
PRACTICE PROBLEMS

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The following information relates to Questions 1–6 and is based on “Guidance for Standards I–VII” and this reading

Jason Locke, CFA, has recently been hired as the Chief Investment Officer of the Escarpment Regional Government Employees’ Pension Fund (the Fund). Currently, he is conducting evaluations of all external managers employed by the Fund to ensure that they are providing the highest possible returns for their mandates, while complying with all applicable laws and regulations.

Locke is evaluating the activity of Niagara Growth Managers (NGM), a local money manager allocated 10 percent of the Fund’s assets. He realizes that any reduction in the allocation to this local manager will be met with considerable political pressure. The investment policy statement (IPS) for NGM’s portion of the Fund’s assets states that NGM is to actively manage an equity portfolio of local small-cap, high-tech companies.

Upon his review of NGM’s activity, Locke is concerned about two items that he would like explained. At a meeting with NGM’s portfolio manager, Emma Black, CFA, Locke asks her to comment on each item:

Commodities Positions

Locke “Over the last year, several large positions in commodities have been taken by the Fund’s portfolio. This is inconsistent with the IPS.”

Black “Commodities have significantly outperformed high-tech equities recently. I added commodities to larger clients’ portfolios on a temporary basis. Clients were not informed because the positions will be sold once market sentiment shifts. I have not managed commodities before, but I am getting good returns.”

“I am uncomfortable with these investments in this portfolio.”

Locke

IPO Share Allocation

Locke “The Fund’s portfolio received 50,000 shares of an initial public offering (IPO) on 1 April. On 15 May, 30,000 shares were removed at the current market price.”

Black “There was a problem with NGM’s IPO allocation algorithm. Initially, you were over-allocated and when we discovered the error, your account was adjusted.”

Locke “Short-term interest should have been credited to the Fund for use of its cash to cover the trade. In any case, this was an IPO of a large international high-tech company. It was not an appropriate investment for the portfolio.”

After the meeting, Locke is not satisfied with Black’s comments and decides that further action is required. He also decides that he will allow NGM to continue to manage Fund assets until he finishes his evaluation. This decision is based on the superior returns of the NGM-managed assets, the significant diversification this portfolio adds to the Fund, and also the political implications of firing the local money manager.

The next week, Locke calls Black and outlines several conditions that must be fulfilled for NGM to continue as a manager for the Fund. One of the conditions outlined relates to trade allocations.

Trade Allocation

Locke “Provide written trade allocation procedures consistent with the CFA Institute Standards of Professional Conduct.”

Black “I will mail you a copy of our new procedures stating that trade allocations must be reviewed at the end of each month against clients’ IPS. It also says that interest will be credited to accounts that have been incorrectly allocated shares and debited from those accounts that should have received shares.”

With his evaluation complete, Locke must now consider whether to retain NGM as one of the Fund's asset managers.

1. According to the CFA Institute Standards of Professional Conduct, Locke owes his primary duty of loyalty in managing the Fund to:
 - A. the plan trustees.
 - B. all of the pension plan beneficiaries.
 - C. the Escarpment Regional Government.
2. With respect to the commodities positions, which of the following actions *best* describes Black's violation of the CFA Institute Standards of Professional Conduct? Black violated CFA Institute Standards by:
 - A. buying an asset class in which she has no prior management experience.
 - B. buying assets that are inconsistent with the portfolio's Investment Policy Statement.
 - C. failing to notify the client that she would temporarily deviate from the client's Investment Policy Statement.
3. With regard to the IPO share allocation, are both NGM's method of trade correction on 15 May and Locke's demand for a short-term interest credit, respectively, consistent with the CFA Institute Standards of Professional Conduct?
 - A. Yes.
 - B. No, only the method of trade correction is consistent.
 - C. No, only the demand for a short-term interest credit is consistent.
4. After his initial meeting with Black, does Locke's decision to allow NGM to continue managing the portfolio violate the CFA Institute Standards of Professional Conduct?
 - A. No.
 - B. Yes, because he allowed political factors to influence his decision.
 - C. Yes, because he is obligated to immediately suspend NGM until he finishes his evaluation.
5. With regard to Locke's condition regarding trade allocation, does Black's response violate the CFA Institute Standards of Professional Conduct with respect to allocation reviews *and* interest adjustments, respectively?

- A. Yes.
 - B. No, it violates the standards only with respect to allocation reviews.
 - C. No, it violates the standards only with respect to interest adjustments.
6. Based on his complete evaluation, what is Locke's *best* course of action with respect to NGM's management of the Fund's assets?
- A. Reduce NGM's allocation of the Fund's assets until NGM has demonstrated its compliance with Locke's conditions.
 - B. Eliminate NGM as a manager since Locke cannot be sure that NGM will act fairly and in accordance with the Fund's IPS.
 - C. Maintain NGM's allocation of the Fund's assets and concentrate on evaluating managers with larger proportions of the Fund's assets or with sub-standard performance.
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The following information relates to Questions 7–12

Elias Nano, a recent MBA graduate and a CFA Level II candidate, is an unpaid summer intern with Patriarch Investment Counsel and expects to be offered a full-time paid position in the fall. Through his efforts, he is able to convince some family members and friends to become clients of the firm, and he now assists with the management of their accounts. His supervisor congratulates him and states: "These clients are the foundation from which you will be able to build your career as an investment advisor." After working hard all summer, Nano is told that Patriarch will not be able to offer him a paid position.

Nano interviews with a number of firms, and tells each one about the accounts that he is managing and expects to be able to bring with him. Because he was merely an intern at Patriarch, he does not think he owes any particular loyalty to Patriarch. He gains further assurance that he can keep the clients from the fact that his former supervisor implied that these were Nano's clients.

Nano subsequently joins Markoe Advisors as an assistant director with supervisory responsibilities. Markoe Advisors is an investment management firm that advertises that it provides customized portfolio solutions for individual and institutional clients. As a matter of policy, Markoe does not reject as a client any individual meeting the account minimum size. Markoe has two strategies—aggressive growth equity and growth equity—and is always fully invested. Nano asks his family and friends to transfer their accounts from Patriarch to Markoe.

As the first CFA candidate to be employed by Markoe, Nano has been asked to head a team that is reviewing the firm's compliance policies and procedures, which Nano considers inadequate and incomplete. He states his concerns to President Markoe: "Although Markoe Advisors, as a firm, cannot adopt the CFA Institute Code of Ethics and Standards of Professional Conduct, the firm can adopt the CFA Institute Asset Manager Code of Professional Conduct." President Markoe tells Nano that the firm is considering acquiring another advisory firm that has similar compliance policies and procedures. Markoe says: "We are not going to consider any compliance changes at this time."

Nano decides to draft a model compliance document to guide discussions about compliance issues at the firm in the future. Nano's initial draft includes the following components of a compliance policy statement:

■ **Performance Presentation**

Performance data must be documented for each of Markoe Advisors' active accounts, be disclosed upon request, and be compared with the firm's composite, which is composed of active accounts only. Performance data must be presented on a before-tax basis to all clients, with the disclosure that all performance data are presented gross of fees.

