

## R58 Guidance for Standards I-VII

Introduction .....	3
Standard I: Professionalism.....	3
Standard 1 (A) Knowledge of the Law.....	3
Standard 1 (B) Independence and Objectivity .....	4
Standard 1 (C) Misrepresentation .....	6
Standard 1 (D) Misconduct.....	8
Standard II: Integrity of Capital Markets .....	9
Standard II (A) Material Nonpublic Information .....	9
Standard II (B) Market Manipulation .....	11
Standard III: Duties to Clients .....	11
Standard III (A) Loyalty, Prudence, and Care .....	11
Standard III (B) Fair Dealing .....	13
Standard III (C) Suitability .....	14
Standard III (D) Performance Presentation .....	16
Standard III (E) Preservation of Confidentiality .....	17
Standard IV: Duties to Employers .....	17
Standard IV (A) Loyalty.....	17
Standard IV (B) Additional Compensation Arrangements .....	19
Standard IV (C) Responsibilities of Supervisors .....	20
Standard V: Investment Analysis, Recommendations, and Actions.....	22
Standard V (A) Diligence and Reasonable Basis.....	22
Standard V (B) Communication with Clients and Prospective Clients .....	23
Standard V (C) Record Retention .....	24
Standard VI: Conflicts of Interest.....	25
Standard VI (A) Disclosure of Conflicts.....	25
Standard VI (B) Priority of Transactions.....	27
Standard VI (C) Referral Fees .....	29
Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate.....	30
Standard VII (A) Conduct as Participants in CFA Institute Programs.....	30
Standard VII (B) Reference to CFA Institute, CFA Designation, and CFA Program.....	31
Summary .....	32
Practice Questions .....	34

This document should be read in conjunction with the corresponding reading in the 2022 Level I

CFA® Program curriculum. Some of the graphs, charts, tables, examples, and figures are copyright 2021, CFA Institute. Reproduced and republished with permission from CFA Institute. All rights reserved.

Required disclaimer: CFA Institute does not endorse, promote, or warrant the accuracy or quality of the products or services offered by IFT. CFA Institute, CFA®, and Chartered Financial Analyst® are trademarks owned by CFA Institute.

Version 1.0

## Introduction

This is a long reading, which provides guidance and recommended compliance procedures for each standard. Several examples are also given on how the standards should be applied. IFT Notes focus on the guidance and recommended compliance procedures. Read the examples (applications of the standards) from the curriculum.

## Standard I: Professionalism

### Standard 1 (A) Knowledge of the Law

Members and Candidates must understand and comply with all applicable laws, rules, and regulations 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 and must dissociate from any violation of such laws, rules, or regulations.

#### Interpretation:

You, as a member or candidate, must be aware of all laws where you conduct business. Stating that you are not aware of the laws and hence a violation occurred, will not be acceptable.

#### Guidance:

- Relationship between the Code and Standards and Applicable Law: Assume you are an investment adviser based in Malaysia. You are a Malaysian citizen and your clients are also based in Malaysia. Here the Malaysian law is the 'applicable law'. As a Level I candidate, the Code and Standards must also be considered. Let's assume that Malaysian laws prohibit participation of investment advisers in IPOs but the Code and Standards allow participation under specified circumstances, then **you have to follow the stricter law** – the Malaysian law in this case. If there is no applicable law or regulation, then Members and Candidates must follow the Code and Standards.
- Investment products and applicable laws: Follow the stricter law.
- Participation in or association with violations by others: You are responsible for violations in which you *knowingly* participate or assist. (*Knowingly* is the key word here.) Assume you are part of a group and you have reasonable grounds to believe a violation is taking place. Under such circumstances:
  - First, make an attempt to stop the behavior by bringing it to the notice of your supervisor/compliance department.
  - Seek the advice of independent legal counsel if the compliance department was not helpful.
  - If this doesn't work, dissociate yourself with that activity. Dissociation varies based on your role in the organization; it could be:

- Removing your name from the investment reports and recommendations.
  - Asking for a different assignment.
  - Refusing to accept a new client or continuing to advise the current client.
  - In extreme cases, leave the organization.
- Not taking an action after reporting a violation (and continuing association with the illegal activity), can be considered as participating in the illegal or unethical conduct.
- If you are not sure that a violation is taking place, then the appropriate action would be to seek the advice of legal/compliance counsel.
- CFA Institute does not compel you to report violations to the government or regulatory organization unless required by law.

**Recommended procedures for compliance:**

- Stay informed: Have a procedure or regular training to keep employees informed of the changes in applicable laws, rules, regulations etc.
- Review procedures: Periodically review firm's written compliance procedures to ensure it conforms to the applicable law.
- Maintain current files: Latest copies of applicable rules and regulations should be available for reference.
- Legal counsel: If in doubt how to respond to a possible violation, seek the advice of legal/compliance personnel.
- Dissociation: Document the violation if you are dissociating from an illegal activity; urge the firm to take steps to cease the activity, and resign in extreme cases.
- Advise/encourage your firm to:
  - Develop and/or adopt a code of ethics.
  - Provide information on applicable laws: make all the information regarding laws and rules available in a central location.
  - Establish procedures for reporting violations: make it easy to report violations.

**Standard 1 (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.

**Interpretation:**

Maintain independence and objectivity. Do not compromise your independence and objectivity under any circumstance as it can hurt not just your firm, but the whole industry. For instance, assume you are writing a research report and the firm you are covering gives you an expensive gift. Accepting the gift may shroud your judgment to be impartial and give an objective report.

**Guidance:**

- Buy-side clients: Assume you work in the research department of a large brokerage firm and you cover pharmaceutical firms. Your research reports are disseminated to a large audience including institutional clients (buy-side clients) such as mutual funds. Assume a mutual fund has a large position in Pfizer stock that you are covering. You are about to give a negative view on the stock that buy-side clients will not be happy about as it will affect their portfolio's performance in the short-term, and attempt to influence you. It is important for analysts not to succumb to pressure and maintain their independence and objectivity.
- Investment banking relationships: Now assume your firm also has an investment banking (IB) division. Pfizer is a client of the firm, and the IB division is working closely on Pfizer's secondary offering. The IB division may influence research analysts to issue favorable research reports. But, as analysts, you must maintain your objectivity.
- Public companies: Pfizer, being a public company, may also try to influence analysts directly (through gifts) for a positive research report – a buy call. Analysts fear retaliation from the company if a negative view is given.
- Issuer-paid research: Assume a company is not being widely followed. If this company approaches you to write a research report for them, and compensates you, then there is a potential conflict of interest. The best practice for independent analysts is to negotiate a flat fee for the report independent of what the recommendation will be, and be thorough and objective with the report. Disclosure of the type of compensation is also important.
- Travel funding: It is best for candidates to use commercial transportation and pay for it themselves, or their firm's transport, and avoid paid travel by the client. Where commercial transportation is not available, members and candidates must accept modestly paid-for travel.
- Credit rating agency opinions: Credit rating agencies provide ratings for fixed-income products. If you are working at a rating agency, you may be offered incentives and compensation by the sponsoring company (companies issuing bonds) to issue a favorable rating. However, you should be objective about the analysis and ensure the processes at your agency do not result in a conflict of interest.
- Influence during the manager selection/procurement process: Assume a large pension fund is in the process of selecting an asset management company (AMC) to manage their assets. In order to get this business, AMCs may try to influence the hiring manager at the pension fund by giving gifts, etc. Irrespective of which side you are in the process (pension fund or AMC which is seeking business), do not solicit gifts or contributions either directly or indirectly that may affect your independence.
- Brokerage houses: Members and candidates hire secondary fund managers to manage specific assets, for trading and reporting. There may be attempts to influence them with gifts or compensation. It is important for members to not accept such gifts and stay objective about the hiring decision.

**Recommended Procedures for Compliance:**

- Protect the integrity of opinions.
- Create a restricted list for companies where a firm wants to disseminate only factual information, and no negative or positive opinion.
- Restrict special cost arrangements: use corporate aircraft only if commercial transportation is not available.
- Limit gifts: a strict limit for token gifts that can be accepted must be established.
- Restrict investments: Enforce prior approval for employees purchasing equity or equity-related IPOs.
- Review procedures.
- Establish an independence policy.
- Appointed officer: appoint a senior officer to ensure compliance with the firm's code of ethics.

**Standard 1 (C) Misrepresentation**

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

A misrepresentation is any untrue statement, or omission of fact, or any statement that is otherwise false or misleading.

**Interpretation:**

The foundation of any client-customer relationship is trust. If trust is lost because of misrepresenting facts, it not only hurts you, but also hurts confidence in the entire profession and integrity of capital markets as well.

**Guidance:**

- Impact on investment practice: Assume your firm has been managing a large cap equity fund for several years and has added a small cap fund last year. If the firm claims it has years of experience managing small cap funds/stocks, then it would be misrepresenting facts.
  - Members and candidates must not misrepresent facts including their qualifications, or credentials. For instance, if you have cleared only two levels of the CFA program, you cannot claim to be a CFA charterholder.
  - When issuing a research report, you may be using third-party information. You must exercise care and diligence when using third-party information such as credit ratings, research, or marketing materials, to ensure there is no misrepresentation.
  - If you are using external managers to manage specific areas, you must not represent their investment practices as your own.
- Performance reporting:
  - If you have chosen a benchmark for your portfolio, are the strategies of both comparable? Are you choosing a benchmark because it makes the portfolio's

- performance look better?
- You must ensure the performance evaluation of your portfolio has a reasonable basis – why have you chosen the reference index or benchmark?
  - Provide pricing information of securities to clients on a consistent basis. Do not change pricing providers solely on the basis of higher value of a security. This is especially true of illiquid securities. This will be misrepresenting information as investors make the decision of whether or not to hold an illiquid security based on the information provided.
- **Social media**: The language used on social media platforms such as Facebook and Twitter is often informal. However, members and candidates must ensure the information provided is the same as in traditional modes of communication. The format must adhere to the Code and Standards, even though there is a great deal of anonymity.
  - **Omissions**: Facts or outcomes must not be omitted, especially when it comes to performance measurement and attribution. For example, assume a manager had exceptional performance in the past three years, but negative returns in the three years preceding it. He must present the performance for the entire period and not omit years of bad performance; that is called cherry picking (or selective presentation).
  - **Plagiarism**: Plagiarism is using the work of others without acknowledging or attributing the source of information. Examples include:
    - Using the research report of another firm, and then redistributing it by changing the names.
    - A research report based on multiple sources of information without naming the sources.
    - Excerpts from articles with little or no change in wording.
    - Not naming specific references, but instead attributing to “leading investment analysts”.
    - Using charts and graphs without naming their sources.
  - Members and Candidates must disclose the source of information used in their reports. If it is paid for, then it must be disclosed. Sentences reproduced must be within quotes and the author named specifically.
  - **Work completed for employer**: Work (models/reports/research) done within a firm may be used by others in the firm without attribution. If the person who developed a model has left the firm, the firm can continue using it as it is a property of the firm without naming the person. However, no one can claim that the work done by the person who has quit the firm has been done by the one who is now using it.

