA Institute for a violation, Hutchins has misused the Professional Conduct Program to settle a dispute unrelated to professional ethics and has thus violated Standard I(D), Misconduct.

2. C According to Standard I(A), informing her supervisor or firm's compliance department is appropriate. Dissociating herself would be premature. She should report her suspicions to a supervisory person and attempt to remedy the situation.

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

4. D According to Standard II(A), members and candidates are under no circumstances allowed to use inside information to trade securities. Carlson must abide by the Code and Standards, which is the most strict regulation in the scenario.

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

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

7. D According to Standard I(A), in some instances reporting a legal violation to governmental or regulatory officials may be appropriate, but this isn't always necessary, and it isn't required under Standard I(A).

8. B According to Standard VII(B), any explanation of the designation in print form should be a concise description of the requirements or of CFA Institute. The other statements contains violations of Standard VII(B), in particular the presentation of the letters CFA. Also, she may not imply superior performance as a result of being a CFA charterholder.

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

10. B According to Standard I(C), factual data from a recognized statistical reporting service need not be cited.

11. B According to Standard III(C), Ellis must consider the suitability of each new investment (as well as current holdings) in light of the portfolio mandate. Ellis must only make investments that are in accordance with the portfolio's investment policy statement. Therefore, Ellis should not purchase the unsuitable bonds as requested by her clients.

12. B By failing to include terminated portfolios in the performance presentation, the performance will have an inherent upward bias, making results appear better than they truly are. By excluding the terminated portfolios, DNR misleads its potential investors and thus violates Standard III(D), Performance Presentation.

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

14. D According to Standard IV(C), reporting the violation and warning the employee to cease activities that violate the law or the Code and Standards are not enough. The supervisor must takes steps (such as limiting employee activity or increasing the level of employee monitoring) to prevent further violations while he conducts an investigation.

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

16. C Jamal failed to properly supervise employees and provide adequate procedures and policies to prevent employee violations. Smith should not have traded her own account ahead of client accounts. Temple should not have disclosed the recommendation change selectively but should have informed his clients fairly and objectively. No inside information was used in the question.

17. A Standard I(B) requires that members and candidates reject offers of gifts or compensation that could compromise their independence or objectivity. Schleifer has appropriately rejected the offer of the hotel accommodations and the use of ChemCo's jet. He may accept the desk clock since this gift is of nominal value and is unlikely to compromise his independence and objectivity. Schleifer cannot accept the tickets to the dinner, however. Since it is a formal high-society dinner, the tickets are most likely expensive or hard to come by. Even though he has disclosed the gift to his employer and he plans to use the dinner as a marketing opportunity for his firm, the gift itself may influence Schliefer's future research in favor of ChemCo. Allowing such potential influence is a violation of Standard I(B).

18. C Standard I(B) requires that an analyst maintain his independence and objectivity by having his firm pay for ordinary travel expenses to visit companies that are the subject of research. However, in some cases, such as remotely located facilities, the company may pay for modest accommodations and chartered flights as long as the transportation and lodging is not lavish and is not intended to exert influence over the analyst.

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

20. A Historical growth can be cited as a fact since it actually happened. Stefano states that her firm expects further growth and profitability which is an opinion. She does not claim that these are facts. In addition, Stefano identifies relevant factors and highlights in particular the most significant risks of investing in South American utilities. She has fully complied with Standard V(B), Communication with Clients and Prospective Clients. Under the Standard, it is not necessary to include every detail about a potential investment in a report. Members and candidates are expected to use their judgment and identify the most important factors to include.

21. C This is not necessarily a violation. Firms can offer different levels of service to clients as long as this is disclosed to all clients. The largest institutional clients would likely be paying higher fees for a greater level of service. Also note that the analyst's brother's account in answer D should be treated similarly to any other client account.