■ **Suitability of Investments**

Markoe Advisors, to maintain consistency of performance, assigns each client to one of the firm's two portfolios. Both of these portfolios are sufficiently broadly diversified to meet the investment objectives of all of our clients.

■ **Disclosures of Conflicts**

Markoe Advisors encourages its staff to be involved in the business and civic community. Only business or civic interests that relate to current portfolio holdings need to be reported to the firm.

■ **Violations**

Any violation of the Markoe Advisors compliance policy statement will be reported to the president, and employees will receive an official warning.

■ **Compensation**

All staff members of Markoe Advisors will discuss with their supervisor all outside compensation that they are receiving or may receive.

7. Does Nano comply with the CFA Institute Standards of Professional Conduct when he asks his clients to transfer their accounts to Markoe Advisors?

A. No.

B. Yes, because he contacted the clients after leaving Patriarch.

C. Yes, because he was an intern and not a paid employee of Patriarch.

- 8.** Is Nano's statement with respect to adoption of the CFA Institute Code of Ethics and Standards of Professional Conduct and the CFA Institute Asset Manager Code of Professional Conduct, respectively, correct?

	<u>CFA Institute Code and Standards</u>	<u>CFA Institute Asset Manager Code of Professional Conduct</u>
A	No	No
B	No	Yes
C	Yes	No

- 9.** According to the CFA Institute Code and Standards, what action should Nano take after discussing the firm's compliance policy with President Markoe? Nano should:

A. resign from the firm.

B. notify the board of directors.

C. decline to accept supervisory responsibilities.

- 10.** Does Nano's draft compliance policy statement conform to the CFA Institute Code and Standards with respect to performance presentation?

A. No, because terminated accounts are excluded.

B. No, because performance is reported to all clients gross of fees.

C. No, because performance data are presented on a before-tax basis.

- 11.** Does Nano's draft compliance policy statement conform to the CFA Institute Code and Standards with respect to:

	<u>suitability of investments?</u>	<u>disclosures of conflicts?</u>
A	No	No
B	No	Yes
C	Yes	No

- 12.** Does Nano's draft compliance policy statement conform to the CFA Institute Code and Standards with respect to:

<u>violations?</u>	<u>compensation?</u>
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A	No	No
B	No	Yes
C	Yes	No

The following information relates to Questions 13–18

Patricia Jollie, CFA, is the fixed-income analyst and portfolio manager at Mahsud Financial Corporation, a small investment firm.

On 5 April, a friend who works for a bond-rating agency mentions to Jollie that a bond the agency is analyzing will experience a rating change. That bond also happens to be in Mahsud Financial's portfolios. Not wanting to trade ahead of the rating change announcement, Jollie decides to wait for distribution of the information through her friend's scheduled interview on a business television program the afternoon of 8 April. On the morning of 8 April, the information is released on a worldwide financial news service. Jollie immediately changes her mind about waiting for the interview and trades the bonds in Mahsud Financial's portfolios.

On 8 April, Jollie also trades a second bond to rebalance one of Mahsud Financial's portfolios. Jollie knows before executing her transaction that the bond is thinly traded. Although Jollie's trade will materially affect the bond's market price, it is not her intention to create price movement. A colleague witnesses the trade and large bond price change and says, "What a market overreaction; the bond price appears to be distorted now!" The colleague also points out to Jollie that Mahsud Financial's policy on market manipulation states: "Mahsud Financial employees must refrain from making transactions that distort security prices or volume with the intent to mislead market participants."

In conducting fixed-income research, Jollie believes that insight into prospective corporate bond returns can be derived from information that is also relevant to a company's stock. She spends several hours a week in equity investment chat rooms on the internet, and she pays particular attention to the research reports posted by Jill Dean, CFA, a self-employed analyst, on www.Jill_Dean_the_Independent_Analyst.com. Prior to writing each report, Dean is paid a flat fee by the companies whose stocks she researches, but she does not reveal this fact to readers of her reports. She produces reports only for those companies whose stocks she can legitimately give "buy" recommendations after conducting a thorough analysis. Otherwise, she returns the flat fee. Investors have come to recognize all her "buy" ratings as having a sound and reasonable basis.

Jollie considers Dean's summaries and forecasts to be very well-crafted. Dean has given Jollie written permission to use her summaries and forecasts, word for word and without attribution, in her own bond analysis reports. On occasion, Jollie has done so. In Dean's other internet postings, she reports the results of relevant academic finance studies. Once Jollie learns of a study by reading Dean's postings, she often reads the original study and mentions the results in her own reports. Jollie always cites the original study only and does not reveal that she learned of the study through Dean.

Mahsud Financial occasionally sponsors seminars on ethics. In the most recent seminar, the main speaker made statements about the relationship between ethics and the law, and also about potential sources of conflict of interest for research analysts. The seminar speaker's statements were:

Statement 1 An illegal action is unethical, and actions that are legal are ethically sound.

Statement 2 For analysts, a major source of conflict of interest is potential profit resulting from a weak barrier between the employer's research department and investment banking department.

Statement 3 For situations in which conflicts of interest cannot be avoided, Mahsud Financial's written compliance policy should include the following component: "For unavoidable conflicts of interest that the employee judges to be material, employees must disclose the conflicts of interest to clients prominently, and in plain language."

Statement 4 On the matter of gifts that might impair employees' objectivity, Mahsud Financial's written compliance policy should also include the following component: "Employees must disclose to Mahsud Financial all client gifts regardless of value."

13. Does Jollie violate the CFA Institute Standards of Professional Conduct by trading on the news of the bond rating change?

A. No.

B. Yes, only because she possessed material nonpublic information.

C. Yes, only because she should have waited to trade until after her friend's television interview took place.

- 14.** Are Jollie's 8 April trade of the second bond and Mahsud Financial's policy on market manipulation, respectively, consistent with CFA Institute Standards on market manipulation?
- A.** Both Jollie's 8 April trade of the second bond and Mahsud Financial's policy on market manipulation are consistent with CFA Institute Standards.
 - B.** Jollie's 8 April trade of the second bond is inconsistent and Mahsud Financial's policy on market manipulation is consistent with CFA Institute Standards.
 - C.** Jollie's 8 April trade of the second bond is consistent and Mahsud Financial's policy on market manipulation is inconsistent with CFA Institute Standards.
- 15.** Does Dean violate CFA Institute Standards in preparing and disseminating her equity reports?
- A.** No.
 - B.** Yes, only by misrepresenting her recommendations as independent.
 - C.** Yes, only by accepting payment from the companies on which she produces reports.
- 16.** In preparing investment reports, does Jollie violate the CFA Institute Standards with respect to her:

	<u>use of Dean's summaries and forecasts?</u>	<u>citation of studies found in Dean's internet postings?</u>
A	No	Yes
B	Yes	No
C	Yes	Yes

- 17.** Are the seminar speaker's Statements 1 and 2, respectively, correct?