**Recommended Procedures for Compliance:**

- **Factual presentations**: Each member and candidate must be aware of the firm’s and the individual’s capabilities and limitations. A written list of the firm’s available services should guide the employees who present to clients.
- **Qualification summary**: Each member and candidate should prepare a summary of

his/her qualifications and experience to present to clients. These must be periodically reviewed.

- Verify outside information: Ensure material from a third-party is accurate before presenting it to clients.
- Maintain web pages: Any information published on a web page must be current, and accurate.
- Plagiarism policy: Maintain copies of research reports/articles used in making your research report, attribute quotations to their source, and attribute summaries to their sources.

### Standard 1 (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.

#### Guidance:

Any act that involves lying, cheating, stealing, or other dishonest conduct is a violation of this standard if the offense reflects adversely on a member's or candidate's professional activities. Although CFA Institute discourages any sort of unethical behavior by members and candidates, the Code and Standards are primarily aimed at conduct and actions related to a member's or candidate's professional life.

Some important points based on examples seen often:

- Using alcohol during business hours, though not illegal impairs a person's ability to think objectively.
- If a member or candidate declares personal bankruptcy, it is not misconduct. But, if the circumstances that led to bankruptcy include deceit or fraud, then it would be a violation and deemed as misconduct.

#### Recommended Procedures for Compliance:

- Code of ethics: Adopt a code of ethics that every member must adhere to.
- List of violations: Communicate to all employees a list of potential violations and the associated sanctions.
- Employee references: Do background (reference) checks of employees to ensure they have not had a brush with the law in the past and are eligible to work in the investment profession.



## Standard II: Integrity of Capital Markets

### Standard II (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.

#### Guidance:

- What is material information? Material information is one that, if disclosed, can have an impact on the price of a security, or information that investors would want to know before making an investment decision. For example, information that the CEO of a company was involved in a scandal to manipulate financial statements and is going to be arrested, is material information. Other common examples include mergers and acquisitions, new product licenses, changes in management, bankruptcies, legal disputes, etc.
- What constitutes “nonpublic” information? As the name implies, information that has not been made public is called nonpublic information. For instance, if a pharmaceutical company has just received news that a particular drug has been approved by FDA and it is not made public yet, then it constitutes nonpublic information. This is also material information as it is something investors would like to know before investing in the company.
- Mosaic theory: As per the Mosaic theory, analysts are free to act on public and nonmaterial nonpublic information without risking violation. Let’s take an example from the curriculum. An analyst is researching a company in the furniture industry. He analyzes the public disclosures, and speaks with many furniture retailers on which he bases his recommendation report. The information gathered from furniture retailers is an example of nonmaterial nonpublic information because the information is not public, and not material by itself to influence the stock prices in any way.
- Social media: Members and candidates must ensure that information obtained from closed groups on social media (Facebook, LinkedIn) is accessible to the public through other sources.
- Using industry experts: Using experts is appropriate as long as members are not requesting or acting on material nonpublic information.
- Investment research reports: Assume you are a well-known analyst and your recommendation reports might impact stock prices. Since you are not an insider and did not base your report on insider information, Standard II (A) does not apply. In this case, you are not required to make the report public. If the public wants access to the report, they can be asked to pay for your services.

#### Recommended Procedures for Compliance:

- Achieve public dissemination: Take steps to publicly disseminate material nonpublic information. Ensure no investment action is taken based on the information.

- Adopt compliance procedures: Adopt compliance procedures to prevent the misuse of material nonpublic information. Ex: review employee trading, investment recommendations, and interdepartmental recommendations.
- Adopt disclosure procedures: Same information should be communicated to the market in an equitable manner. The information received by buy-side clients should be the same as sell-side clients, and the same goes for large firms and small firms.
- Issue press releases: Press releases must be made before conference calls and analyst meetings so that new information is disclosed at such gatherings.
- Firewall elements: A firewall is an information barrier created to prevent the flow of material nonpublic information within a firm; for instance, between the brokerage and investment banking departments of a firm. Listed below are a few ways a firewall is implemented:
  - Review of employee trading.
  - Route interdepartmental communications through the compliance or legal department.
  - Document how to enforce procedures to limit information flow within the firm.
  - Review/restrict proprietary trading when a firm is in possession of material nonpublic information.
- Appropriate interdepartmental communications: Document procedures for how interdepartmental communications must occur, review trading activity, and what actions to take if violations occur.
- Physical separation of departments: To prevent sensitive information flowing from one department to another. Ex: IB/corporate finance to be physically separated from sales and research of a brokerage firm.
- Prevention of personnel overlap: An employee should be on only one side of the firewall. For instance, an employee working in the commercial lending department of a bank must not be associated with its trust/research departments.
- A reporting system: Have a reporting system in which authorized people can review and approve communications between departments. If sharing of certain information is necessary across the firewall, then a designated officer must ascertain whether sharing is essential and must monitor the process.
- Personal trading limitations: Enforce restrictions on personal trading by employees. Monitor both proprietary and personal trading.
- Record maintenance: Maintain records of interdepartmental communication.
- Proprietary trading procedures: Outline procedures for under what situations there should be restrictions on proprietary trading:
  - Market making: Restrictions on trading if the firm is a market maker can be counterproductive as it may be a signal to traders that the firm is in possession of some material nonpublic information. The firm must take the contra side of unsolicited customer trades.

- Arbitrage trading: Must not engage in proprietary trading if it is in possession of sensitive information.
- Communicate to all employees: Educate employees through trainings on how to identify material nonpublic information and how to act (consult a supervisor/compliance officer) if they possess such information. Circulate written compliance policies and procedures to all employees.

## Standard II (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.

### What it includes:

- Disseminating false information into the market.
- Misleading market participants by distorting prices.

### Guidance:

- Information-based manipulation: Spreading false rumors to induce trading by others. For example, an analyst may pump false information into the market through blogs or some other media to artificially inflate stock prices.
- Transaction-based manipulation: Transactions that artificially affect the prices or volume of a security. For example, if transactions show a security to be more liquid, then market participants perceive it favorably and may buy. For example, a large firm may have offices in Tokyo and Chicago. One office may sell a large number of shares and the other office may buy. While it may appear as if the liquidity/trading volume of the security is up. But, in reality, the trading was within the firm.

## Standard III: Duties to Clients

### Standard III (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.

### Interpretation:

Client interests come first, followed by the employer and, then personal interests of the member or candidate. The only exception is that the integrity of capital markets must take precedence over the client's interests if there is a conflict. Prudence requires caution and discretion. When handling funds of a client, prudence requires that you treat them with the same skill, care, and diligence as you would treat your own funds.

**Guidance:**

- Understanding the application of loyalty, prudence, and care: Investment advisers have different job roles; some have fiduciary responsibilities that are imposed by law and require a higher level of trust than other business roles. Irrespective of whether or not they are in a fiduciary role, members and candidates are expected to work in the client's best interest, and be loyal, prudent, and exercise care in managing the client's portfolio.
- Identifying the actual investment client: Identify who is the actual client. It's often easy to define a client but there are instances when it may not be clear. For example, if a pension plan hires an investment manager, then the client is not the pension plan but the beneficiaries of the plan. In this case the hiring entity is not your client. In some cases, there may not be any direct clients or beneficiaries. Ex: a fund manager managing the fund to an index. In such cases, fund managers should invest according to the stated mandate.
- Developing the client's portfolio: Care must be taken in developing portfolios, which are consistent with the clients' objectives, circumstances, constraints, and risks. Investment decisions should be based on the overall portfolio, rather than the characteristics of an individual investment.
- Soft commission (dollar) policies: Assume a client has hired you to manage his funds. You have discretion over the selection of brokers to execute transactions. Conflicts may arise if you use client brokerage (money paid by the client for trade execution) to purchase research services from the broker. This practice is called "soft dollars" or "soft commissions." If you pay a higher brokerage commission than you would normally pay, to allow for the purchase of goods or services, without a corresponding benefit to the client, you have violated the duty of loyalty to your client.
- Proxy voting policies: Assume you are an investment manager and you have purchased 1 million shares of General Electric on behalf of your client. Since you are managing your client's portfolio, you can vote on behalf of the client. You should perform a simple cost-benefit analysis to decide whether or not to vote. When you vote it should be in the best interest of the client (shareholder), not the company management. Your firm's proxy voting policies should be disclosed to clients.

**Recommended Procedures for Compliance:**

- Regular account information: Submit a quarterly statement to the client that includes credits, debits, securities holdings, and transactions during the period. Indicate whether the client must hold or sell assets. And if sold, where the proceeds should be invested in and when.
- Client approval: If unsure of what course of action to take with respect to a client, members and candidates must discuss with the client in writing and take approval.
- Firm policies: Encourage firms to adopt these policies:
  - Follow all applicable rules and laws.
  - Establish the investment objectives of the client: return requirements, risk profile,

- experiences, and constraints.
- Consider all the information when taking actions: the client's needs and circumstances, the client's portfolio, and an investment's individual characteristics.
- Carry out regular reviews: If a client's circumstances have changed (sudden need for large sums of money, or an unexpected inflow of money), then they must be addressed.
- Deal fairly with all clients with respect to investment actions.
- Disclose conflicts of interest.
- Disclose compensation arrangements: If a manager is compensated based on the returns generated for a client, then it must be disclosed to the client.
- Maintain confidentiality.

