4. l.

PRACTICE PROBLEMS

The following information relates to Questions 1–6

Bornelli Asset Management offers traditional long-only funds as well as a variety of hedge funds for both private and institutional clients. Bornelli is a well-managed firm of more than 100 employees. Its board of directors has voted to adopt the Asset Manager Code of Professional Conduct (the Code).

Bornelli has hired Ava Campanelli as chief compliance officer with responsibility for implementing the Code. Campanelli develops a plan to evaluate the firm's current policies and procedures for compliance with the Code. Campanelli begins by reviewing three of the firm's compliance procedures:

Portfolio review	Portfolio information provided to clients is reviewed by an independent third-party.
Record retention	The firm retains records to substantiate all investment decisions for seven years. In compliance with regulatory requirements, the firm also retains copies of all emails for the same period. The firm retains its records in a combination of both hard-copy and electronic formats.
Investigation of complaints	The chief compliance officer (CCO) is responsible for investigating and documenting all complaints. The CCO reports to the chief investment officer and works with management to take appropriate disciplinary action in cases of compliance breaches.

Campanelli then evaluates the firm's business-continuity plan. Under the current plan, the technology division backs up all of the firm's computer systems and client records twice daily. The back-ups are stored in a fireproof storage facility offsite. Bornelli outsources certain emergency plans to a disaster recovery firm. The disaster recovery firm is responsible for developing and implementing plans to communicate with employees and mission-critical vendors and suppliers in the event of a facility or communication disruption. The same firm also provides plans for contacting and communicating with clients in event of an extended disruption.

For her next project, Campanelli reviews the disclosures provided to both prospective and current clients. The disclosures regarding management fees state:

> Bornelli charges a 2% asset-based management fee. In addition to the management fee, clients may pay an incentive fee at the end of each year. The incentive fee is equal to 20% of the account's net investment income and net realized and unrealized capital gains for the year.
>
> No incentive fee will be paid unless the Fund has offset all prior net realized capital losses and net investment losses with realized capital gains, unrealized appreciation, and net investment income from all securities held by the Fund.

Campanelli's evaluation of the management fee disclosures is interrupted by a more urgent matter involving a client. The client has requested monthly performance reporting of his investment in a long-short equity hedge fund. The fund's administrator argues "Our procedures call for us to provide clients with both gross- and net-of-fees returns within 30 days of the end of the quarter." He adds "Quarterly reporting is the industry standard."

The administrator complains "This client, Rossi, is overly demanding. He telephoned yesterday and requested an itemization of the fees and other costs charged to him for the past three years. He wants to know the specific management fee, the incentive fee, and the amount of commissions paid. The more time we spend answering his requests, the less time we have to research investments." Campanelli promises to look into the matter for the administrator.

The following week, Campanelli meets with Lee Bruno, manager of the firm's alternative assets fund. Bruno informs Campanelli, "The fund has a three-year lock-up period. We disclosed to all the prospective clients in writing before they invested that this is a long-term investment and that they should not focus on short-term performance results. During the lock-up period, we provide semiannual reporting. After the lock-up, we report quarterly."

Bruno informs Campanelli that whenever possible, the firm uses fair market prices to value client holdings. He adds "Of course, our fund invests in alternative assets—some of which are very difficult to value. They aren't like public equities with independent, third-party market quotations available, so we use an internal model to value client holdings." He continues, "We disclose the use of internal models for valuation purposes on all our reports."

Following her conversation with Bruno, Campanelli researches a complaint from a new client regarding the valuations of his fund's holdings. The client complains that another management firm reported much lower valuations on similar instruments. Campanelli researches the methodologies Bornelli uses for valuing fund holdings. She determines the following:

- All publicly traded US and foreign equities, including large-, mid-, small-, and micro-cap shares are valued at the last available closing price.
- The value of certain securities such as swaps are based on quotes collected from broker-dealers.
- When prices are not available from either of the above sources, valuations are based on internal models.

1. Are the three compliance procedures reviewed by Campanelli consistent with both the required and recommended standards of the CFA Institute Asset Manager Code of Professional Conduct?

   A. No, the procedures regarding record retention are inconsistent.

   B. No, the procedures regarding portfolio review are inconsistent.

   C. No, the procedures regarding investigation of complaints are inconsistent.

2. Is Bornelli's disaster recovery plan consistent with both the required and recommended standards of the Asset Manager Code?

   A. Yes.

   B. No, because the plan lacks a backup plan for monitoring, analyzing, and trading investments.

   C. No, because the plan only provides for contacting and communicating with clients during periods of extended disruption.