	<u>Statement 1</u>	<u>Statement 2</u>
A	No	No
B	No	Yes
C	Yes	No

- 18.** Are the seminar speaker's Statements 3 and 4, respectively, sufficient to meet the requirements of related CFA Institute Standards?

<u>Statement 3</u>	<u>Statement 4</u>
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|----------|-----|-----|
| A | No | No |
| B | No | Yes |
| C | Yes | No |

The following information relates to Questions 19–24

Stacia Finnegan, CFA, manages a regional office of Harvest Financial’s brokerage business. Her responsibilities include training all personnel in compliance with the firm’s standards, policies, procedures, and applicable laws and regulations.

Finnegan is currently providing training on the firm’s new PlusAccount, a comprehensive fee-based brokerage account. “PlusAccounts,” she tells the brokers, “are an excellent way to ensure that the financial advisor does not recommend trades for the purpose of generating commissions. The advisor and client’s interests are aligned.” She continues, “You will find that many clients will benefit from converting a traditional brokerage account to a PlusAccount. Be aware, however, that PlusAccounts are not appropriate for all categories of investors, including buy-and-hold clients and certain clients with assets less than \$50,000.” Finnegan distributes written compliance procedures for establishing and maintaining PlusAccounts. She carefully explains that regulatory rules “require that we have reasonable grounds for believing that the PlusAccount is appropriate for a particular customer. Additionally, we must review each account on an annual basis to determine whether PlusAccount status remains appropriate. The policies outlined in these documents are designed to ensure compliance with industry standards and regulatory requirements. You must follow these compliance procedures exactly.”

Finnegan then distributes and explains the sales and disclosure materials for clients. The materials include the following fee structure:

PlusAccount Annual Fee (as a Percent of Assets)*		
Account Asset Level	Equity (%)	Mutual Fund/Fixed Income (%)
From 0–\$250,000	2.00	1.00
Next \$250,000	1.50	1.00
Next \$250,000	1.25	1.00
Next \$250,000	1.00	1.00
More than \$1 million	0.75	0.75

*Minimum annual fee of \$1,000 billed quarterly.

Finnegan spends the rest of the afternoon training the staff on detailed procedures and answering their questions.

Chris Klein is a registered broker and financial advisor with Harvest. He is also a Level II Candidate in the CFA Program. Klein is excited about the new PlusAccounts and believes that they will be attractive for many clients.

One of Klein's clients is Elaine Vanderon, who contributes weekly to her brokerage account. Under Vanderon's directions, Klein invests the weekly contributions in actively managed mutual funds (unit trusts). The funds have below-average management fees and average returns. Commissions for Vanderon average \$35 per transaction.

When Vanderon's account reaches \$50,000 in assets, Klein recommends conversion to a PlusAccount. He carefully explains that in a PlusAccount, both the cost of investment advice and many implementation costs are wrapped into the management fee billed on a quarterly basis. Stock and bond commissions, he tells Vanderon, are discounted by 70%. Klein informs Vanderon that in a PlusAccount, she can buy or sell thousands of mutual funds or unit trusts (including those in which she invests) for no commissions or transaction charges. He explains that PlusAccounts are ideal for clients who trade often—or as part of a periodic investment program such as hers. Vanderon reads through the disclosure material provided by Klein and accepts his recommendation.

Klein routinely informs clients about the benefits of PlusAccount status and presents them with all the disclosure materials. Another client Klein encourages to open a PlusAccount is Lee Brown. Brown has accumulated stock holdings of \$300,000 and trades equities almost daily. His annual commissions for the previous twelve months equal \$9,100. His portfolio is well-diversified. He has a high risk tolerance and prefers growth stocks. After explaining the fee structure, Klein tells Brown "The PlusAccount is ideal for an active trader like you."

One year later, Finnegan is promoted. She delegates supervisory responsibility for Klein and 15 other brokers to her assistant branch manager.

The same month, Klein meets with Vanderon and Brown to review their portfolios and financial situations. Both clients are happy with their PlusAccounts. Vanderon's commission costs have declined to zero. Her account continues to grow in line with her plans and expectations. Brown is also happy with his account. His annual commission costs have declined 70% to \$2,700.

Two months later, Vanderon receives a \$1 million inheritance and places it in her PlusAccount. Although he conducted a full review two months earlier, Klein meets with Vanderon to review her financial situation and discuss potential changes to her investment policy. During their meeting, Klein mentions that he has completed Level III of the CFA examination. He informs Vanderon "Completion of the CFA Program has enhanced my portfolio management skills." He tells Vanderon "As a CFA charterholder, I am the best qualified to manage your investments." Vanderon congratulates Klein on his accomplishment and agrees to consider any changes he recommends to her PlusAccount.

The following month, Klein telephones Vanderon to recommend a highly-rated mutual fund. Klein states "The fund has an excellent performance history and is ranked in the top decile of comparable funds. For the past three- and five-year periods, its average annual return has exceeded the benchmark by 90 basis points. Of course, past performance is no guarantee of future returns, but several of my clients hold this fund and they are all very happy with it. One of them invested \$50,000 five years ago. That investment is worth more than \$100,000 today." When Vanderon asks about fees, Klein explains that the fund's management fees are 25 basis points higher than those of her existing investments. He adds "Because of your PlusAccount status, you won't incur a brokerage commission for this transaction even though I will receive a referral fee if you invest in the fund."

Six months later, Brown suffers serious medical and financial problems and stops trading. Klein telephones him to review his financial situation. Brown insists that he will make a full recovery and that he will be trading again shortly. During the next twelve months, Brown is too ill to trade. His growing expenses force him to withdraw large amounts from his PlusAccount. Within another 18 months, his PlusAccount value is less than \$50,000.

- 19.** When recommending Vanderon convert to a PlusAccount, does Klein violate any CFA Institute Standards of Professional Conduct?
- A.** No.
 - B.** Yes, because he does not have a reasonable basis.
 - C.** Yes, because the account is unsuitable for Vanderon.
- 20.** When recommending Brown convert to a PlusAccount, does Klein violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, relating to suitability.
 - C.** Yes, relating to reasonable basis.
- 21.** When meeting with Vanderon, does Klein violate any CFA Standards?

- A. No.
 - B. Yes, because he improperly references the CFA designation.
 - C. Yes, because he claims enhanced portfolio management skills.
22. When recommending the mutual fund to Vanderon, does Klein violate any CFA Standards?
- A. No.
 - B. Yes, relating to suitability.
 - C. Yes, relating to referral fees.
23. In the eighteen months following Brown's change in financial situation, Klein is *least likely* to have violated the Standard relating to:
- A. loyalty, prudence, and care.
 - B. diligence and reasonable basis.
 - C. communication with clients and prospective clients.
24. In her supervisory duties, does Finnegan violate any CFA Standards?
- A. No.
 - B. Yes, because she fails to ensure that compliance procedures are enforced.
 - C. Yes, because she delegates supervisory authority to her assistant branch manager.

