CFA Institute Ethics Cases

Standards of Practice Handbook, 9th edition (CFA Institute, 2005)

"CFA Institute Soft Dollar Standards" (AIMR, 1998; reprinted 2004)

"Asset Manager Code of Professional Conduct," including Appendix A (CFA Institute Centre for Financial Market Integrity, 2005)

Acertado/Boswin Case Scenario[1]

Anne Boswin, CFA, is a senior fixed-income analyst at Greenfield Financial Corporation. Boswin develops financial models for predicting changes in bond prices. On the premise that bonds of firms targeted for leveraged buyouts (LBOs) often decline in value, Boswin develops a model to predict which firms are likely to be subject to LBOs.

Boswin works closely with another analyst, Robert Acertado, CFA. Acertado uses Boswin's model frequently to identify potential LBO targets for further research. Using the model and his extensive research skills, Acertado makes timely investment recommendations and develops a strong track record.

Based on this record, Acertado receives an employment offer from the asset management division of Smith & Garner Investments, Inc., a diversified financial services firm. With Boswin's consent, Acertado downloads the model before leaving Greenfield.

At Smith & Garner, Acertado presents the idea of predicting LBO targets as a way to identify bonds that might decline in value and thus be good sell recommendations. After Acertado walks his boss through the model, the supervisor comments, "I like your idea and your model, Robert. I can see that we made the right decision in hiring you."

Because Smith & Garner has both an Investment Banking (IB) and Asset Management (AM) division, Acertado's supervisor reminds him that he should not attempt to contact or engage in conversation with anyone from the Investment Banking division. The supervisor also directs him to eat in the East end of the company cafeteria. "The West end is reserved for the IB folks, and you may laugh at this, but we actually put up a wall, between the two ends. If anyone were to accuse us of not having a firewall, we could actually point to it!" Robert's supervisor also tells him, "There should be absolutely no conversation about divisional business while in the hall and elevator that serves as a common access to the cafeteria for both divisions. We are very strict about this."

The following week, Acertado is riding alone in the elevator when it stops on an IB floor. As the doors begin to slide open, Acertado hears a voice whispering "I am so pleased that we were able to put the financing together for Country Industries. I was concerned because the leverage will go to 80%—higher than our typical deal." As soon as the doors open enough to reveal that the elevator is occupied, all conversation stops.

Late that afternoon, Acertado uses the LBO model to measure the probability of Country Industries receiving an LBO offer. According to the model, the probability is 62%—slightly more than the 60% Acertado generally requires before conducting additional research. It is late in the afternoon and Acertado has little time to research the matter fully before the end of the trading day. He checks his inputs to the model. In the interest of time, Acertado immediately recommends selling Country Industries' senior bonds held in any long-only accounts. He also recommends establishing positions in derivatives contracts that will benefit from a decline in the value of Country Industries' bonds.

The next morning, after the firm has established the derivatives positions he recommended, Acertado calls Boswin. Knowing that his former associate will be preparing Greenfield's monthly newsletter, he tells her "I ran Country Industries through your model and I think it is likely that they will receive an LBO offer." Acertado explains some of the inputs he used in the model. At the conclusion of the conversation Boswin responds, "You may be right. Country Industries sounds like a possible LBO candidate, and thus, a sell rating on their senior

[1] This case was written by Sarah W. Peck, PhD.

bonds would be in order. If I'm lucky, I can finish researching the issue in time to include the recommendation in the upcoming newsletter. Thanks. It was good talking with you, Robert."

After the conversation with Acertado, Boswin quickly runs Country Industries through the model. Based on her inputs, the model calculates that the probability of an LBO is 40 percent—not enough, in Boswin's opinion, to justify further research. She wonders if there is a discrepancy between her inputs and Acertado's. Pressed for time, Boswin resumes her work on the upcoming newsletter rather than investigating the matter.

Acertado soon begins searching the internet for information on companies that the model predicts have more than a 60% probability of an LBO offer. He scours blogs and company websites looking for signs of a potential offer. He uses evidence of rumored offers in developing sell recommendations on various corporations' bonds.

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1. When downloading the model from Greenfield Financial Corporation, does Acertado violate any CFA Institute Standards of Practice and Professional Conduct?
   A. No.
   B. Yes, because he does not have written permission from Boswin.
   C. Yes, because he does not have permission from Greenfield Financial Corporation.

2. When using the model at Smith & Garner, Acertado is *least likely* to violate the Standard relating to:
   A. misrepresentation.
   B. loyalty to employer.
   C. material nonpublic information.

3. When making the recommendation regarding Country Industries, does Acertado violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to diligence and reasonable basis.
   C. Yes, relating to material nonpublic information.