22. C One week is likely an acceptable waiting period.

23. B Standard I(C)—in the other choices, Olson misrepresents the services that she or her firm are capable of performing, her qualifications, her academic or professional credentials, or the firm's credentials. The firm is small and most likely cannot perform all investment services the client may require. The firm cannot guarantee future outperformance of the market indexes. Olson hasn't been in the business for a long time as she claims and cannot guarantee the performance of any investment. The firm doesn't have a long history (only 6 months).

24. D Standard III(A)—Herbst is acting as a fiduciary for the pension plan beneficiaries. She may pay higher-than-average brokerage fees so long as doing so benefits the pension beneficiaries, not other clients. Trading with selected brokers solely to gain referrals is not likely to be in the pension beneficiaries' best interest since it does not take into account other important factors for selecting brokerage firms. Minimizing contributions benefits the plan sponsor, not the plan beneficiaries to whom the fiduciary duty is owed. Choosing brokers based on quality of services provided is reasonable.

25. C Minter is required by Standard V(C) to maintain hard copy *or* electronic documentation of the research and data supporting current investment recommendations for at least seven years (since there is no regulatory guidance on an appropriate length of time).

26. A Nieder must not take models or documents from his previous employer without explicit permission to do so [Standard IV(A)]. He is allowed, however, to reproduce the model from memory but must recreate the supporting documentation to maintain compliance with Standard V(C), Record Retention.

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

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

29. A There is no indication that Servais has inside information pertaining to the situation at the five firms in question—only the two firms that have already gone public with the information. It is common knowledge that the other five firms follow the same boron handing procedures. She is, therefore, in compliance with Standard V(A) concerning the use of material nonpublic information in the issuance of the investment recommendation.

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

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

32. C The furtive release of such information to a limited circle via an internet chat room does not cause the information to be public. The information is also clearly material. Therefore Green is not allowed to trade on the information under Standard II(A).

33. A Albright is entitled to accept work for which she receives outside compensation as long as the appropriate consent is obtained. Under Standard IV(A), such consent must be obtained from her employer prior to beginning the work.

34. C It is not reasonable for Bixby to expect a 40-to-60 stock mid-cap portfolio to track the entire S&P 500 Index, which is a large-cap index. He should know that there will be periods of wide variance between the performance of the portfolio and the S&P 500 Index. There is no assurance that a premium of 2 to 4% will consistently be obtained. Bixby is in violation of Standard III(D) since he has made an implicit guarantee of the fund's expected performance.

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

36. B Members and candidates are required to maintain knowledge of and comply with the applicable securities laws governing their professional activities. This type of securities fraud would almost certainly be against the law in most jurisdictions. Matthews's actions, therefore, are in violation of Standard I(A), which require knowledge of and adherence to applicable laws. He has also violated Standard I(D), which prohibits professional misconduct involving fraud and other acts that reflect poorly on the professional's reputation.

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

38. A There is no violation of the CFA Institute Standards regarding this matter. The referral arrangement is fully disclosed to clients before they agree to do business with Pick. Therefore clients can fully assess how the agreement will affect their account before hiring Pick as their asset manager.

39. B Johnson has apparently let his recreational passion cloud his judgment. This is not to say that Swordfish Enterprises is not or will not be an excellent investment. However, if he had never heard of the firm previously, issuing an investment recommendation without conducting a thorough financial investigation indicates a failure to exercise diligence and also indicates that he lacks a reasonable and adequate basis for his recommendation. He is in violation of Standard V(A).

40. C Even though the shares are held in trust, this could still be construed as a conflict of interest. Lyons is obligated under Standard VI(A) to inform his employer of the potential conflict. If he is then authorized to issue investment recommendations on the security in question, the existence of a potential conflict must be disclosed in the report.

41. B The recommended procedure in Standard III(D) - Performance Presentation, is to present the performance of a composite as a weighted average of the performance of similar portfolios rather than using a single representative account.

42. C The recommended procedure according to Standard III(B) - Fair Dealing, is to disseminate new recommendations to all clients who express an interest or for whom the investment is suitable. Not all clients need to be informed but the selection should be based on suitability of the specific investment. The other three are main headings in the "Recommendations" section of the Standard.