The following information relates to Questions 25–30

A.J. Vinken, CFA, manages the Stonebridge Fund at Silk Road Capital Management. He develops a growth-stock selection model which produces highly favorable simulated performance results. He would like to employ the model in managing the Stonebridge Fund, a large-capitalization equity fund. He drafts a letter for distribution to all shareholders. In it, he discusses in detail his approach to equity selection using the model. He includes both the actual and simulated performance results of the Stonebridge Fund for the past three years as seen in Exhibit 1:

Exhibit 1. Stonebridge Fund Annual Returns

Year	Stonebridge Fund (Simulated)	Stonebridge Fund (Actual)
1	10.71%	9.22%
2	2.83%	-4.13%
3	22.23%	22.23%
Average annual return	11.92%	9.11%

Vinken writes, “Using the proprietary selection model for the past three years, the Stonebridge Fund would have earned an average annual return of almost 300 basis points in excess of the fund’s actual return. Based on these simulated results, I am confident that employing the model will yield better performance results in the future; however, Silk Road Capital Management can make no statement of assurances or guarantee regarding future investment returns.”

D.S. Khadri, CFA, is also a portfolio manager at Silk Road. She recently assumed management of the small-cap Westlake Fund from Vinken.

Khadri implements an electronic record-retention policy when she becomes the Westlake manager. In accordance with her policy, all records for the fund, including investment analyses, transactions, and investment-related communications with clients and prospective clients, are scanned and electronically stored. Vinken maintained the same records in hard-copy format for the five years that he managed the Westlake Fund. Khadri has begun the process of scanning all of the past records of the Westlake Fund; however, Vinken complains that Khadri is wasting company resources by scanning old records. Vinken insists that he will continue to maintain only hard-copy records for the Stonebridge Fund for the five years required by regulators.

Khadri writes a performance review of the Westlake Fund for its quarterly newsletter. She reports that Silk Road Capital Management is moving toward compliance with the Global Investment Performance Standards (GIPS). She states, “The Westlake Fund is already partially GIPS compliant. We expect to be fully compliant with the GIPS standards within the next 12 months.”

In the quarterly newsletter, Khadri makes the following statements:

Statement 1 “China’s pegging of the yuan to the US dollar will end within the next 12 months which will lead to the yuan increasing in value by more than 40%, supporting our overweighting of Chinese-related stocks in the Westlake Fund.”

Statement 2 “Increased geo-political uncertainty around the globe should keep oil prices at 3-year levels and supports our recommendation for an over-weighting of energy in the small-cap energy sector.”

Khadri also reports:

“The quarterly return of the Westlake Fund was 4.07%. The quarterly return exceeded the performance of its benchmark, the Russell 2000 Index by .16%. Investors should not expect this type of performance to continue into the foreseeable future.*

* Additional detailed information available upon request.”

After the quarterly newsletter is distributed, a client contacts Khadri claiming that the Westlake Fund actually underperformed the benchmark during the quarter. After researching the issue, Khadri confirms that the client is correct and sends him a letter in which she provides the corrected results. In her letter to the client, she blames the discrepancy—which was the result of a human typographical error—on a computer programming error.

- 25.** In his letter regarding the stock-selection model, does Vinken violate any CFA Institute Standards of Professional Conduct?
- A.** No.
 - B.** Yes, because he uses simulated performance results.
 - C.** Yes, because he claims that the new model will yield better performance results.
- 26.** Are the record-retention policies of both Khadri and Vinken consistent with CFA Institute Standards?
- A.** Yes.
 - B.** No, Khadri’s policy is not consistent.
 - C.** No, Vinken’s policy is not consistent.
- 27.** Are Khadri’s statements regarding compliance with the Global Investment Performance Standards consistent with CFA Institute Standards?
- A.** Yes.
 - B.** No, because Khadri may not claim partial compliance.
 - C.** No, because Khadri fails to disclose the areas of noncompliance.

28. Are Khadri's statements in the quarterly newsletter consistent with CFA Institute Standards?
- A. Yes.
 - B. No, because Statement 1 is opinion, not fact.
 - C. No, because Statement 2 is opinion, not fact.
29. Are Khadri's newsletter comments regarding returns consistent with CFA Institute Standards?
- A. Yes.
 - B. No, because Khadri used an inappropriate benchmark.
 - C. No, because Khadri did not disclose whether the performance results are before or after fees.
30. When responding to the client complaint regarding Westlake's performance, Khadri *least likely* violates the Standard relating to:
- A. misconduct.
 - B. misrepresentation.
 - C. performance presentation.

The following information relates to Questions 31–36

Omega Financial, a large financial services firm, makes a market in more than 500 stocks. As a market-maker, the firm executes institutional orders as well as retail orders placed by its private wealth unit, its broker-dealer affiliate, and other third-party broker-dealers.

A page in Omega's compliance manual, which adheres to all legal and regulatory requirements, includes the following information:

OTC Stocks in Which Omega is a Market-Maker

Definitions:

Riskless principal transaction: an order in which a firm, after receiving a customer's order, executes the order on a principal basis from another market center.

Net Trade/Trade on a net basis: a principal transaction in which a market-maker, after having received an order, executes the order at one price with another broker-dealer or

another customer and then sells to (buys from) the customer at a different price.

Compliance Policies:

Institutional Orders

Riskless principal transactions may be traded on a net basis.

Retail Orders

Riskless principal transactions may not be traded on a net basis. They receive the same execution price without mark-up, mark-down, commissions, or fees.

Consistent with regulatory requirements, Omega discloses the information about riskless principal transactions to all clients and third-party broker-dealers. In addition, Omega informs third-party broker-dealers that it will seek best execution on retail orders.

Omega is developing an automated order-handling system to improve efficiencies in order flow. Anticipated benefits of the new system include much faster execution speeds. Additionally, the system design includes a trading mechanism that will execute portions of certain large orders to reduce market impact. The trading mechanism delays some orders to allow the firm to obtain a better overall price.

Xavier Brown, CFA, is responsible for overseeing the project to ensure its timely completion. Brown enlists the compliance department to review the programming during the initial development phase and identify any potential problems. The compliance department compares the order-handling function of the new system to the third-party software currently in use. They identify a number of potential problems including delays in execution of certain large market orders and embedded mark-ups and mark-downs on stocks in which the firm makes a market. According to the compliance department, changes are necessary to comply with regulatory requirements.

Brown directs the programmers to correct the problems and run tests and simulations. The programmers spend the next few months making changes to the system and adding comments throughout the code that clearly explain the purpose of particular functions. After several months, the programmers report that they have corrected all the identified problems and run the necessary tests and simulations. The following month, the firm switches to the automated order-handling system as planned.