### Standard III (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.

#### Interpretation:

The standard focuses on dealing ***fairly and objectively*** with all clients. It does not mean equally because the circumstances of every client will be different. Also, a firm may offer different levels of services. A client paying a higher fee for a personalized service cannot be treated in an equitable manner with one who is not. Moreover, it is also not possible to communicate information to all clients at the same time as the modes of communication may vary (e-mail, phone, and fax).

#### Guidance:

- Investment recommendations: This point is for members and candidates whose primary role is to prepare investment recommendations to be disseminated to the public. Investment recommendation is any opinion to buy, sell, or hold a security/investment. This standard discusses how recommendations must be disseminated to clients:
  - All your clients must have a fair opportunity to act on the investment recommendation.
  - There should **not** be selective disclosure such that your large clients receive a report first and the smaller clients receive it later. There may be practical difficulties in reaching all clients at the exact same time because of time differences and modes of communication, but an effort must be made to communicate in an equitable manner.
  - There may be instances when you may change your recommendation. Let's assume you issued a buy recommendation for a stock erroneously. You changed it later to sell and if there are clients who have acted on the buy order but are not aware of the change to *sell*, you must advise them of the change before accepting the order.
- Investment action: This point is for members and candidates whose primary role is to

take actions based on investment recommendations received either from within the firm or external sources.

- Take care to treat all clients fairly.
- IPO and secondary offerings: Distribute to all clients for whom the investments are appropriate. Allocation of the stock should be consistent with the policies of the firm.
- Oversubscribed issues: Distribute on a pro rata and round-lot basis. Refrain from buying for individual and family accounts and free those shares for clients. But, if a family-member is a fee-paying client, then the family member must be treated on an equal basis as any other client.
- Block trade: All accounts of clients in a block trade must be given the same execution price and charged the same commission fee.
- Orders must be time stamped.
- Orders are to be executed on a first-in and first-out basis.
- Disclose to the client the allocation procedures that the firm follows.
- Members and candidates must not withhold securities of IPOs, trading at a premium in the secondary market, for their benefit.

#### **Recommended procedures for compliance:**

- Develop firm policies.
  - Limit the number of people who know that a recommendation is going to be disseminated.
  - Shorten the time frame between the decision to make an investment recommendation and actual dissemination.
  - Publish guidelines for pre-dissemination behavior: Firms must be encouraged to have guidelines that prohibit personnel, who know about the recommendation, from taking action or discussing it.
  - Simultaneous dissemination: Once dissemination to all clients has happened, members and candidates may follow up with individual clients.
  - Maintain a list of clients and their holdings.
  - Develop and document trade allocation procedures (discussed above).
- Disclose trade allocation procedures.
- Establish systematic account review: Conduct periodic review to ensure no client is receiving preferential treatment and trades are based on the account's objectives. If the manager is selling from one account and buying it for another account, he must document the reasons for both the transactions.
- Disclose the levels of service and the associated fees to all clients.

**Standard III (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 client's 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 only investment actions that are consistent with the stated objectives and constraints of the portfolio.

**Interpretation:**

Determine the suitability of an investment before taking action based on the clients' circumstances and other factors. It is the responsibility of members and candidates who provide investment advice to a client to determine the suitability of an investment. Sell-side analysts and other members who execute instructions are **not** responsible for suitability analysis.

**Guidance:**

- Developing an investment policy: Gather client information (personal data, objectives, risk, and circumstances) at the start of the relationship. Develop an IPS that outlines return requirements, risk tolerance, and all investment constraints. Also outline the roles and responsibilities of the parties in the advisory relationship, when reviews will happen and evaluation of the IPS will take place. Set the long-term capital market expectations. Develop an appropriate asset allocation strategy for the client.
- Understanding the client's risk profile: Measure a client's risk tolerance to match suitability and appropriateness of an investment. Is the use of derivative appropriate for a client's account? With leverage and limited liquidity, comes risk.
- Updating an investment policy: IPS is to be updated at least annually to reflect changes in market expectations and circumstances of the client. Needs and circumstances of the clients can change at any time and the investment recommendations/decisions must take note of this. Examples of changes in an individual's circumstances: tax status, number of dependents, liquidity needs, loss of job/change in current income, etc.
- The need for diversification: Combining different investments reduces the risk of a portfolio having all assets in a single investment. An investment that is relatively risky on its own may be suitable in the context of the entire portfolio.



- Addressing unsolicited trading requests:
  - Requests from clients for trades that do not align with the risk and return objectives of a client's IPS: Members and candidates must take efforts to balance the client's request while not deviating from the IPS.
  - Unsolicited requests that are not suitable investments: If your clients ask you to make a trade that is not in accordance with the IPS, then refrain from making the trade until you discuss it with the client. Educate the client about the deviation from the current IPS.
  - If the client insists on making the trade and if you think it will have a material impact on the portfolio, update the IPS. If the client refuses to have the IPS modified, then determine the future of the advisory relationship.
- Managing to an index or mandate: Invest according to the mandate. For example, assume you are a portfolio manager for a small cap fund and your mandate is to include stocks below a certain market capitalization. You would be deviating from the mandate if you buy large cap stocks even if you expect large caps to perform exceptionally well.

#### **Recommended Procedures for Compliance:**

- Investment policy statement: Both individual and institutional investors must have an IPS. The IPS should outline the following: client identification, investor objectives, investor constraints, and performance measurement benchmarks.
- Regular updates: IPS is to be updated on a regular basis (at least annually) to reflect changing circumstances and capital market expectations.
- Suitability test policies: Firms must be encouraged to have test procedures to determine the suitability of investments for different types of clients.

#### **Standard III (D) Performance Presentation**

When communicating investment performance information, members and candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

#### **Guidance:**

- Provide credible performance information to clients and prospective clients. Should not state that past performance can be obtained again.
- Avoid misstating performance or misleading clients.
- If the presentation is brief, make detailed supporting information available to clients and prospects on request.

#### **Recommended Procedures for Compliance:**

Applying the GIPS standards is recommended, but not required. Firms that claim compliance without applying GIPS standards must do the following:

- Consider the knowledge and sophistication of the audience.
- Present the performance of the weighted composite of similar portfolios rather than using a single representative account. Assume there are three portfolios with similar



mandates worth 2 million, 10 million, and 8 million. If they generated returns of 9%, 2%, and 2%, respectively, then take a weighted average of returns.

- Include terminated accounts as part of performance history. Also state when those accounts were terminated.
- Include disclosures that fully explain the performance results being reported.
- Maintain the data and records used to calculate the performance being presented.

### Standard III (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.
2. Disclosure is required by the law.
3. The client or prospective client permits disclosure of the information.

#### Guidance:

- Status of client: Even if an entity is no longer a client, members and candidates must maintain the confidentiality of client records.
- Compliance with laws: Comply with applicable law. If a client is involved in illegal activities and the applicable law requires members and candidates to maintain confidentiality, then the information must not be disclosed.
- Electronic information and security: Members and candidates need to be aware of possible accidental disclosures. They should take care when communicating sensitive client information. For instance, assume two clients an investment manager is dealing with, have similar names. When sending an e-mail with updated IPS, the investment manager types in the name of the intended recipient and doesn't realize that it goes to the other client instead of the intended recipient. Such mistakes can have dire consequences.
- Professional conduct investigations by CFA Institute: If permissible under law, members and candidates must cooperate with PCP and provide information about a client in support of an investigation. Any information given to PCP stays confidential.

#### Recommended Procedures for Compliance:

- The simplest, most conservative, and most effective way to comply with Standard III (E) is to avoid disclosing any information received from a client, except to authorized fellow employees who are also working for the client.
- Communicating with clients: Follow firm-supported communication methods and compliance procedures when communicating confidential information.

## Standard IV: Duties to Employers

### Standard IV (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.

The order of this standard reveals the order of significance: if you recall, first was the integrity of capital markets followed by duties to clients, and now duties to employers.

#### Interpretation:

- Assume you work for an investment management firm and have committed to work 45 hours a week. During this time, you'll not indulge in any activity that will deprive your employer of your skills and abilities.
- Now, assume you are about to place a large buy order for a stock for a client. You are tempted to place an order for your own account before buying for the client. This is called front running and it must be avoided, as you must place your client and employer's interests before your own interests.
- Everything else takes precedence before duty to your own self. Of course, it's not a blanket statement that requires members and candidates to always put work ahead of personal commitments and important family obligations. The standard recommends members to enter into a dialogue with employers to strike a balance between work and personal life.

#### Guidance:

- The employer must not have rules/written policies that conflict with responsibilities of members and candidates. If there are any, then you must encourage your employer to change those policies.
- Independent practice: Independent practice is engaging in a business activity where you get paid, and the work is not related to the employer. Assume you are thinking of starting an independent practice to work over the weekends or after-work hours. There are certain rules that govern this:
  - You must not start a practice that conflicts with the interests of your employer.
  - Obtain consent from your employer before starting the practice. Disclose the types of services you will render, the expected duration of the services, and the compensation.
- Leaving an employer: Assume you have submitted your resignation and decided to leave your employer. There is a one-month notice period. During this period:
  - You must continue to act in the best interests of your current employer.
  - You must not reveal trade secrets to your new employer.
  - You must not misuse client lists.

- You must not solicit existing clients to shift their business to the new employer.
- Once you have left your current employer and are being paid by the new employer, you may seek business from old clients if you have not signed a non-compete agreement with the previous employer.
- Guidelines for what is acceptable after starting work at a new firm:
  - It is okay to use skills and experience gained at the previous employer as they are not considered confidential. Ex: financial modeling skills acquired at the previous employer. Knowledge of the names of former clients is not considered confidential.
  - One must not use anything (records/work) stored in paper or electronic format from the previous firm. Ex: Excel model for the pharmaceutical industry developed at the previous employer.
- Use of social media:
  - Follow firm policies with respect to social media for interacting with clients and prospective clients. Ex: when employees are leaving an organization, it may not be appropriate to announce it on social media as firms may have rules on how and when to announce this to clients.
  - The recommended practice is to have separate accounts for personal and professional social media activities.
  - If there are no firm rules, it's best to act in the spirit of the Standard and not engage in any activity that would harm the employer.
- Whistle-blowing: Bringing insider knowledge of illegal/unethical activities in an organization to the attention of law enforcement activities is called whistle-blowing. Whistle-blowing is acceptable if the intent is to protect the integrity of capital markets and the client's interest. However, whistle-blowing is not acceptable if the intent is for personal gain.
- Nature of employment: Understand the nature of employment (are you a full-time employee or a contractor?). You need to be aware of the terms of the relationship: number of hours, compensation, benefits, work location, client expectations, etc.