43. D It is required under Standard V(A) that third-party research assumptions be reviewed and both the independence and objectivity of the research and recommendations be evaluated. The other choices are recommended policies and procedures under the Standard.

44. B Standard VI(B) regarding the Priority of Transactions recommends that members and candidates avoid the appearance of conflict of interest by not participating in IPOs. If a family member is a fee-paying client, the member or candidate should treat them like any other client, not giving any advantage or disadvantage to their accounts. The fact that a member or candidate has a beneficial interest in a client account does not preclude treating it like any other fee-paying account.

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

Global Investment Performance Standards

Study Session 1

Exam Focus

This topic review covers the key features of the Global Investment Performance Standards (GIPS®) as adopted by CFA Institute in 1999 and subsequently updated. Compliance with GIPS is voluntary. For the Level 1 exam you are responsible for only the "Introduction to the Global Investment Performance Standards (GIPS®)" and the Preface, Section I, and Section II (through II.0: Fundamentals of Compliance) of the GIPS document. The GIPS document is included in the book of candidate readings for Level 1 and is also available on the CFA Institute Web site. A helpful glossary of terms is included in the document. Candidates should not underestimate the importance of this material for the exam.

Introduction to the Global Investment Performance Standards (GIPS®) and Global Investment Performance Standards (GIPS®)

LOS 4.a: Explain why the GIPS standards were created, what parties the GIPS standards apply to and who is served by the standards.

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

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

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

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

LOS 4.b: Describe the key characteristics of the GIPS standards and the fundamentals of compliance.

GIPS Objectives

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

Key Characteristics of GIPS

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

Fundamentals of compliance contain both requirements and recommendations:

Definition of the firm—requirements:

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

Definition of the firm—recommendations:

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

Document policies and procedures—requirements:

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

Claim of compliance—requirements:

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

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

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

Firm fundamental responsibilities—requirements:

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

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

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

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

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

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

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

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

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

Firms that previously presented performance in compliance with a particular Country Version of GIPS (CVG) may claim GIPS compliance for any CVG-compliant results prior to January 1, 2006. Firms that report such

CVG-compliant performance data must continue to include that performance data in subsequent GIPS-compliant presentations until a minimum of ten years of compliant performance is presented.

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

LOS 4.f: Name and characterize the eight major sections of the GIPS standards.

0. *Fundamentals of compliance.* These are issues for firms to consider when claiming GIPS compliance. Definition of the firm is part of this. The next LOS covers this section in greater detail.
1. *Input data.* Input data should be consistent in order to establish full, fair, and comparable investment performance presentations.
2. *Calculation methodology.* Certain methodologies are required for portfolio and composite return calculations. Uniformity in methods is required.
3. *Composite construction.* Creation of meaningful, asset-weighted composites is important to achieve a fair presentation.
4. *Disclosures.* Certain information must be disclosed about the presentation and the policies adopted by the firm.
5. *Presentation and reporting.* Investment performance must be presented according to GIPS requirements, and other firm-specific information should be included when appropriate.
6. *Real estate.* These provisions apply to all real estate investments (land, buildings, etc.) regardless of the level of control the firm has over management of the investment.
7. *Private equity.* These must be valued according to the GIPS Private Equity Valuation Principles, which are contained in Appendix D, unless it is an open-end or evergreen fund (which must follow regular GIPS).

Once a firm claims GIPS compliance, the firm has an option to hire an independent third party to verify the claim of compliance.

The purpose of verification is to provide assurance that compliance has been adhered to on a firm-wide basis. Verification adds credibility.

LOS 4.g: Explain the requirements for verification of compliance with GIPS standards.

Verification—requirements:

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

Verification—recommendations:

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

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

Concept Checkers: Global Investment Performance Standards

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

2. At a regional conference for institutional portfolio managers, Jason Morris makes four comments in a presentation centered on explaining the reasons for the creation of GIPS. Which of Morris' comments is incorrect? GIPS were created:
   A. to improve comparability of performance results among investment firms.
   B. to reduce historical performance inflation caused by excluding results of terminated portfolios.
   C. to alleviate the ambiguity caused by investment firms' manipulated forecasts of expected portfolio returns.
   D. in response to performance reporting abuses which included only reporting results over periods of exceptional returns.