Joy Chen, CFA, trades Xydeo stock for Omega. One month following the switch to the new order-handling system, Chen is able to execute a number of principal riskless transactions for both institutional and retail clients at \$25.00 per share. When processing the customer buy orders totaling 500,000 shares, the new system automatically uses the best-publicized price of \$25.01 and the firm issues client confirmations showing a purchase price of \$25.01.

Stephen Smith, CFA, works across from Chen on the trading desk at Omega. His seat is close to a speaker for the company's squawk box, which is used to broadcast information about current analyst recommendations; news about market events; and information about pending block trades.

Smith's young brother-in-law, Adolfo Garcia, recently accepted a position as a broker at a third-party broker-dealer that trades with Omega. Garcia has a modest income and little savings. He is enthusiastic about investments and has enrolled as a CFA candidate. Smith calls Garcia early each morning to talk about the previous day's events. At the end of their conversation, Smith places the call on speakerphone and resumes his work.

In his office, Garcia can hear Omega's squawk box over the speakerphone. Garcia enjoys listening as Omega analysts discuss changes in ratings, economic forecasts, and capital market developments. He is careful not to trade in stocks mentioned explicitly on the squawk box. Rather, he sometimes researches competitors and other firms operating in the same industry. In one case, he immediately shorts the stock of Tefla Corporation after an Omega analyst downgrades a firm in the same industry.

Garcia frequently places large block orders for low-priced small-capitalization stocks at the market price. Once the new system is operational, Smith processes the orders through the new trading-system mechanism, which delays execution of portions of the orders and allows the firm to obtain a better price for Garcia.

- 31.** For a CFA charterholder, would adhering to Omega's policies regarding riskless principal transactions result in a violation of the CFA Institute Standards of Professional Conduct?
- A.** No.
 - B.** Yes, because Omega disadvantages institutional clients.
 - C.** Yes, because disclosure of the policy does not relieve Omega of its obligation to treat clients equally.
- 32.** When overseeing the development of the automated-trading system, does Brown violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, because he accepted an assignment for which he was inadequately trained and skilled.
 - C.** Yes, because he did not ensure that the final system complied with regulatory requirements.
- 33.** With regard to Chen's trades in Xydeo, do the institutional and retail trades both comply with CFA Institute Standards?
- A.** Only the retail trades comply.
 - B.** Only the institutional trades comply.
 - C.** Neither the retail nor the institutional trades comply.

- 34.** When placing the morning phone call on speakerphone, does Smith violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, his duty to Omega.
 - C.** Yes, his duty to clients and to Omega.
- 35.** When listening to the Omega squawk box, does Garcia violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, the standard regarding professionalism.
 - C.** Yes, the standard regarding material nonpublic information.
- 36.** When shorting Tefla stock, does Garcia violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, because he does not have a reasonable basis for the trade.
 - C.** Yes, because he is in possession of material nonpublic information.
-

The following information relates to Questions 37–42

Sebastian Riser, CFA, works as a portfolio manager for Swibank, a small private bank in Switzerland. Riser manages the accounts of his clients according to best practices, keeping clients' interests before those of the bank and his own. He allocates investments in a fair manner when he deems them consistent with the stated objectives and constraints of clients.

Swibank has a Luxembourg subsidiary, which distributes fund-of-funds products. Riser recently received a request to serve on the board of directors for the subsidiary. In this role, Riser would advise management on business strategies; market opportunities; potential clients; and current and prospective fund managers. For his role on the board, Riser would receive an annual payment directly from the subsidiary equivalent to 5% of his total portfolio manager salary in Switzerland.

The following month, Riser accepts the position on the board. The subsidiary registers each new fund-of-funds product with regulatory authorities in Luxembourg and discloses Riser's role as a board member in the required filings, which are public and readily available.

Riser serves as the contact person for the subsidiary's institutional clients in Switzerland and participates in the subsidiary's road shows in Switzerland. His role during these road shows varies. On some occasions, he simply attends the presentations while the operating management sells the products; on others he gives the actual presentation promoting the products. Riser's name does not appear in the promotional material distributed at the road shows.

Alexander Komm, a long-time colleague of Riser, is the founder of Komm Private Management, which provides asset management, advisory, and trust services to high-net-worth individuals. The firm has several well-managed proprietary funds. Komm offers Riser a position with the firm as managing partner. Riser is flattered, but declines the offer, explaining that he is very happy working at Swibank.

That same week, the subsidiary informs Riser that it needs an experienced fund manager to manage a new publicly-traded Japanese equity product. Riser is convinced that Komm Private Management would be qualified and recommends the firm for the new product. After a thorough search process, the subsidiary hires Komm Private Management for the new product.

Six months later, after numerous discussions, Komm finally convinces Riser to join Komm Private Management as a managing partner. The following week, Riser submits his resignation at the private bank. His position on the board of the subsidiary is not dependent on his employment at the bank, and he agrees to serve the remaining three years of his term.

After signing and submitting his employment contract to Komm, Riser takes three weeks of vacation before starting his new position. During this time he purchases 2,000 shares of the new Japanese equity product for his private account. When he begins working at Komm Private Management, he purchases a large block of shares in the Japanese equity product, which he allocates according to internal procedures to all accounts for which it is suitable.

- 37.** According to the CFA Institute Standards of Professional Conduct, before accepting the position on the board of the subsidiary, Riser should:
- A.** receive verbal consent from Swibank.
 - B.** receive verbal consent from his clients.
 - C.** disclose to his employer the financial compensation proposed by the subsidiary.
- 38.** When participating in the road shows in Switzerland, Riser *least likely* violates the Standard relating to:
- A.** Disclosure of Conflicts.
 - B.** Independence and Objectivity.

C. Additional Compensation Arrangements.

- 39.** When recommending Komm, does Riser violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, relating to duties to employer.
 - C.** Yes, relating to disclosure of conflicts.
- 40.** When resigning from Swibank, does Riser violate any CFA Institute Standards?
- A.** No.
 - B.** Yes, because he breaches his duty of loyalty to his employer.
 - C.** Yes, because he does not resign his position with the Luxembourg subsidiary.
- 41.** In his original purchase of 2,000 shares of the Japanese equity product, Riser *least likely* violates the Standard relating to:
- A.** Suitability.
 - B.** Priority of Transactions.
 - C.** Integrity of Capital Markets.
- 42.** According to CFA Institute Standards, Riser is not required to disclose to clients his:
- A.** holdings of the Japanese equity product.
 - B.** relationship with the Swibank subsidiary.
 - C.** compensation from the Swibank subsidiary.
-

The following information relates to Questions 43–48

Prudent Investment Associates (PIA) is a small-cap equity investment management company that uses fundamental equity analysis in its investment decision-making process. All portfolio managers at PIA manage both discretionary and non-discretionary accounts. Kevin Danko, CFA, is PIA's owner and chief investment officer and supervises May Chau, a recently hired portfolio manager. PIA has adopted the CFA Institute Code of Ethics and Standards of Professional Conduct.