4. In his phone conversation with Boswin, Acertado *least likely* violates the CFA Institute Standard relating to:
   A. Suitability.
   B. Integrity of capital markets.
   C. Preservation of confidentiality.

5. When analyzing the probability of an LBO of Country Industries, does Boswin violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to independence and objectivity.
   C. Yes, relating to diligence and reasonable basis.

6. When searching blogs does Acertado violate any CFA Institute Standards?
   A. No.
   B. Yes, because he misuses company resources.
   C. Yes, because he seeks inside information on the blogs.

Discussion Questions:

1. Suppose rather than overhearing a conversation by investment bankers, Acertado sees employees walking in the parking lot with materials prominently displaying the logo of a large consumer products company. After some additional research, Acertado initiates trades in the consumer products company. Is he acting on material nonpublic information? What if he recognizes the CFO of the company in the parking lot?

2. Suppose Acertado's Country Industries recommendation is reviewed and approved by the company's compliance officer. Does the compliance officer's approval of the trade alleviate Acertado of any responsibility for trading on insider information?

3. Is Acertado's conversation with Boswin an attempt to manipulate the market? Why or why not?

Suggested Issues for Discussion Question 1:
Students can discuss what constitutes material nonpublic information, what makes such information material, and whether Acertado is engaging in illegal insider trading. If students conclude that Acertado is not breaking the law, they can discuss whether Acertado's actions affect the integrity of capital markets and the possible impact.

Some students might point out that even if Acertado is engaging in insider trading it is unlikely that he would be detected and/or convicted because the additional research and the use of the model appear to provide him with a reasonable basis. This can lead to further discussion about whether it is appropriate or advisable to engage in behavior based on the premise that detection and/or conviction is unlikely. Following the Martha Stewart case, many professionals will consider not only the legal issues associated with material nonpublic information, but also the risk and burden associated with an unwelcome and intrusive investigation and the possible reputational risk involved.[2]

Suggested Issues for Discussion Question 2:
Students can discuss the role of compliance polices regarding trading in stocks of companies that are investment banking clients. Is it reasonable for Acertado to conclude that he had done nothing illegal or unethical since the compliance officer approved the trade? This should lead to a discussion about the difference between compliance and ethics.

Suggested Issues for Discussion Question 3:
Some candidates may feel that Acertado is attempting to manipulate Boswin and thus the market by encouraging issuance of a sell recommendation in the upcoming newsletter. They might argue that Acertado and his firm stand to profit from their derivatives positions if a sell

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[2] Beginning in 2004, Martha Stewart, Chair and CEO of Martha Stewart Living Omnimedia, served five months in prison and nearly six months of house arrest for obstructing justice during an investigation of alleged insider trading activity in ImClone. She was never convicted of insider trading. In 2006, Stewart reached a settlement with the Securities and Exchange Commission on the issue. The settlement included a five-year bar from serving as a director or officer of a public company in addition to fines and penalties. Stewart disgorged approximately $45,000 in avoided losses and paid a civil penalty three times that amount. At the time of the trading scandal, Stewart earned a $900,000 salary and was worth an estimated $650 million. During the investigation, scandal, and trial, Omnimedia's stock price declined by 50%, reducing her net worth by more than $300 million.

recommendation by Boswin leads to intense selling pressure. Although Acertado may be attempting to manipulate his colleague, his actions do not constitute market manipulation. The Standard relating to Market Manipulation prohibits members from engaging in practices that distort prices or artificially inflate trading volumes with the intent to mislead market participants. The Standard also prohibits information-based manipulation such as spreading false rumors to induce trading by others, but Acertado is not spreading false rumors. He is attempting to spread information that he believes accurate. Having taken his position, Acertado hopes to profit when other market participants have access to the same information and develop a similar conclusion.

Reference: "Code of Ethics and Standards of Professional Conduct" Standards of Practice Handbook, 9th edition (CFA Institute, 2005)

Standard II. Integrity of Capital Markets

Apfelbaum Kapital Case Scenario[3]

Erik Brecksen, CFA, a portfolio manager at Apfelbaum Kapital, is a strong advocate of the CFA program. He displays the CFA logo on both his letterhead and business cards and prefers to hire only CFA candidates or charterholders. Brecksen recently recruited Hans Grohl, a CFA candidate and recent MBA graduate from a top university with excellent quantitative analysis skills. After receiving Grohl's letter of acceptance, Brecksen instructs the personnel department to order business cards and letterhead for Grohl, telling them "Use mine as a template. Just change the name, title, and other information as necessary." When Grohl arrives for his first day of work, he receives business cards and letterhead displaying his name, the firm name, and the CFA logo.