3. Are the firm's disclosures regarding management fees consistent with the required and recommended standards of the Asset Manager Code?

A. Yes.

B. No, because they do not use plain language.

C. No, because they do not include the average or expected expenses or fees clients are likely to incur.

4. Are the performance reporting procedures described by the fund's administrator consistent with the required disclosure standards of the Asset Manager Code?

A. Yes.

B. No, because the AMC requires firms to report performance to all clients on a monthly basis.

C. No, because the AMC requires firms to provide performance on a monthly basis when requested by clients.

5. To comply with both the required and recommended standards of the Asset Manager Code, must Bornelli honor Rossi's telephone request regarding an itemization of fees?

A. Yes.

B. No, because the firm is not required to disclose the amount of incentive fee charged to an individual client.

C. No, because unless the firm claims compliance with the Soft Dollar Standards, it is not required to disclose the amount of commissions paid on clients' behalf.

6. Are the policies of the alternative assets fund consistent with the required and recommended standards of the Asset Manager Code?

A. Yes.

B. No, the frequency of reporting is inconsistent with the AMC.

C. No, the use of internal valuation models is inconsistent with the AMC.

The following information relates to Questions 7–12

Henry Schmidt, David Zane, and Andrew Ronoldo founded SZR LLC (SZR), an investment advisory firm managing portfolios for individuals. Although none of the founders holds the CFA charter, SZR has adopted the CFA Institute Asset Manager Code of Professional Conduct.

SZR's client portfolios average $50,000 and are entirely invested in SZR's commingled fund, managed by Ronoldo. Ronoldo implements a quantitative enhanced index process in SZR's fund and has consistently added moderate performance (alpha) over the fund's mid-cap benchmark index. After five years of strong performance, Ronoldo worries that the mid-cap fund will lag broad market indexes, so he decides to broaden the fund's strategy. After doing research, he adds micro-cap, foreign, and convertible preferred stocks to the fund and doubles some holdings so that their weights are much larger than they are in the benchmark index. Since the fund achieves even stronger performance, both against the benchmark mid-cap index and major market indexes, Ronoldo plans to describe the new strategy in the company's next annual newsletter, due to be sent to clients in three months.

As a prominent member of the community, Schmidt has just joined the board of a local company, Trezeguet Baking Company, which recently went public. Trezeguet's shares are in most micro-capitalization (cap) indexes. As a board member, Schmidt receives a small annual stipend of $2,000; however, he is granted several thousand stock options, which he can exercise after 24 months' board service. Since his stipend is insignificant and he will not exercise his options for at least 24 months, Schmidt does not disclose his Trezeguet board service to SZR clients.

One of SZR's clients is president of Sastre International. Because of SZR's success, this client hires SZR to manage $800 million of Sastre International's corporate cash in a separate account, but asks that its hiring of SZR not be made public. Sastre's board asks Ronoldo to direct all of the Sastre account trades through a local financial advisor, to thank the advisor for selecting SZR. Ronoldo is concerned that this direction may limit SZR's ability to achieve best execution, but after Sastre acknowledges in writing that this is their preference, Ronoldo agrees to follow Sastre's direction.

As head of operations, Zane wishes to simplify trading and implements a new trade policy: first place trades for the Sastre account through the local financial advisor and then submit the commingled fund's trades through national brokerage houses and electronic networks. The local financial advisor is pleased with this arrangement, as he is able to buy securities before other clients; he informs Zane that he'll recommend SZR to additional clients.

Schmidt, SZR's sales director, sends the commingled fund's stellar performance track record to several investment consultants, who serve as "gatekeepers" for large institutional clients, but he is told that SZR is too small to be considered by their clients. After Schmidt reveals that Sastre has recently hired SZR, and offers to negotiate the same special fee discount that has been given to Sastre, one consultant agrees to consider SZR for its clients. The consultant indicates that if SZR agrees to sponsor the consulting firm's annual conference, Schmidt will meet many potential clients. Schmidt considers this conference sponsorship, but decides that it is too costly for SZR's budget, so he declines the offer.

As SZR grows, Zane hires his brother-in-law, John Karna (top salesman for a local auto parts company) as Compliance Officer. Karna is tasked with writing SZR's Code of Ethics and its Investment Policies and Procedures Manual. Karna is also put in charge of the firm's Business Continuity Plan. The plan consists of his taking home, each evening, the computer records of SZR's daily trades.

7. Does Ronoldo violate the CFA Institute Asset Manager Code of Professional Conduct with respect to his broader investment strategy?

- **A.** No.
- **B.** Yes, with respect to client disclosure only.
- **C.** Yes, with respect to reasonable and adequate basis only.