Chau is enrolled to sit for the Level III CFA examination. In its marketing brochure, PIA states: "May Chau is a Level III candidate in the CFA Program." A colleague tells Chau this presentation may be incorrect according to the CFA Institute Code and Standards and suggests the following change: "May Chau has passed Level II of the CFA examination."

PIA has established a relationship with Fair Trading Incorporated (FTI), a regional investment bank and broker/dealer. FTI provides clients with access to research and analysts' recommendations via a user-registered website. This access is available on the condition that clients not forward any of the research and recommendations to any other parties. In exchange for this access and after concluding that FTI provides best execution, Danko directs to FTI most of his trade orders.

FTI also provides to a select group of brokerage clients, including PIA, information regarding several of its investment banking customers. This information includes the customers' own earnings projections. FTI instructs this select group of brokerage clients not to disseminate these earnings projections to the public until released by the investment banking customers.

On a regular basis, Danko reviews the list of "strong buys" on FTI's website to see if there have been any new "buy" recommendations. Danko quickly places orders for discretionary client accounts to purchase shares of any company for which the investment recommendation has been changed to a "strong buy." He takes this action so discretionary account clients do not miss any price appreciation. After each purchase, he instructs Chau to perform the appropriate fundamental analysis on these companies within five business days so the research file is adequately documented.

From time to time, PIA receives initial public offering (IPO) allocations from FTI. Danko allocates these IPOs to those discretionary accounts that normally participate in IPOs. If the IPO is oversubscribed, he excludes his wife's discretionary non-fee-paying account so that he is not accused of bias when allocating the oversubscribed IPOs.

During a recent presentation, Danko and Chau are asked what procedures PIA uses to ensure employees do not benefit from information prior to executing trades in client accounts. Danko responds that PIA has the following Trading Procedures:

Procedure 1 Investment personnel are not permitted to trade securities for five business days prior to trades executed in discretionary client accounts.

Procedure 2 Each quarter a randomly selected group of investment personnel must provide duplicate trade confirmations to the PIA compliance officer.

Investment personnel must receive prior approval for personal trades or
Procedure 3 those trades greater than \$5,000.

- 43.** Does the reference to Chau's participation in the CFA Program, as presented in the marketing brochure, or in the suggested change, violate CFA Institute Standards of Professional Conduct?
- A.** No.
 - B.** The marketing brochure is a violation, but the suggested change is not a violation.
 - C.** The suggested change is a violation, but the marketing brochure is not a violation.
- 44.** Does Danko violate CFA Institute Standards when he directs trades to FTI?
- A.** No.
 - B.** Yes, because by trading with FTI, Danko is putting PIA's interests ahead of his clients.
 - C.** Yes, because Danko has a duty to provide FTI's research to PIA's clients before executing trades.
- 45.** According to CFA Institute Standards, which of the following actions is the *most* appropriate for Danko to take with respect to the use of the earnings projections? Danko should:
- A.** disclose the information to the public.
 - B.** terminate PIA's relationship with FTI.
 - C.** keep the information confidential and not use it in his analysis.
- 46.** Does Danko's decision to purchase shares that are recommended as a "strong buy" violate the CFA Institute Standards?
- A.** No.
 - B.** Yes, because Danko must have a reasonable and adequate basis prior to purchasing the shares.
 - C.** Yes, because Danko must give non-discretionary accounts the opportunity to purchase equities at the same time he purchases equities in the discretionary accounts.

47. Does Danko violate the CFA Institute Standards when he allocates oversubscribed IPO issues?
- A. No.
 - B. Yes, because he should allocate the oversubscribed IPOs across all discretionary accounts.
 - C. Yes, because he should treat his wife's account the same as other discretionary accounts and include it in the oversubscribed IPO allocations.
48. Which of PIA's Trading Procedures is *most* consistent with the CFA Institute Standards?
- A. Procedure 1.
 - B. Procedure 2.
 - C. Procedure 3.
-

SOLUTIONS

1. B is correct. Locke's primary duty is to his clients. In the case of a pension plan, the clients are all of the ultimate beneficiaries.
2. B is correct. Under no circumstances should a manager take investment action that is inconsistent with the client's IPS.
3. C is correct. Locke's interest claim is legitimate since the Fund's cash was employed to purchase equities that were later removed from the account. Therefore, the Fund is owed interest for the period in question.
4. A is correct. Until Locke's investigation is complete, he has no obligation to suspend the manager or take any other action. He believes the manager can and does add value through superior returns and diversification, and therefore it may be reasonable to retain NGM if Locke can be satisfied that the manager can act within the constraints of the IPS and CFA Institute Standards. Until the analysis is complete, it would not be practical, and Locke would be violating his duty to act in his clients' best interests by suspending the manager and leaving the assets unmanaged or to temporarily moving them to another manager for safe-keeping.

5. A is correct. Client suitability for an investment must be reviewed prior to allocation, not afterward. With respect to interest adjustments, clients who were incorrectly allocated shares must be paid for the use of their cash; however, in no instance should clients suffer a loss because of an allocation error by the manager (that is, have interest removed from their portfolio even though shares are put in their account on a back-dated basis).
6. B is correct. Locke has a duty to the pension plan beneficiaries to act in their best interests. He would be violating that duty if he continues to employ a manager who does not manage its mandate or demonstrate that it is aware of and complies with its own duties to clients. He must demonstrate his own professional competence by firing the manager.
7. B is correct. Standard IV(A) prohibits employees from soliciting the clients of employers prior to, but not subsequent to, their departure.
8. B is correct. The CFA Code and Standards apply to individual members and candidates of CFA Institute, but firms are encouraged to adopt the Code and Standards as part of their firm code of ethics. The CFA Institute Asset Manager Code of Professional Conduct has been drafted specifically for firms.
9. C is correct. Standard IV(C) states that the member or candidate should decline in writing to accept supervisory responsibility until the firm adopts reasonable procedures to allow him to adequately exercise such responsibility.
10. A is correct. Standard III(D) states that both terminated and active accounts must be included as part of the performance history.
11. A is correct. By placing all clients in one of the two specialized portfolios it operates, Markoe Advisors is not giving adequate consideration to the individual needs, circumstances, and objectives of each client as required by the Standards. In addition, the Standards require that members and candidates disclose all actual and potential conflicts of interest, not just those that relate to current portfolio holdings.
12. A is correct. The Standards require that the supervisor promptly initiate an investigation to ascertain the extent of the violation and should take steps to ensure that violations will not be repeated by limiting or monitoring the employees' activities. The Standards also require that members and candidates obtain written permission from their employer before accepting any compensation or benefits from third parties that may create a conflict of interest.
13. A is correct. Jollie did not act on the material nonpublic information she possessed but waited until it became public. According to the *Standards of Practice Handbook*, "It is not necessary ... to wait for the slowest methods of delivery."