**Recommended procedures for compliance:**

- Competition policy: Relates to the independent practice, we saw in the guidelines section. You must understand the rules/procedures of your firm with respect to pursuing an independent practice.
- Termination policy: Understand the termination policies of your employer. resignation process, how to disclose to clients/staff, are social media disclosures permitted /prohibited, how to transition ongoing research and account related responsibilities etc.
- Incident-reporting procedures: Be aware of incident-reporting procedures at your firm. If there is none, encourage your firm to adopt one.
- Employee classification: Understand your status within the firm: part-time, full-time, or contractor. Be aware of the policies that apply to your class.

## Standard IV (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.

### Interpretation:

- Assume you are a portfolio manager working for an investment management firm. Assume a client has benefited immensely from your work, and would like to gift an expensive cruise trip for you and your family as a token of appreciation. This is an example of additional compensation.
- Assume you use a brokerage firm to execute orders for your clients. If the brokerage wants to send a gift so that you continue to direct business to them in the future, it is an example of additional compensation.

### Guidance:

- Obtain permission before accepting compensation that might create a conflict. You must first disclose to your employer and obtain written consent for any compensation that may create a conflict.
- "Written consent" includes any form of communication that can be documented.
- Not all gifts need to be reported. For example, if a brokerage firm sends you a desktop calendar, or if a client sends you a pen as a token gift (not of significant value), then it need not be reported.
- Discuss possible limitations to their abilities to provide services that may be competing with your employer's during the negotiation and hiring process.

### Recommended procedures for compliance:

- Make an immediate written report to your supervisor and compliance officer specifying any compensation you propose to receive.
- The details of the report should be confirmed by the party offering the additional compensation, including performance incentives offered by clients. In our earlier example, where the client offered an expensive vacation, when you disclose the same to your employer, it must be validated by the client. This written report should state the terms of any agreement.

## Standard IV (C) Responsibilities of Supervisors

Members and Candidates must make reasonable efforts to ensure that anyone subject to their supervision or authority complies with applicable laws, rules, regulations, and the Code and Standards.

### Interpretation:

- This standard applies to anyone who has supervisory responsibilities, irrespective of

whether or not the employees under their supervision are CFA Institute members, CFA charterholders, or candidates.

- If the number of employees under supervision is large, then supervisors may delegate responsibilities to subordinates, but that does not absolve them of responsibility in case a violation happens. Supervisors must ensure their subordinates are aware of the rules, applicable laws, firm policies, Code and Standards, etc.
- They must have regular training programs on compliance policies for employees under their supervision.
- If the compliance procedures at a firm are inadequate, they must bring it to the attention of the firm's senior managers.
- If the compliance procedures are inadequate or non-existent, then members and candidates should decline supervisory responsibility.

**Guidance:**

- System for supervision
  - Understand the compliance procedures of the firm.
  - Ensure adequate compliance procedures are in place that cover all possible violations. It is not possible to cover every potential violation that may occur.
  - Once a violation is detected, a supervisor must immediately report the misconduct and initiate an assessment to determine the extent of wrongdoing. It is not sufficient to warn the employee or rely on his/her statements that it will not recur.
  - He must also ensure that the act is not repeated until the investigation is complete.
- Supervision includes detection
  - Supervisors are responsible for detecting violations.
  - Supervisors are responsible for ensuring compliance procedures are implemented and that they are followed through periodic review.
  - Assume you as a supervisor have taken adequate steps to ensure compliance procedures are in place. Despite this, a violation occurs. Since adequate steps were taken, you as a member may not be in violation of the standard under these circumstances. However, it is an indication that the existing compliance procedures are not sufficient.

**Recommended Procedures for Compliance:**

- Encourage firms to adopt a code of ethics for strong ethical foundation.
  - Have adequate compliance procedures to ensure the policies in the Code and Standards, and securities laws are implemented at the firm, and adhered to, on a daily basis.
  - Distinguish between the code of ethics and compliance procedures. Keeping them separate helps serve their individual purpose.
    - Compliance procedures must be written in plain language, free of terminology, such that any average person can understand and assimilate them easily.
    - Assign a compliance officer who has the authority to implement the firm's compliance procedures.
-

- Establish the hierarchy of supervision and assign duties among supervisors.
- Once the compliance system is in place, supervisors must periodically monitor to detect violations and, if discovered, must take the necessary actions.
- Implementation of compliance education and training.
- Establish an appropriate incentive structure.
  - Supervisors and firms must analyze the compensation structure to see if it encourages profits at the expense of ethical behavior.
  - Is “*how*” profits are generated given less importance than “*how much*” profits are made for the firm?

## Standard V: Investment Analysis, Recommendations, and Actions

### Standard V (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.

#### Interpretation:

The level of diligence and thoroughness of research depends on the investment philosophy the member/firm is following and the role of the member in the investment decision-making process.

#### Guidance:

- Define diligence and reasonable basis.
- When using secondary or third-party research (research conducted by someone outside the member’s firm) make reasonable efforts to ensure third-party research is sound.
- Ensure the firm has a policy about periodic review of approved third-party research providers. If not, you must encourage the firm to adopt a formal review practice.
- You may rely on the judgment of others (senior managers) in your firm if you believe the due diligence done by them was adequate.
- When using quantitatively oriented research, ensure the soundness of models. You are not expected to become an expert in every technical aspect of the models, but you must understand the data, parameters, assumptions, and limitations of these models. Test the output of these models under various scenarios before distributing the product. Ensure that the model includes a broad range of scenarios – even high-risk and potentially negative outcomes that are not commonly encountered.
- Developing quantitatively oriented techniques: If you are involved in developing new models/algorithms, then you must exercise higher diligence in reviewing new products than individuals who would use these models. Include data for both positive and negative

economic cycles. Test models using adverse volatility and performance expectations. Test the model for a wide range of input expectations.

- Selecting external advisers and sub-advisers: If you are using external advisers to manage a specific mandate, then you must diligently review them just as you would an individual fund/security. Review if the published return information is accurate. Understand the adviser's compliance procedures, investment process, and if he/she adheres to the stated strategy.
- Group research and decision making: Often, members and candidates are part of a group that collectively produces an investment analysis or research. The group arrives at a consensus and gives a recommendation. The names of the members are included in the report. If you do not agree to the final recommendation, but believe that consensus opinion has a reasonable and adequate basis, and is independent and objective, then you need not dissociate yourself or ask that your name be removed from the report.

#### **Recommended Procedures for Compliance:**

- Establish a policy that research reports must have a reasonable and adequate basis. Either an individual or a review committee consisting of a group of employees must be appointed to review the report before it is circulated to the outside world.
- Develop written guidance for analysts, supervisory analysts, and review committee that outline due diligence procedures if a recommendation has a reasonable and adequate basis.
- Develop criteria for assessing the quality of research.
- Develop written guidance for testing of all computer-based models.
- Develop measurable criteria for assessing outside providers. This relates to the guidelines for using external/third party research (we saw this in the previous section).

#### **Standard V (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 they use to analyze investments, select securities, and construct portfolios, and must promptly disclose any changes that might materially affect those processes.
2. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
3. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions, and include those factors in communication with clients and prospective clients.
4. Distinguish between fact and opinion in the presentation of investment analyses and recommendations.

#### **Interpretation:**

This standard emphasizes the need for communicating clearly and frequently with clients. It



is important to communicate to clients what factors were considered while making the recommendation. If there is a change in the risk characteristics of a security or asset, then this must also be communicated.

**Guidance:**

- Informing clients of the investment process: Describe your/firm's investment decision-making process to the client. This must include the pros and cons, risks and limitations of the process.
  - Just communicating the final recommendation (for instance, buy/sell a security) to the client is not sufficient. You must explain in simple language the investment process.
  - If there is any change in the process, inform the client.
  - Communicate to the client if any external advisers are being used for their expertise to manage a specific strategy.
- Different forms of communication: Communication is not restricted to traditional written report. It could be in-person meetings, e-mail, telephone conversation, etc.
  - Care should be taken when communicating through social media.
  - If the recommendation is concise (stock-list), then you must notify clients that additional information will soon be made available.
- Identifying risk and limitations: Disclose to clients the risks and limitations of the investment process/product. For example, if a product has been in existence for two years, then the research is based on only on two years' worth of data and that needs to be communicated.
- Report presentation: In the report include those elements that were important for analysis and conclusion.
- Distinction between facts and opinions in reports: Assume you are recommending a sugar stock because you believe that the government will raise the export quota limit. But, this has not been done yet; so, it is just your opinion. It is important to distinguish between facts and opinion by stating this is an opinion. But, for instance, if you were presenting the performance of the past three quarters, then this would be a fact.

**Recommended Procedures for Compliance:**

The information included/excluded in research reports varies given the diverse nature of clients and investment assets. There is no specific checklist for what must be included. But firms must have a rigorous methodology to review research meant for dissemination to clients.

**Standard V (C) Record Retention**

Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment-related communications with clients and prospective clients.



**Interpretation:**

Members and candidates must retain records that support their research, analysis, and conclusion. What records to maintain depends on the member involved in the decision-making process. Records can be maintained either in hard copy or electronic format.

**Guidance:**

- New media records: It is the member's/candidate's responsibility to maintain a record of information posted/discussed in social media even if the firm does not have a record retention policy yet. Examples include twitter/blog posts, Facebook updates, etc.
- Records created as part of any professional activity are the property of the firm; if a member decides to leave the firm, he/she cannot take the records or supporting documents without the consent of the previous employer.
- Members cannot reuse historical research reports if the supporting documentation is not available.
- Every country/jurisdiction where you operate may have certain rules for how much data to retain. For instance, a country's regulator may call for retaining data for the past five years. Similarly, firms may also have policies for retaining research/communication records. CFA Institute recommends retaining records for at least **seven** years.