3. Which of the following statements most accurately describes verification under GIPS? Verification:
   A. may be performed on single composites.
   B. is required for a firm to claim GIPS compliance.
   C. requires a verification report to be issued for the entire firm.
   D. is required for all composites in existence prior to January 1, 2000.

4. Benson Asset Management Inc. is seeking to become compliant with GIPS. The firm has hired an independent consultant to assist in ensuring that Benson's policies and procedures conform to the standards. All of the following recommendations made by the consultant are required under GIPS **EXCEPT**:
   A. Benson must disclose the results of its independent verification process in its composite presentations.
   B. all of Benson's accounts managed by third party advisers selected by Benson must be included in the firm's composites.
   C. Benson's policies and procedures that are instrumental to maintaining compliance with GIPS must be documented in writing.
   D. compliant presentations for discontinued composites must be made available to any prospect requesting one up to five years after discontinuation.

5. Assume that on January 1, 2001, a 15-year-old firm with no GIPS-compliant performance history wishes to claim compliance with GIPS. Which of the following statements accurately reflects appropriate actions for the firm to take to claim compliance with the standards?
   A. Report up to ten years of non-GIPS-compliant history, as long as it discloses why the performance presentation is not in compliance with GIPS.
   B. Retroactively comply with GIPS for the year beginning January 1, 2000, and report nine additional years of performance history (ten total) with a disclosure of why the earlier years are not GIPS compliant.
   C. Retroactively comply with GIPS for the year beginning January 1, 2000, and report four additional years of performance history (five total) with a disclosure of why the earlier years are not GIPS compliant.
   D. Retroactively comply with GIPS for the 5-year period January 1, 1996, through December 31, 2000, and report five additional years of non-GIPS-compliant performance with a disclosure of why the performance in these years is not GIPS compliant.

6. Vivian Müller, compliance director for ABC Investments, is reviewing GIPS compliance policies put in place by her employees. In the policies, the employees have included several future GIPS requirements that are currently only recommended. All of the following policies are only recommended EXCEPT:
   A. calculation of composite returns must be done based on monthly asset weighted returns of the underlying portfolios.
   B. restructuring of the firm's organization cannot be used as a basis to change the historical performance results of a composite.
   C. all investments in land, in-process building construction, and finished buildings must be valued every three months.
   D. performance presentation for carve-out returns is only permitted for portfolios managed separately with their own cash balances.

7. Which of the following is an inaccurate statement about the major components of GIPS?
   A. GIPS cover the professional qualifications of those responsible for managing assets at a firm claiming compliance.
   B. GIPS cover the way investment firms calculate composite returns as well as the method used to create the composite itself.
   C. GIPS apply to many categories of portfolio assets including stocks, bonds, real estate, and private equity.
   D. GIPS require that firms claiming compliance disclose certain information related to performance presentations and firm policies.

8. Mason Smith is trying to decide which of the following composite definitions, submitted by his junior analysts, would be considered a viable composite according to GIPS. Which composite will meet the standards? A composite that includes:
   A. all accounts that are managed directly from the firm's Hong Kong office.
   B. all actively managed portfolios but excludes passively managed portfolios.
   C. portfolios that have experienced at least a positive 3% return over the last five years.
   D. all portfolios that are managed to provide a return equal to that of the S&P 500 Index.

9. Mack Stevens has assembled several articles written about GIPS. Each article has listed at least one objective of GIPS. All of the following statements collected from the articles correctly describe objectives of GIPS EXCEPT:
   A. GIPS attempt to gain worldwide acceptance of performance calculation and presentations standards in a fair format with full disclosure.
   B. GIPS try to provide an opportunity for large and small firms to compete on an equal footing through external rules and regulations.
   C. GIPS seek to encourage equitable competition among investment firms in all markets without stifling new market entrants in the process.
   D. GIPS strive to make sure that firms have reliable and precise reporting, record keeping, advertising, and presenting of investment performance.