14. A is correct. Jollie's transaction is a legitimate market order in a thinly-traded security, and Mahsud Financial's policy statement is consistent with CFA Institute Standards relating to the Integrity of Capital Markets.
15. B is correct. It is not a violation to accept compensation from an issuer in exchange for research but such arrangements must be disclosed prominently and in plain language.
16. B is correct. Receiving Dean's written permission does not absolve Jollie of her responsibility to provide attribution. Because Jollie uses the results of the research studies and does not use Dean's interpretation of the studies, it is appropriate to cite the original authors only.
17. B is correct. The first statement is incorrect and the second statement is correct. What is legal is not necessarily ethical. A weak barrier between the employer's research department and investment banking department is a potential source of conflicts.
18. B is correct. Statement 3 is incorrect. The disclosure of a conflict should be made—prominently and in plain language—regardless of whether the member views the conflict as material, so the client can determine the materiality of the conflict. Statement 4 is in compliance with CFA Institute Standards. The Mahsud Financial disclosure requirement meets CFA Institute Standards. Gifts from clients should be disclosed to the employer, which is responsible for determining whether the gift could affect the employee's independence and objectivity.
19. A is correct. Klein does not violate the CFA Standards of Professional Conduct when recommending a PlusAccount to Vanderon. His actions comply with Standard III(A)—Loyalty, Prudence, and Care; Standard III(C)—Suitability; and Standard V(A)—Diligence and Reasonable Basis. As required, Klein discloses the fee structure associated with the PlusAccount. Based on the fee structure and Vanderon's trading activity, the PlusAccount appears to be a suitable investment vehicle. By converting to PlusAccount status, Vanderon will incur an annual fee of \$1,000 and eliminate approximately \$1,800 in annual brokerage commissions. The potential savings of approximately \$800 provides a reasonable basis for recommending PlusAccount status.
20. A is correct. Klein does not violate CFA Standards when recommending a PlusAccount to Brown. His actions comply with Standard III(A)—Loyalty, Prudence, and Care; Standard III(C)—Suitability; and Standard V(A)—Diligence and Reasonable Basis. As required, he discloses the fee structure. Based on the fee structure and Brown's annual commissions, the PlusAccount appears to be a suitable investment vehicle. By converting to PlusAccount status, Brown will incur an annual fee of \$5,750 and save approximately \$6,400 in annual brokerage commissions. The potential savings of approximately \$650 provides a reasonable basis for recommending PlusAccount status.

- 21.** B is correct. Klein improperly references the CFA designation when he states “As a CFA charterholder, I am the best qualified to manage your investments.” He is in violation of Standard VII(B)—Reference to CFA Institute, the CFA Designation, and the CFA Program.
- 22.** C is correct. Klein violates Standard VI(C) relating to Referral Fees because he fails to provide appropriate disclosure. The Standard states that members must disclose the nature of the consideration or benefit—for example, whether flat fee or percentage basis; one-time or continuing benefit; based on performance—together with the estimated monetary value. Although Klein acknowledges receipt of referral fees from the fund, he does not disclose an estimated dollar value or the nature of the consideration.
- 23.** C is correct. In the months following Brown’s change in financial status, Klein is least likely to violate Standard V(B) relating to communication with clients because he disclosed the basic format and other pertinent information regarding PlusAccounts and he distinguished between fact and opinions. During the time period, Klein does not make any new recommendations to Brown and thus is least likely to violate the Standard relating to Communication with Clients and Prospective Clients. During the period, Klein is in jeopardy of violating several other standards including those relating to Loyalty, Prudence, and Care; Suitability; and Diligence and Reasonable Basis. Because of the fee structure, PlusAccount status is not suitable for a client who trades infrequently. Klein neglects his duty of loyalty, prudence, and care by maintaining the PlusAccount Status for more than one year after Brown’s change in trading activity. A diligent review of the account would indicate whether a client has a reasonable basis for maintaining PlusAccount status. Thus, Klein is most likely to violate Standards III(A), III(C), and V(A) during the period in question.
- 24.** B is correct. Finnegan violates Standard IV(C)—Responsibilities of Supervisors by failing to ensure that compliance procedures are enforced. As she informed her staff, Harvest “must review each account on an annual basis to determine whether PlusAccount status remains appropriate.” Had Vanderon’s and Brown’s accounts been reviewed annually in accordance with compliance procedures, it would have been clear that the PlusAccount was no longer suitable for either. Delegating supervisory authority to another individual does not violate the Standards.
- 25.** A is correct. Vinken does not violate any CFA Standards of Professional Conduct in his letter. In accordance with Standard III(D)—Performance Presentation, he presents fair, accurate, and complete information when he identifies actual and simulated performance results. Also in accordance with the Standard, he does not guarantee superior future investment returns. In accordance with Standard V(B)—Communication with Clients and Prospective Clients, Vinken describes to his clients and prospective clients the process and logic of the new investment model. By providing the basic details of the model, Vinken provides his clients the basis for understanding the limitations or inherent risks of the investment strategy.

- 26.** A is correct. The policies of both Khadri and Vinken are consistent with Standard V(C)—Record Retention, which states that members and candidates must develop and maintain appropriate records to support their investment analyses, recommendation, actions, performance and other communications with clients and prospective clients. The records required to support recommendations and/or investment actions depend on the role of the member or candidate in the investment decision-making process. Records can be maintained either in hard copy or electronic form. Even though they use different methods, Khadri and Vinken each maintain the appropriate records and have adequate systems of record control.
- 27.** B is correct. Khadri is in violation of Standard III(D). When claiming compliance with GIPS, firms must meet all the requirements. GIPS standards, while voluntary, only apply on a firm-wide basis. Neither a firm nor a fund can claim partial compliance with GIPS standards.
- 28.** B is correct. Standard V(B)—Communication with Clients and Prospective Clients requires the member or candidate to separate and distinguish “facts from opinions” in the presentation of analyses and investment recommendations. Statement 1 in the newsletter states that “China’s pegging of the yuan to the US dollar *will* end within the next 12 months which *will* lead to the yuan increasing in value by more than 40%, supporting our over-weighting of Chinese-related stocks in the portfolio.” Khadri does not clearly differentiate between opinion and fact. The statement about the future of oil pricing is not as questionable because Khadri uses the term “should” which helps clients understand that this is an opinion and not a certainty. Members may communicate opinions, estimates, and assumptions about future values and possible events but they must take care to differentiate fact from opinion.
- 29.** C is correct. Khadri violates the Standard relating to Performance Presentation because he does not disclose whether the performance results are before or after fees. Standard III(D) requires that members make reasonable efforts to ensure that investment performance information is “fair, accurate, and complete.” According to the guidance provided in the *Standards of Practice Handbook*, members should include disclosures that fully explain the performance results (for example, whether the performance is gross of fees, net of fees, or after tax).
- 30.** C is correct. As Khadri provides the corrected information in her letter to the client, she is least likely to violate the Standard relating to performance presentation. She is more likely to violate the Standards relating to Misconduct and Misrepresentation because she knowingly misrepresents the cause of the error. Standard I(D)—Misconduct requires that members not engage in any professional conduct involving dishonesty. Standard I(C) prohibits members from knowingly making any misrepresentation relating to investment actions and professional activities.