**Recommended Procedures for Compliance:**

- The responsibility to maintain records that support investment action generally falls with the firm rather than individuals.
- You should archive research notes and other documents that support investment-related communications.
- If the firm has policies and procedures to facilitate record retention, then you must follow them. If not, you must encourage your firm to adopt policies for preserving records.

**Standard VI: Conflicts of Interest****Standard VI (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, or employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

**Interpretation:**

Conflicts occur often in the investment profession. They occur between the interests of clients, interests of employers, or your own personal interests. Disclose the conflict of interest in plain language to employer, clients, or prospective clients.

**Guidance:**

- Disclosure of conflicts to employers. Some examples:

- Assume you are working in an investment management firm. You manage a client's portfolio that has performed extremely well. The client is happy and wishes to compensate you for this performance. This is a conflict of interest with other clients and you must disclose this to your employer.
  - Assume you volunteer at a charity organization that is in no way related to your work, and you are not paid for it. However, you are passionate about the work you do at this charity which keeps you busy on weekends and mentally occupied during the week, and is depriving your employer of your skills. You must disclose this potential conflict of interest to your employer.
  - Assume you hold stocks in your personal account for which your firm has a *buy* recommendation and is suitable for many clients. This may create a conflict of interest.
  - Firms create policies to prevent actions that may appear as a conflict of interest. Policies include restrictions on personal trading, outside board membership, etc.
  - Disclosure to clients: There are numerous instances where a conflict of interest exists; these should be disclosed to clients so that they understand the cost of their investments and the benefits received by the firm. A few instances are highlighted below:
    - Assume you hold stocks of General Electric (GE). You are asking your client to buy shares of GE; it may create a potential conflict of interest as, if your client buys and the stock price increases, you will benefit from the movement.
    - You receive compensation (1% commission) from your employer when you recommend certain mutual funds. You must disclose this to the client as the client may believe this recommendation is keeping the client's best interests in mind. Following the disclosure, the client may decide whether the mutual fund is suitable or not.
    - Assume you issue a buy recommendation on General Electric and recommend your client to buy the stock. If your firm also has an investment banking relationship, for instance, then it must be disclosed to the client. The client can then decide if it is in his best interest, or the interest of the firm and GE.
  - Cross-departmental conflicts: Assume you are a research analyst (sell-side analyst) working at a brokerage firm. Your firm has an investment banking department, and may pressurize you to write favorable reports for companies with whom they have an existing relationship or are trying to forge one. Ideally, existing companies should be on a restricted list. But, if that is not possible, then you must make a disclosure of the investment banking relationship in the recommendation report. Another example where such conflicts may arise is buy-side analyst/ banks with underwriting powers.
  - Conflicts with stock ownership: Members and candidates must disclose any material ownership in a stock/investment that they are recommending to clients.
  - Conflicts as a director: There are three possible conflicts of interest if you are an investment professional and serving as a director of a company:
    - Duties owed to clients and duties owed to shareholders of the company.
-

- As a director, you may receive securities/options to purchase securities of the company as compensation. A conflict may arise if trading in these securities increases the value of the security.
- As a director, you may be privy to material nonpublic information about the company. There may be a perception that the director communicates this information to his firm and investment recommendations are based on that information.

**Recommended procedures for compliance:**

- Disclose special compensation arrangements with the employer that might conflict with client interests, such as bonuses based on short-term performance criteria, commissions, incentive fees, performance fees, and referral fees.
- If the firm does not permit such disclosure, you should document the request and consider dissociating from the activity. For example, if you receive a 1% bonus from your firm for selling certain mutual funds and your firm does not permit disclosing this compensation, then you should consider dissociating from the activity.

**Standard VI (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.

**Interpretation:**

If you are trading for your own account, then you are the beneficial owner. But, assume the transaction happens in your children's or spouse's account. Even though those accounts are not in your name, you benefit from them and you are the beneficial owner. The account here applies to any account with whom you have a direct relationship.

**Guidance:**

- Avoiding potential conflicts: Conflicts between client's interest and investment professional's interest may occur. There is nothing unethical about managers, advisers, or mutual fund employees making money from personal investments as long as they follow these three rules:
  - The client is not disadvantaged by the trade. For example, if you are executing a sell trade, then it should not affect your clients in any way.
  - The investment professional does not benefit personally from trades undertaken for clients.
  - The investment professional complies with applicable regulatory requirements.
- Personal trading secondary to trading for clients: The order of executing trades is: clients, employers, and then your personal account, or one in which you are the beneficial owner. The rationale is to prevent personal transactions from adversely affecting the interests of clients or employers.
- Impact on all accounts with beneficial ownership: Members and Candidates may

undertake transactions in accounts for which they are a beneficial owner, only after their clients and employers have had an adequate opportunity to act on a recommendation. For example, assume you are working as an investment manager and your group made a *buy* recommendation on a stock. The client must get the first opportunity to act on the recommendation, then the employer, and then you.

- How should family accounts be treated? : Assume a close family member is a client. He/she should receive the same level of service as any other client. If you have a beneficial relationship in the fee-paying account, then you may be subject to preclearance or reporting requirements of the employer.

### **Recommended Procedures for Compliance:**

- Limited participation in equity IPOs: Some IPO (initial public offerings) issues are highly sought after and the share price rises in value significantly after the issue is brought to the market. Usually, it is a hot IPO if the supply is limited and the demand is high. Purchase of the IPO by investment professionals creates a conflict of interest in two ways:
    - It may appear as if investment personnel are taking the opportunity away from clients for personal gain. For example, assume both you and your client are allotted 200 shares in an IPO. The client had applied for 400 but only got 200. Allotment to your account will make it seem as if some opportunity was taken away from the client for your gain.
    - The party that is giving the investment professional this opportunity to participate in the IPO is possibly trying to influence him/her in the future investment decisions.
  - It is recommended that members and candidates should pre-clear participation in IPOs even where there is no appearance of conflict of interest, and stay away from equity IPOs. From a firm's perspective, it may not be right to follow a blanket policy that bans employees from IPOs. Instead, it would be appropriate to have reliable and systematic procedures in place to identify any conflict of interest, and dealt with by supervisors.
  - Restrictions on private placements: Private placements are transactions where you get shares of a company through a private offering, and not through a public offering. The conflict of interest here is similar to that of IPOs as it may seem that this participation in private placement is a favor for future business deals. Assume you have participated in a private placement. When the investment goes public, it may seem as if you have a vested interest if you recommend the investment to clients regardless of its suitability.
  - Establish blackout/restricted periods: To prevent front running (the practice of trading for one's personal account before client accounts), firms have blackout periods during which investment personnel cannot trade for their personal accounts. This is to safeguard the interests of the clients. The policy on blackout and restricted periods varies from firm to firm depending on their size. It can range from a total ban on trading to preventing the investment manager from front running.
  - Supervisors must establish reporting procedures for investment personnel. For example:
-

- Disclosure of holdings in which the employee has a beneficial interest: This should be done at the beginning of employment and at least annually thereafter.
- Providing duplicate confirmations of transactions: Investment personnel must direct their brokers to provide duplicate copies of all the securities transactions done with them. It serves two purposes: a) discourages unethical behavior because there is an independent verification b) a clear transaction history and flow of money is available, and not just the holdings.
- Preclearance procedures: Obtaining clearance for planned trades helps reduce conflict of interest.
- Members and candidates must disclose to investors their firm's policies about personal investing/trading. It should be in simple language that investors can understand.

### Standard VI (C) Referral Fees

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

#### Interpretation:

- Assume you provide equity investment advisory service to a client. The client is now interested in making fixed income investments as well. So, you refer someone providing this service to the client. You receive a fee for this from the person/firm giving fixed income advice. As per this standard, you must disclose the fee you get for the referral.
- Another example is where you recommend your client to purchase a mutual fund, and the fund pays you a commission. You must disclose this arrangement to the client so that he/she can understand the full cost of the investment and the benefit you are receiving.
- Say you receive a reference from someone/firm, and you pay a referral fee to the party introducing the client. You must disclose to the client the fee paid for this referral.

#### Guidance:

- Advise the client or prospective client about any referral fees before entering into any formal agreement.
- Disclose the nature of the consideration or benefit. For example, flat fee or percentage basis, one-time fee, or continuing benefit based on performance must be disclosed.

#### Recommended Procedures for Compliance:

- Encourage your employer to develop procedures related to referral fees. The firm may completely restrict such fees.
- Provide clients notification of approved referral fee programs and provide the employer regular (at least quarterly) updates on the amount and nature of compensation received.

## Standard VII: Responsibilities as a CFA Institute Member or CFA Candidate

### Standard VII (A) Conduct as Participants in CFA Institute Programs

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of CFA Institute programs.

#### Interpretation:

- This standard covers the conduct of CFA Institute and Members involved with the CFA Program.
- CFA Institute programs include the CFA program, certificate in investment performance measurement (CIPM), and the Claritas® Investment Certificate.
- The standard covers many aspects such as cheating on any CFA Institute examinations, violating the testing policies, disclosing confidential exam information to the public, and improperly using any association with the CFA Institute to further personal or professional goals.

#### Guidance:

- Confidential program information: Candidates are prohibited from disclosing confidential material related to the CFA exams. Examples of information that cannot be disclosed include:
  - Specific details of questions appearing in the exam.
  - Discussing what areas or formulas were tested on the exam.

However, candidates may discuss non-confidential information and curriculum material with others while preparing for the exam.

- Additional CFA program restrictions:
  - There are additional policies that define allowed and disallowed actions during the exam. Testing policies include calculator policy (only two calculators are allowed) and the personal belongings policy.
  - Members may participate as volunteers in various aspects of the CFA program such as grading, administering, or developing the exam. But they are not allowed to:
    - Disclose any material appearing on the exam.
    - How questions are scored.
    - Any information on the exam process.
- Expressing an opinion: Members are free to express their opinion or discontent with CFA Institute regarding its policies and procedures. For example, if you say the exam was not a good representation of the curriculum, then it is not a violation of the standard. However, if you discuss specific topics or questions, then it is a violation.