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

Answers – Concept Checkers: Global Investment Performance Standards

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

2. C GIPS were created to reduce ambiguity of performance reporting among investment firms. Past abuses of performance reporting include representative accounts (showing only top performers), survivorship bias (deleting poor performers), and varying time period (showing only the time period with the best performance).

3. C A single verification report is issued with respect to the whole firm: GIPS verification cannot be carried out for a single composite.

4. A Verification is not currently required under GIPS. Firms that choose to undergo the verification process are encouraged, but not required, to make a specific verification disclosure in composite presentations and advertisements that reference the firm's GIPS verification.

5. D In order to claim GIPS compliance, a firm must present at least five years of annual investment performance that is compliant with GIPS. If a firm or composite is less than five years old, the performance since the inception of the firm or composite must be presented.

6. B Firms cannot alter historical performance records of composites simply because of a reorganization of the firm. This is a current requirement of GIPS. All of the other answer choices are future requirements that are currently only recommended.

7. A There are no GIPS related directly to the qualifications of employees managing assets at an investment firm whether it claims compliance with the standards or not. The major sections of GIPS are as follows: input data, calculation methodology, composite construction, disclosures, presentation and reporting, real estate, and private equity.

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

9. B GIPS seek to promote global self regulation through voluntary acceptance and adherence to the standards. The other statements correctly state objectives of GIPS.

10. C GIPS verification must be performed by an independent third party. The SEC audit does not constitute a GIPS verification.

The following is a review of the Quantitative Methods principles designed to address the learning outcome statements set forth by CFA Institute®. This topic is also covered in:

THE TIME VALUE OF MONEY

Study Session 2

EXAM FOCUS

This topic review covers time value of money concepts and applications. Procedures are presented for calculating the future value and present value of a single cash flow, an annuity, and a series of uneven cash flows. The impact of different compounding periods is examined, along with the procedures for solving for other variables in time value of money problems. Your main objective in this chapter is to master time value of money mechanics (i.e., learn how to crunch the numbers). There will be a lot of time value of money problems and applications on the exam, so be prepared to deal with them. Work all the questions and problems found at the end of this review. Make sure you know how to grind out all the time value of money problems on your calculator. The more rapidly you can do them (correctly), the more time you will have for the less predictable parts of the exam.

TIME VALUE OF MONEY CONCEPTS AND APPLICATIONS

In order for money to have time value, it must be possible to invest it at a positive rate of return. The rate of return (interest rate) that provides money with time value is composed of three components:

- **Risk-free rate.** This is the rate that is earned on a riskless investment, and it represents the compensation that investors require to defer current consumption. The rate on short-term U.S. Treasury securities is typically used to represent the risk-free rate.
- **Inflation premium.** This is the return that investors require to compensate them for the change of purchasing power over an investment horizon.
- **Risk premium.** This is the compensation that investors require for being exposed to various types of investment risk.

The concept of **compound interest** or **interest on interest** is deeply embedded in time value of money (TVM) procedures. When an investment is subjected to compound interest, the growth in the value of the investment from period to period reflects not only the interest earned on the original principal amount but also on the interest earned on the previous period's interest earnings—the interest on interest.

TVM applications frequently call for determining the **future value** (FV) of an investment's cash flows as a result of the effects of compound interest. Computing FV involves projecting the cash flows forward, on the basis of an appropriate compound interest rate, to the end of the investment's life. The computation of the **present value** (PV) works in the opposite direction—it brings the cash flows from an investment back to the beginning of the investment's life based on an appropriate compound rate of return.

Being able to measure the PV and/or FV of an investment's cash flows becomes useful when comparing investment alternatives because the value of the investment's cash flows must be measured at some common point in time, typically at the end of the investment horizon (FV) or at the beginning of the investment horizon (PV).