- 31.** A is correct. Mark-ups and mark-downs in net trades are considered fees paid by clients. Standard III(B)—Fair Dealing requires that members treat all clients fairly in light of their investment objectives and circumstances. Treating institutional and retail investors differently is not a violation. According to the Standards, members can differentiate their services to clients but different levels of service must be disclosed and should not negatively affect clients. Omega has made the appropriate disclosures to its clients in compliance with legal and regulatory requirements as well as the Standards.
- 32.** C is correct. Brown is in violation of Standard IV(C)—Responsibilities of Supervisors because he did not ensure that the final system complied with regulatory requirements. According to the Standard, Brown has a responsibility to make reasonable efforts to detect and prevent violations of applicable laws, rules, and regulations. Alerted to potential problems by the compliance department, he had a responsibility to ensure that the modifications corrected the potential problems without introducing new problems.
- 33.** B is correct. Only the institutional trades comply with CFA Institute Standards. All the trades were processed on a net basis. Because the firm disclosed that institutional orders may be executed on a net basis, the institutional trades did not result in a violation. The firm disclosed to clients that in riskless principal trades, retail clients will receive the same execution price without mark-up. Executing the retail orders on a net basis with a \$.01 mark-up resulted in a violation of Standards I(C) and III(B) relating to misrepresentation and fair dealing.
- 34.** C is correct. Smith violated his duties to both clients and Omega by not protecting confidential information. By providing Garcia access to confidential information such as changes in recommendations and information regarding block trades, Smith provided Garcia the opportunity to front-run, which could cause harm to both Omega and its clients. Thus, Smith's actions violate his duty of loyalty, prudence, and care to his clients and his duty of loyalty to his employer, Standards III(A) and IV(A), respectively.
- 35.** B is correct. Garcia violated the Standard of Professionalism by engaging in eavesdropping on confidential information including changes in analyst recommendations and pending block trades. According to Standard I(D) members must not engage in professional conduct involving dishonesty, deceit, or fraud or commit any act that reflects adversely on their professional reputation, integrity, or competence. Garcia engages in deceitful conduct in obtaining information from the squawk box. His actions reflect adversely on his professional reputation and integrity and thus violate Standard I(D). Garcia is not in violation of Standard II(A)—Material Nonpublic Information, although he listens to the material nonpublic information on pending block trades. Possession of such material nonpublic information is not a violation of the Standard, which prohibits acting on the information.

- 36.** C is correct. Garcia is in possession of material nonpublic information and acted on it in violation of Standard II(A). After the analyst's recommendation has been issued and/or distributed publicly, Garcia would be free to make the trade. Because this is a personal purchase, the standard relating to diligence and reasonable basis is not applicable.
- 37.** C is correct. According to Standard IV(B), members must not accept compensation that competes with their employers' interest unless they obtain written consent from all parties involved. Thus Riser must receive written, not verbal, consent from his employer before accepting the position on the subsidiary's board. According to the recommended procedures for compliance, Riser should make an immediate written report to his employer specifying the terms of the agreement; the nature of the compensation; the approximate amount of the compensation; and the duration of the agreement. The Standards do not require that members receive permission from clients before accepting board positions.
- 38.** C is correct. Riser least likely violates Standard IV(B)—Additional Compensation Arrangements when participating in the road shows. The Standard provides guidance regarding the acceptance and disclosure of compensation that might conflict with an employer's interests. Participating in the road shows and receiving compensation from the subsidiary do not appear to conflict with his employer's interests.
- When participating in the road shows, Riser may violate Standards I(B)—Independence and Objectivity and VI(A)—Disclosure of Conflicts. The Standard relating to Independence and Objectivity requires that members use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Riser's role as board member could jeopardize his objectivity and create a conflict of interest. Standard VI(A)—Disclosure of Conflicts requires that members make full and fair disclosure of all matters that could reasonably be expected to impair the independence and objectivity or interfere with respective duties to the clients, and prospective clients. Full disclosure allows clients to judge motives and possible biases for themselves. Riser does not appear to make adequate disclosure.
- 39.** A is correct. No violation occurred. Riser's recommendation is based on his knowledge of Komm and the firm's "well-managed proprietary funds." He does not have a conflict when he makes the recommendation.
- 40.** A is correct. No violation occurred. Riser is not required to resign his position with the subsidiary. Riser did not engage in any activities that would conflict with his employer's interest before his resignation became effective.

- 41.** A is correct. Riser least likely violates Standard III(C) relating to suitability when purchasing shares for his own account. Riser may violate Standard II(A)—Material Nonpublic Information and possibly Standard VI(B)—Priority of Transactions when making the purchase. If, when trading for his own account, Riser knows that he will place a large block trade for Komm clients, he may be in possession of material nonpublic information. Standard VI(B) covers the activities of all members who have knowledge of pending transactions that may be made on behalf of their clients or employers. Riser has accepted the position of managing partner, has recommended the manager for the product, and knows, or should know, that he will purchase the product for at least some Komm clients once he begins work at Komm. His purchase ahead of Komm's clients might be front-running. Best practice would be to delay his private account purchase until after he purchases shares for clients.
- 42.** C is correct. Standard VI(A)—Disclosure of Conflicts requires that members and candidates 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 their employer. Riser's holdings of the Japanese equity product and his position on the board of the subsidiary could impair his objectivity and must be disclosed to clients. He need not disclose his compensation from the subsidiary because it is not a referral fee.
- 43.** A is correct. Both the first and second presentations are consistent with the CFA Institute Code and Standards. According to the Standards, candidates may reference their participation in the CFA Program as long as they are active, but they cannot imply a partial designation. A statement about the level of the exam successfully passed or a level of the exam upcoming is appropriate, whereas indicating or implying a partial designation or citing a future date of expected completion of a level in the CFA Program is prohibited.
- 44.** A is correct. Danko directs his trading with FTI only after taking into account FTI's ability to provide best execution. There is no indication that FTI requires a certain amount of trading for access to the website, only that access is provided in exchange for orders. This arrangement for trading in return for research services is discussed in the Guidance to the Standards under Standard III(A).
- 45.** C is correct. The information that Danko received is material non-public information. Disclosing the information to the public is not his role; further, earning gains for his clients does not excuse the violation and is not a justifiable reason for taking action on the material non-public information. The only entities that should release the information are the corporations or another entity with their permission, perhaps FTI.
- 46.** B is correct. Investment decision-making due to speed or based on third-party research alone is insufficient for meeting the standard set by Standard V(A).

47. A is correct. When an issue is oversubscribed, allocations cannot be made to accounts where members and candidates have beneficial interest; client orders must be filled first.
48. A is correct. A blackout period is appropriate for investment decision-making personnel so that managers do not take advantage of their knowledge of trading activity and 'front run' the trade. The actual detail of the blackout period is not specified in the Standards, only that one should exist.

NOTES

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