**Standard VII (B) Reference to CFA Institute, CFA Designation, and 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 of or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

**Interpretation:**

- It is not intended to prohibit factual statements related to the benefits of earning the CFA designation.
- However, the merits of CFA Institute, the CFA Program, and the Code and Standards must be expressed as the opinion of the speaker.
- This standard applies to all forms of communication.
- It is not allowed to state that someone with a CFA designation will exhibit superior performance.

**Guidance:**

- CFA Institute membership: CFA Institute member refers to regular/affiliate members of the CFA Institute who have fulfilled the following membership requirements:
  - Remit annually to CFA Institute a completed Professional Conduct Statement.
  - Annually pay CFA Institute membership dues.
- Using the CFA designation: Once you have earned the right to use the CFA designation, you must follow the rules associated with the usage of the designation. CFA charterholders are individuals who have earned this right by completing the CFA program and have the required years of work experience. They must also satisfy the membership requirements in order to use the designation.
- Referring to candidacy in the CFA program: Candidates may refer to their participation in the CFA program. A person is a candidate if the person appears for a specified examination after completing the registration process or the person has appeared for a specified examination, but the results are yet to be announced.
- Members and candidates must encourage their firms to create templates consistent with standard VII(B).

**Instructor's Note:** This is the most important reading in Ethics and will represent a major percentage of the Ethics questions on the Exam. To do well on this topic you should carefully study all the examples (Applications of the Standard) in the curriculum and also do as many practice questions as possible.



## Summary

**LO.a: Demonstrate the application of the Code of Ethics and Standards of Professional Conduct to situations involving issues of professional integrity.**

Read the “Application of the Standard” segment for each standard in the curriculum.

**LO.b: Identify conduct that conforms to the Code and Standards and conduct that violates the Code and Standards.**

**LO.c: Recommend practices and procedures designed to prevent violations of the Code of Ethics and Standards of Professional Conduct.**

1.A. Knowledge of the law	Understand applicable law and rules. Comply with the more strict law. Do not knowingly participate /disassociate from such activity.
1.B. Independence and objectivity	Use reasonable care and judgment. Maintain independence and objectivity. Do not offer/solicit gifts.
1.C. Misrepresentation	Do not misrepresent facts/performance reports. Avoid plagiarism. Do not omit facts.
1.D. Misconduct	Aimed at professional life; acts like lying, cheating, and stealing affect professional reputation/integrity.
2.A. Material Nonpublic Information	Do not act or cause others to act on material nonpublic information. Achieve public dissemination. Not a violation: Mosaic Theory = material public information + nonmaterial nonpublic information.
2.B. Market Manipulation	Information-based manipulation: Blogs, other media to inflate stock prices. Transaction-based manipulation: Make a security to appear more liquid.
3.A. Loyalty, Prudence and Care	Use reasonable care and exercise prudent judgment. Place client’s interests before your employer or your interests. Soft dollars should benefit the client. Strive for best execution.
3.B. Fair Dealing	Deal fairly and objectively with all clients. Note: it does not state <i>equally</i> because of different levels of service. Fee-paying family member should be treated no different than any other client. Disseminate reports without being partial. Same time is not possible because of different modes of communication.
3.C. Suitability	Develop IPS. Understand client’s risk profile. Update IPS periodically.
3.D. Performance Presentation	Do not misstate performance. Ensure performance information is fair, accurate and complete.



3.E. Preservation of Confidentiality	Maintain confidentiality of current, former and prospective clients unless: a) law mandates disclosure b) illegal activities by client c) client permits disclosure.
4.A. Loyalty	Avoid front running. Get written consent from employer before starting an independent practice. You cannot take proprietary information, client lists of the previous employer.
4.B. Additional Compensation Arrangements	Do not accept gifts, benefits, or compensation that will create a conflict of interest.
4.C. Responsibilities of Supervisors	Ensure anyone under your supervision complies with applicable laws, rules, regulations, and Code and Standards.
5.A. Diligence and Reasonable Basis	Exercise diligence, independence, and thoroughness in analyzing investments and making recommendations. Be diligent and have a reasonable basis, even when using secondary or third-party research.
5.B. Communication with Clients and Prospective Clients	Disclose to clients the investment process. Identify risks and limitations. Distinguish between fact and opinion.
5.C. Record Retention	Maintain records that support your analysis and research. Code and Standards recommend storing records for at least seven years.
6.A. Disclosure of Conflicts	Make full and fair disclosure of matters that may impair independence and objectivity. Disclosure to be made in plain language. Ex of conflicts: stock ownership, director, cross departmental (IB/research) conflicts.
6.B. Priority of Transactions	Any account from which you benefit makes you the beneficial owner. Personal trading secondary to trading for clients. Establish blackout periods to prevent front running. Limit participation in IPO.
6.C. Referral Fees	Disclose referral fee to clients, prospective clients, and employers.
7.A. Conduct as participants in CFA Institute Programs	Keep questions, exam information confidential. Comply with program restriction. You may express an opinion on the difficulty of exam, curriculum etc.
7.B. Reference to CFA Institute, the CFA designation, and the CFA program	Pay annual dues and fill professional conduct statement to claim membership. References to partial designation not allowed (CFA, Level 1). CFA mark can be used if you've cleared all three levels and fulfilled the membership requirements.

## Practice Questions

1. Nargis Dilawez, CFA, works as an independent research analyst and uses various online social media sites to make announcements, recommendations, and analyses of various securities. She is a resident of Country S where there is no law against posting of comments and opinions, but since her views are read globally she is worried about regulators in certain countries who impose restrictions and requirements on online communications. According to the Standards, Dilawez should:
  - A. continue to post her comments since her resident country does not impose any regulatory restrictions.
  - B. discontinue immediately and wait for the restrictions to ease in the nonresident countries.
  - C. seek guidance from appropriate, knowledgeable, and reliable sources to diligently follow legal and regulatory trends affecting her professional responsibilities.
2. Laura Erik is an analyst at MY Investment Bank, which is one of the underwriters of Parco Inc. Brown discovers that the company has not given accurate earnings figures. The actual figures are much lower than the numbers presented. The preliminary prospectus has been distributed. Erik talks to her supervisor, who casually dismisses the matter. Erik requests her manager to assign him to another project. Her action most likely conforms to which Standard?
  - A. Knowledge of the Law.
  - B. Independence and Objectivity
  - C. Communication with Clients and Prospective Clients.
3. Hadley, CFA, works as a fund manager for SCS Securities which historically has focused on developed and emerging market equities. Due to his past experience, Hadley is also knowledgeable about frontier markets. After discussing the matter with the Chief Investment Officer (CIO) of Westlink, he decides to extend his fund's investment universe to include equities from frontier markets. The firm's marketing and promotional literature is updated to reflect the change in investment strategy. Which of the following standard has Hadley least likely violated?
  - A. Communications with Clients and Prospective Clients.
  - B. Knowledge of the Law.
  - C. Both A and B
4. Wynona Fritz works for Brady Brokerage as a fixed income analyst. She is also registered to take the Level III examination. After analyzing both the qualitative and quantitative aspects of Saber Inc., Fritz concludes that the company is not correctly rated by the credit rating agency and should be downgraded due to the leverage in its capital structure. A senior manager from the investment banking department informs her that Saber Inc. has

chosen Brady Brokerage as one of the firms to underwrite and market their new bond issue. Fritz is concerned that her report will cause the company to terminate their relationship with Brady and affect her employment. According to the Standards, Fritz should:

- A. dissociate from the report, the underwriting, and the client.
  - B. be independent and objective in her analysis based solely on the company's fundamentals.
  - C. change her recommendation about the credit rating to remove the conflict.
5. Julie Grosky, CFA, works for Harvest Mutual Fund where she manages a fixed-income fund. In a hastily compiled performance review, Grosky reports to her clients that her fund has exceeded the benchmark by 0.20%. Stuart Brennan is a client of Harvest, who writes back to inform Grosky that the fund actually underperformed the benchmark. Grosky incorrectly blames the error on a computer program newly implemented at Harvest. Grosky least likely violated the Standard relating to:
- A. Misrepresentation.
  - B. Misconduct.
  - C. Independence and Objectivity.
6. William Joe, a CFA charterholder, is a portfolio analyst with Amore Financials, and manages the portfolio of Steve Tylor. Although Joe receives a salary from his employer, Taylor tells him that "any year my portfolio exceeds a rate of return of 12% before tax; you can fly to Maldives at my expense and use my apartment for a week". Joe fails to inform his employer of the arrangement and his vacation in Maldives the following year. Joe least likely violated the CFA Institute Standards of Professional Conduct related to:
- A. Independence and Objectivity.
  - B. Additional Compensation Arrangement.
  - C. Neither A nor B.
7. Steve Miller is enrolled as a candidate in the CFA Program. He works as an assistant manager in Trust Investment Bank. He enjoys drinking liquor during his lunch break. Miller's colleagues have noticed that he is visibly intoxicated after the lunch break and is not in a position to make rational investment decisions. Miller most likely violates the Standard of:
- A. Misconduct.
  - B. Knowledge of the Law.
  - C. Disclosure of Conflicts.
8. Greg Lou works for a firm that advertises its past performance in various periodicals. Lou discovers that some accounts have left the firm recently and the returns of these accounts are not included in the promotional material. The omission has led to inflated

performance returns. Lou is asked to use the same material while soliciting clients. By doing so, Lou will most likely be violating the CFA Institute Standard of:

- A. Fair Dealing.
- B. Misrepresentation.
- C. Diligence and Reasonable Basis.