8. Does Schmidt violate the CFA Institute Asset Manager Code of Professional Conduct with respect to his current Trezeguet board service?

- **A.** No.
- **B.** Yes, with respect to priority of client interests only.
- **C.** Yes, with respect to priority of client interests and participation in business relationships.

9. By agreeing to Sastre's direction, does Ronoldo violate the CFA Institute Asset Manager Code of Professional Conduct?

- **A.** No.
- **B.** Yes, only with respect to best execution.
- **C.** Yes, only with respect to fair and equitable trade allocation.

10. Does Zane's revision of SZR's trading process violate the CFA Institute Asset Manager Code of Professional Conduct?

A. No.

B. Yes, only with respect to best execution.

C. Yes, with respect to best execution and fair, equitable trade allocation.

11. Does Schmidt violate the CFA Institute Asset Manager Code of Professional Conduct in his interaction with consultants?

A. No.

B. Yes, only with respect to confidentiality.

C. Yes, only with respect to business relationships that could affect independence.

12. Does Karna's role as Chief Compliance Officer, and the process of SZR's Business Continuity Plan, respectively, conform to the requirements and recommendations of the CFA Institute Asset Manager Code of Professional Conduct?

A. Neither Karna's role nor the Business Continuity Plan conforms.

B. Karna's role conforms, but the Business Continuity Plan does not conform.

C. Karna's role does not conform, but the Business Continuity Plan does conform.

SOLUTIONS

1. C is correct. According to the recommendations of Section D(2) of the Asset Manager Code, where possible, the CCO should be independent from the investment and operations personnel and should report directly to the CEO or the board of directors.

2. B is correct. According to the guidance provided in Section D(6) of the Asset Manager Code, the level and complexity of business-continuity planning depends on the size, nature, and complexity of the organization involved. Bornelli is a large firm with hedge fund investments and it should have alternative plans for monitoring, analyzing, and trading investments if primary systems become unavailable.

3. C is correct. According to the recommendations and guidance of Section F(4d) of the Asset Manager Code, managers must disclose to prospective clients the average or expected expenses or fees clients are likely to incur, and to existing clients the actual fees and other costs charged to them.

4. A is correct. The performance reporting procedures described by the administrator are consistent with the Asset Manager Code (AMC) which requires disclosing the "performance of clients' investments on a regular and timely basis." The AMC recommends that "managers should report to clients at least quarterly, and when possible, such reporting should be provided within 30 days after the end of the quarter." The AMC also states that "at a minimum, Managers should provide clients with gross- and net-of-fees returns." Because quarterly reporting is the recommended minimum, managers may choose to provide more timely performance to clients.

5. A is correct. According to the recommendations of Section F(4d) of the Asset Manager Code, managers should disclose to each client the actual fees and other costs charged to them, together with itemizations of such charges, when requested by clients. The disclosure should include the specific management fee, incentive fee, and the amount of commissions paid on clients' behalf during the period.

6. B is correct. Clients must have regular performance information to evaluate their overall asset allocations and to determine whether rebalancing is necessary. This concept applies even to investment vehicles with lock-up periods. According to the Asset Manager Code, unless otherwise specified by the client, managers should report to clients at least quarterly, and when possible, within 30 days of the end of the period.

7. B is correct. Ronoldo should have disclosed his change in investment strategy to clients, allowing them to move their accounts if not in agreement. Until he disclosed a planned change in strategy, he should have continued to manage in the manner for which clients had hired him.

8. C is correct. Schmidt is on the board of a company whose stock is in microcap indexes. This is a conflict of interest, as Ronoldo's widened investment guidelines allow purchase of Trezeguet stock for the fund. As Schmidt is an insider for the company and received options that can be sold (after 24 months), this relationship should be terminated.

9. A is correct. The Sastre board requests directed trading for its discretionary account and acknowledges, in writing, that trading through the local financial advisor may limit best execution. As this is a discretionary (not pension) account, the client has the right to direct to a less-than-optimal trading venue.

10. C is correct. Zane should have pursued best execution for all clients in the fund (which is not accomplished by placing trades with the local financial advisor first versus with national brokers or electronic networks), and fairly traded for all clients. While Sastre is welcome to direct trades, Zane's change in procedures harms other clients.

11. B is correct. Schmidt violated Code A-2 by revealing Sastre's hiring of SZR and its special fee discount.

12. A is correct. Karna's qualification as compliance officer is inadequate (D-2, D-5), and taking tapes home each night is inadequate business continuity for a firm of $1.5 billion (D-6).