9. Elizabeth Pinto, CFA, is a portfolio manager for OXY Investments. She manages a strategic allocation equity fund known as Strategic Fund. Pinto reports the performance of Strategic Fund in its quarterly newsletter and states, "Strategic Fund was able to surpass its benchmark by 0.12%. However, this type of performance should not be expected from the fund always." Farrukh Jamali is a client of Pinto and follows the performance of Strategic Fund closely. Upon receiving the newsletter, he immediately contacts Pinto and informs him that the fund never exceeded its benchmark but in reality had underperformed. Pinto recalculates the results after the complaint, which confirm Jamali's claim. He sends Jamali the correct results and blames the discrepancy on typographical error. Pinto most likely violates the Standard relating to:
- A. Misconduct.
  - B. Independence and Objectivity.
  - C. Loyalty, Prudence, and Care
10. Isaac Dobrogost, a candidate in the CFA Program, works as an investment advisor for Zenith Mutual Fund. He is invited by one of his clients, Sahara Inc. (SI), a manufacturing company, to meet with the finance director along with a few large stakeholders of SI. In the meeting Dobrogost finds out that the company is going through a lean period and will announce a decrease in earnings in their next quarter financial results. Can Dobrogost use this information to change the rating of the company from "buy" to "sell"?
- A. No.
  - B. Yes, because this information is given directly by the company.
  - C. Yes, because it has been disseminated to the other stakeholders as well.
11. Weinberg Inc., a global asset management company, has a large position in Wessner Pharma. The trading volume of this stock is low. In order to boost the liquidity of the stock, multiple trading desks at Weinburg start buying and selling Wessner shares from each other. The CFA Institute Standard most likely violated by Weinberg is:
- A. Market Manipulation.
  - B. Misconduct.
  - C. Acting on Non Public Information.
12. Smith White, CFA, manages a balanced fund at MAP Investments. He wants to build substantial position in the stock of ATR Company. He realizes that buying a substantial holding of the stock will not be easy since it is thinly traded. White is also a regular

participant in various social media sites as well as internet chat rooms where he mentions that ATR is going to face some unusual losses in future in terms of penalty. The company has not yet announced any such news. White believes that this will build selling pressure in the stock and he will be able to get the desired holding of the stock easily. White most likely violated the CFA Institute Standards of Professional Conduct related to:

- A. Market Manipulation.
- B. Material Nonpublic Information.
- C. Disclosure of Conflicts.

13. Janice McDowell, CFA, is the chief investment officer of Zenith Investment Bank and wants to improve the diversification of one of its balanced funds in order to improve its returns. The investment policy statement of the fund mentions low risk investments in large-cap equities, government bonds of AA ratings, and corporate bonds of high investment grade ratings. However, a new IPO offering of a small pharmaceutical company with high growth potential promises high returns since the issue is being offered at a discount. He immediately allocates some portion of the issue to his fund without exceeding the limit on the equity exposure of this fund. McDowell has least likely violated the CFA Institute Standards of Professional Conduct relating to:

- A. Loyalty, prudence and care.
- B. Suitability.
- C. Fair dealing.

14. Eileen Connors is a chief trader for Ascot Investments, a money management firm. She has been told recently by her most lucrative client, Shelby Company, that if the performance of its accounts did not improve they will be forced to change their money managers. Connors has purchased certain securities a few days back, whose price has gone up significantly. She has failed to allocate these trades due to her busy schedule. After the threat from Shelby, she decides to allocate the profitable trades to Shelby's account, while spreading the losing trades to other Ascot's accounts. Has Connors violated any Standard?

- A. Yes, related to Fair Dealing.
- B. No.
- C. Yes, related to Diligence and Reasonable Basis.

15. David Moore, CFA works as an analyst for Zeem Investments. He has been asked to cover investments in the Asian markets for their high rate of return. The trip is sponsored by BLU, an investment and brokerage firm. Moore knows that BLU charges commission at a higher rate than the other brokerage facilities used by his firm. Nevertheless, he convinces the trading desk at Zeem to give more business to BLU so he can take the trip. Moore is most likely violating the CFA Institute Standard of Professional Conduct related to:

- A. Misconduct.
  - B. Misrepresentation.
  - C. Loyalty, Prudence, and Care.
16. Jessica Morales works as an investment adviser for Chris Crosby, a middle-aged, risk-averse investor. As per the investment policy statement, Morales invests in low-risk, high-income equities for Crosby keeping in mind his current needs and objectives. Recently Crosby's mother passed away leaving him with a significant inheritance. Morales continues to invest as before without any change in the investment strategy. According to the CFA Institute Standards of Professional Conduct, Morales should:
- A. stay abreast of changes in the client's net worth and accordingly update the investment policy to reflect changes in investment objectives.
  - B. consider the long-term aspect of Morales' investments and continue with the current strategy.
  - C. keep changing the asset allocations in line with market changes.
17. Samina Haq a CFA candidate, works for Superior Trust Company. While reviewing the performance of one of the trust funds, she finds out that the trust fund has on an average performed at 5% for the last three years, yet the brochure of her fund advertises an annual compound growth rate of 20% which happened only in the past year. It also boasts of a consistent increment in the investment value above the entire market, which also took place during last year. Haq's highest priority in avoiding a violation of the CFA Institute Standards of Professional Conduct is to:
- A. correct the performance calculation and length of time.
  - B. continue with the advertisement since it did rise above the market.
  - C. use the firm's average rate of return in her marketing material for all accounts.
18. Penelope Cox is employed by Jameason Investment, and provides investment advice to the trustees of SYU University in order to recommend investments that would generate capital appreciation in endowment funds. Cox has been given internal reports by the trustees that highlight the expansion of the university. Cox is approached by Bradley Cooper, a local philanthropist who is considering a generous contribution to SYU and another university in the area, but he would like to see the expansion plans of SYU before making the donation. Cox knows that he does not want to speak to the trustees hence she gives a copy of the internal report to Cooper. Has Cox violated the Code and Standards?
- A. No.
  - B. Yes, preservation of confidentiality.
  - C. Yes, loyalty.
19. Lara Whitman, CFA, worked for Rapid Results Brokerage Company (RRBC) as a trader. She recently resigned her position as a trader to join another competing investment and

brokerage firm. Whitman did not sign any non-compete agreement while at RRBC that would have prevented her from soliciting former clients. Whitman, however, had saved her client list and records, while working at RRBC, in her personal computer at home as a second copy. She accesses this file to contact her former clients in her new job. The Standard most likely violated is:

- A. Loyalty.
- B. Duties to Clients.
- C. Communications with Clients and Prospective Clients.

20. Robert Blake is on the board of directors of Rice Industries and receives free tickets at the end of each quarter for his entire family to travel to any city of their choice in Europe for his services to the board. Blake does not disclose this information to his employer since it is not a monetary compensation. Has Blake violated any CFA Institute Standards of Professional Conduct?

- A. No.
- B. Yes, he has to inform his employer of the benefit he receives.
- C. Yes, because he has bought stock of Rice for some of his clients where appropriate.

21. Anna Becker is employed by Jergen Investment Management Company (JIMC). Becker is a Level II candidate and is the only CFA candidate employed by JIMC. Becker is given supervisory responsibilities of the compliance department and asked to review the firm's compliance policies and procedures, which she finds inadequate. She voices her concerns during a meeting with the CEO who tells her to submit her recommendations in a report, but these will not be implemented since the firm is undergoing a change in structure and no compliance changes will be entertained till then. According to the Code and Standards, Becker should:

- A. decline to accept supervisory responsibilities.
- B. accept supervisory responsibilities and lay down the compliance policies and procedures for future.
- C. wait till a new structure is implemented and then review the entire firm.

22. Greg Lou has been asked by his firm, Binkley Investment Management, to find an adviser for one of its funds which invests in derivatives and complex securities. Lou selects 12 firms based on their annual total return performance and finalizes on the adviser with the highest annual total return. Which CFA Institute Standards of Professional Conduct did Lou violate?

- A. Communications with Clients and Prospective Clients.
- B. Professional Misconduct.
- C. Diligence and Reasonable Basis.

23. Alex Karachanis, CFA, is an independent financial advisor with a roster of over 100



clients. Along with advisory services, he also facilitates in executing the trades for his clients and manages their portfolio. Adonia Papadakis signed up Alex in November 2013 to advise and manage her portfolio. After detailed discussions on Adonia's circumstances and return requirements, it was agreed that only large-cap equity investments will be made. In mid-2013 Alex felt that large-cap stocks were excessively overvalued and shifted 50% of the portfolio to small-cap stocks. Over the next six months, small-cap stocks significantly outperformed large-cap stocks. It is now January 2014 and Adonia has just received her account statement for 2013. She is very happy with the performance of her portfolio. Which Standard did Alex least likely violate?

- A. Performance Presentation.
- B. Communication with Clients and Prospective Clients.
- C. Loyalty, Prudence and Care.

24. Raza Jaffery works as an independent analyst for the medical equipment industry. His reports are based on an analysis of customer interviews, manufacturers, on-site company visits, and secondary research from other analysts. Jaffery does not maintain any records or files for the information he collects but he mentions the source of his research in his reports. If the clients need information on the specific web sites, Jaffery always provides them with the relevant information. Jaffery most likely violated which of the following Standards?

- A. Record Retention.
- B. Diligence and Reasonable Basis.
- C. Misrepresentation.

25. Carla Simone, a CFA candidate and a research analyst, follows firms in the beverage industry. She has been recommending the purchase of Citrus because of its introduction of a popular new drink for athletes and exercise enthusiasts. Simone's husband has inherited, from a relative, the stock of Citrus worth \$3.5 million. Simone has been asked to write a follow up report on Citrus. She writes the report and gives a strong buy recommendation. The report does not mention her husband's ownership of the stock. Has Simone violated the CFA Institute Standards?

- A. No.
- B. Yes, disclosure of conflicts.
- C. Yes, independence and objectivity.

26. Izzy Zubeika, CFA, works for Topworth Mutual Fund and is a portfolio manager for an aggressive growth equity fund. She is planning to sell a large portion of her investment to meet the medical costs of her ailing husband. Zubeika wants to sell her stake in Royal Beverages, but her firm has recently upgraded the stock from "hold" to "buy". Nevertheless, after receiving approval from her employer she informs her broker to conduct the trade. Has Zubeika violated any CFA Institute Standards of Professional



Conduct?

- A. Yes related to Market Manipulation.
- B. Yes, related to Priority of Transactions.
- C. No.

27. Dave Daisuke, CFA, works in the corporate finance department of Advile Securities. He receives a non-cash compensation for every referral he makes to the brokerage department. This arrangement is an accepted norm within the company but the clients are not informed because no cash is given out within the firm for interdepartmental referrals. According to the CFA Institute Standards, the most appropriate action to take for the firm to avoid a violation is to:
- A. adjust the non-cash compensation in the salaries of the personnel including Daisuke who are referring clients to the brokerage department.
  - B. disclose to clients at the time of a referral, the referral arrangements within Advile's departments.
  - C. stop the referral policy to remove any conflicts of interest.
28. Lauren Crawley is enrolled to take the Level I exam. As he tries hard to remember a formula to complete a question he notices that the person in front of him gets up to drink water and a piece of paper slips from his pocket and falls on Crawley's table. In order to avoid a violation of the CFA Institute Standards of Professional Conduct, the least appropriate action taken by Crawley is to:
- A. remove it without looking at it and call the proctor.
  - B. immediately call the proctor to her table and have the paper removed.
  - C. look at the paper and then remove it before anyone else notices it.
29. Ankit Aacharya, CFA, while making the marketing material for his firm Aakash Capital writes in the brochure, "Aakash Capital is committed to achieving excellent performance for its clients. It hires the most eligible personnel in the field of investment management. Most of the employees have either completed the CFA Program or are enrolled as candidates in the CFA Program. As a CFA charterholder, I am the most qualified to manage client investments." Aacharya most likely violated the Standard with improper references to the:
- A. CFA designation.
  - B. CFA Program.
  - C. CFA Institute.
30. Sarah Kevin, a CFA candidate, writes in her blog after taking the Level II exam of the CFA program. She posts that the fixed income part of the exam was very easy while the equity questions were difficult and time consuming. She further writes that a question from equity was not properly structured and she was confused by the language. Sarah further

describes a question in the Fixed Income portion in detail and asks if anyone can explain it to her. Sarah has most likely violated the Standard related to:

- A. Misconduct.
- B. Independence and objectivity.
- C. Conduct as Participants in the CFA Program.

**Solutions**

1. C is correct. According to Standard I(A) Knowledge of the Law Dilawez should adopt the stricter law.
2. A is correct. Erik's actions are in line with Standard I(A) Knowledge of the Law. After knowing that the preliminary prospectus is misleading, Erik reported her findings to her supervisor. Since the matter was not corrected, Erik should dissociate from underwriting. She can also seek legal advice to determine whether additional reporting or other action should be taken. According to Standard 1 (A) Knowledge of the Law, "Members and Candidates must understand and comply with all applicable laws, rules, and regulations 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 and must dissociate from any violation of such laws, rules, or regulations". B is incorrect. Standard I(B) Independence and Objectivity involves members and candidates not accepting any gifts or benefits that could be expected to compromise their independence and objectivity. C is incorrect. According to Standard V(B) Communication with Clients and Prospective Clients, Members and Candidates must:
  - i. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.
  - ii. Disclose to clients and prospective clients significant limitations and risks associated with the investment process.
  - iii. 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.
  - iv. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.
3. B is correct. Standard I (A) Knowledge of the Law is not violated. It is a sub-standard of Standard I Professionalism. There is not enough information provided in the question that implies that Westlink and Lee did not comply with applicable laws, rules, and regulations of any government, regulatory organization etc. In fact, it is informed that due to his past experience, Hadley is also knowledgeable about frontier markets. SCS and Hadley's current clients need to be informed along with the prospective clients, of the change in the fund's mandate since they might have objections concerning the Fund's new allocations. Hence Standard V(B) Communications with Clients and Prospective Clients is violated. Significant risks and limitations of the new investments should also be

disclosed along with their impact on the fund as a whole. Standard V (B) requires that Members and Candidates must disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

4. B is correct. Fritz should be independent and objective in her report. Alternatively, Brady Brokerage could place Saber Inc. on a restricted list and issue only factual information. Standard I(B) Independence and Objectivity.
5. C is correct. Standard I(B) Independence and Objectivity involves members and candidates not accepting any gifts or benefits that could be expected to compromise their independence and objectivity. Since no benefits were received Grosky has least likely violated I(B). Grosky most likely violated the Standards I(C) Misrepresentation, and I(D) Misconduct because she knowingly misrepresents the cause of the error.
6. A is correct. Joe has not violated Standard 1 (B) Independence and Objectivity as accepting such a compensation from his client whose portfolio he is managing does not automatically imply that his independence or objectivity is compromised. Standard 1 (B) Independence and Objectivity requires that “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”. Standard IV(B) Additional Compensation Arrangements is violated by not informing his employer of the arrangement with Steve Talyor and his vacation in Maldives the following year. According to Standard IV(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. Joe should have considered the following before accepting such a compensation.
  - Obtain permission before accepting compensation that might create a conflict. He must first disclose to his employer and obtain written consent for any compensation that may create a conflict.
  - “Written consent” includes any form of communication that can be documented.
7. A is correct. Refer to Standard I(D) Misconduct.
8. B is correct. By not including the returns of the accounts who have left the firm in the promotional material, Lou has violated Standard I(C) Misrepresentation. According to Standard I (C) Misrepresentation, “Members and Candidates must not knowingly make

any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities". A misrepresentation is any untrue statement, or omission of fact, or any statement that is otherwise false or misleading. The omission of the accounts who have recently left the Firm has led to inflated performance returns. Standard III (B) Fair Dealing is not violated. This Standard requires that "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". Standard V (A) Diligence and Reasonable Basis is not violated. According to Standard V (A) Diligence and Reasonable Basis, Members and Candidates must:

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

9. A is correct. Standard I (D) Misconduct requires that 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. Any act that involves lying, cheating, stealing, or other dishonest conduct is a violation of this standard if the offense reflects adversely on a member's or candidate's professional activities. Devgan violated this standard by blaming the discrepancy in performance results on typographical error rather than telling the truth. The Standard relating to Standard I(B) Independence & Objectivity has not been violated because Pinto has not received any gifts, benefits or consideration to compromise his independence and objectivity. Standard III (A) Loyalty, Prudence, and Care is not violated. This Standard says that 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.
10. A is correct. If the information is not publicly disseminated by the company and Dobrogost uses it, then it becomes material nonpublic information, hence a violation of Standard II(A). A small group of stakeholders does not qualify as the public. He cannot use the information.
11. A is correct. Refer to Standard II(B) Market Manipulation. Weinberg created an appearance of greater liquidity of stock through its trading strategy and was able to manipulate the market.
12. A is correct. White has violated Standard II (B) Market Manipulation because he was trying to artificially decrease the price of the APR's stock in order to buy the holdings.

Standard II (B) requires that Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants. This is “Information-based manipulation” which refers to “Spreading false rumors to induce trading by others. White has not violated Standard II (A) Material Nonpublic Information which states that 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. White has not violated Standard II (A) Material Nonpublic Information which states that 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. White has also not violated the Standard VI (A) Disclosure of Conflicts. According to this standard, 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, or employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

13. C is correct. The Standards related to III(A) Loyalty, Prudence, and Care and III(C) Suitability are violated. The IPS mentions low-risk securities, and describes the asset classes. Therefore investment in the pharma stock may not be suitable for this portfolio.
14. A is correct. Connors has violated Standard III(B) Fair Dealing by failing to deal fairly with all her clients in taking these investment actions.
15. C is correct. Moore is violating Standard III(A) Loyalty, Prudence and Care. He should have weighed the benefits of the trip against the commission charged by BLU. He should have also determined whether best execution and prices could be received from BLU. Standard 1 (D) Misconduct is not violated. This Standard requires that “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”. He has not violated Standard I(C) Misrepresentation. Standard 1 (C) Misrepresentation requires that “Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities”. A misrepresentation is any untrue statement, or omission of fact, or any statement that is otherwise false or misleading.
16. A is correct. Refer to Standard III(C) Suitability.
17. A is correct. According to Standard III(D) Performance Presentation, Haq needs to correct the calculation and length of time specifying the performance of her trust fund.

18. B is correct. Cox was given the internal reports by the trustees; because the information was confidential Cox should have refused to divulge it to Cooper. Therefore, by handing the internal reports to him Cox violates Standard III(E) Preservation of Confidentiality.
19. A is correct. Standard IV(A) Loyalty is most likely violated. A member cannot take records or work performed on behalf of the firm in paper copy or electronically without permission to another firm. In this case she cannot use the firm's records of clients without the firm's permission.
20. B is correct. Blake has violated Standard IV(B) Additional Compensation Arrangements by failing to disclose to his employer benefits received in exchange for his services on the board.
21. A is correct. According to Standard IV(C) Responsibilities of Supervisors, a member or candidate should decline in writing to accept supervisory responsibilities until reasonable compliance procedures are laid down by a firm for her to assume and exercise responsibility.
22. C is correct. Lou violated Standard V(A) Diligence and Reasonable Basis by not conducting sufficient review of potential firms.
23. A is correct. Standard III(D) Performance Presentation is not violated as Alex sends a quarterly itemized statement of the funds and securities in his custody and the transactions that occurred during this period. Standard V(B) Communication with Clients and Prospective Clients is violated because Alex should have discussed the change with the client before moving to small-cap stocks. Standard III(A) Loyalty, Prudence, and Care is violated because small-cap stocks might not correspond to client's risk profile.
24. A is correct. Refer to Standard V(C) Record Retention. Jaffery must carefully document and maintain copies of all information that goes in his reports in order to avoid violation of Standard V(C).
25. B is correct. Simone must disclose her husband's ownership of the stock to avoid violation of Standard VI(A) Disclosure of Conflicts.
26. C is correct. No violation has occurred because she has received approval from her employer. Standard VI(B) Priority of Transactions does not limit transactions of employees which are different from the current recommendations as long as they do not disadvantage the current clients.
27. B is correct. Disclosure to clients is important even if the referrals result in a noncash compensation. Refer to Standard VI(C) Referral Fees
-



28. C is correct. Refer to Standard VII(A) Conduct as Participants in CFA Institute Programs.
29. A is correct. CFA Institute and CFA designation were improperly referenced. Refer to Standard VII(B) Reference to CFA Institute, the CFA designation, and the CFA Program.
30. C is correct. Sarah has violated the Standard VII(A) Conduct as Participants in the CFA Institute Programs by sharing exam content, undermining the validity and integrity of the exam and CFA institute programs. This standard covers many aspects such as cheating on any CFA Institute examinations, violating the testing policies, disclosing confidential exam information to the public, and improperly using any association with the CFA Institute to further personal or professional goals. Standard 1 (D) Misconduct is not violated. This Standard requires that “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”. Standard 1 (B) Independence and Objectivity is also not violated. This Standard requires that “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”.