Apfelbaum Kapital stresses "top-down" fundamental analysis and uses a team approach to investment management. The firm's investment professionals, all of whom are CFA charterholders or candidates, attend weekly investment committee meetings. At the meetings, analysts responsible for different industrial sectors present their research and recommendations. Following each presentation, the investment committee, consisting of senior portfolio managers, questions the analyst about the recommendation. If the majority of the committee agrees with the recommendation, the recommendation is approved and the stock is placed on a restricted list while the firm executes the necessary trades.

Apfelbaum considers its research proprietary. It is intended for the sole use of its investment professionals and is not distributed outside the firm. The names of all the investment personnel associated with the sector or investment class are listed on each research report regardless of their actual level of contribution to the report.

On Grohl's first day of work, Brecksen assigns him responsibility for a company that Brecksen covered previously. He provides Grohl with his past research including all of his files and reports. Brecksen instructs Grohl to report back when he has finished his research and is ready to submit his own research report on the company.

Grohl reads Brecksen's old reports before studying the financial statements of the company and its competitors. Taking advantage of his quantitative analysis skills, Grohl then conducts a detailed multi-factor analysis. Afterward, he produces a written buy recommendation using Brecksen's old research reports as a guide for format and submits a draft to Brecksen for review.

Brecksen reviews the work and indicates that he is not familiar with multi-factor analysis. He tells Grohl that he agrees with the buy recommendation, but instructs Grohl to omit the multi-factor analysis from the report. Grohl attempts to defend his research methodology, but is interrupted when Brecksen accepts a phone call. Grohl follows Brecksen's instructions and removes all mention of the multi-factor analysis from the final report. Brecksen presents the completed report at the weekly meeting with both his and Grohl's names listed on the document. After Brecksen's initial presentation, the committee turns to Grohl and asks about his research. Grohl takes the opportunity to mention the multi-factor analysis. Satisfied, the committee votes in favor of the recommendation and congratulates Grohl on his work.

Ottie Zardt, CFA has worked as a real estate analyst for Apfelbaum for the past 18 months. A new independent rating service has determined that Zardt's recommendations have resulted in an excess return of 12% versus the industry's return of 2.7% for the past twelve months. After learning about the rating service, Zardt immediately updates the promotional material he is preparing for distribution at an upcoming industry conference. He includes a

[3] This case was written by David S. Krause, PhD, and Dorothy C. Kelly, CFA.

reference to the rating service and quotes its returns results and other information. Before distributing the material at the conference, he adds a footnote stating "Past performance is no guarantee of future success."

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1. According to the CFA Institute Standards of Professional Conduct, may Brecksen and Grohl both use the letterhead and business cards provided by Apfelbaum Kapital?
   A. Yes.
   B. No, because candidates may not use the logo.
   C. No, because the logo may not be used on company letterhead.

2. When preparing the initial draft for Brecksen's review, does Grohl violate any CFA Standards?
   A. No.
   B. Yes, because he used Brecksen's research reports without permission.
   C. Yes, because he did not use reasonable judgment in identifying which factors were important to the analyses.

3. When instructing Grohl to eliminate the multi-factor analysis from the research report, does Brecksen violate any CFA Standards?
   A. No.
   B. Yes, relating to record retention.
   C. Yes, relating to diligence and reasonable basis.

4. When removing the multi-factor analysis from his research report, does Grohl violate any CFA Standards?
   A. No.
   B. Yes, because he no longer has a reasonable basis for his recommendation.
   C. Yes, because he is required to make full and fair disclosure of all relevant information.

5. When listing their names on the research report, do Brecksen and Grohl violate any CFA Standards?
   A. No.
   B. Yes, because Brecksen misrepresents his authorship.
   C. Yes, because Grohl should dissociate from the report.

6. When distributing the material at the industry conference, does Zardt violate any CFA Standards?
   A. No.
   B. Yes, because Zardt does not verify the accuracy of the information.
   C. Yes, because analysts can not claim performance or promote the accuracy of their recommendations.

Standard V(A) Diligence and Reasonable Basis, Standard V(B), Communication with Clients and Prospective Clients, Standard VII(A), Conduct as Members and Candidates in the CFA Program, and Standard VII(B), Reference to CFA Institute, CFA Designation, and the CFA Program

Samuel Telline Case Scenario[4]

Samuel Telline, CFA, is a portfolio manager at Aiklin Investments with discretionary authority over all of his accounts. One of his clients, Alan Caper, Chief Executive Officer (CEO) of Ellipse Manufacturing, invites Telline to lunch.

At the restaurant, the CEO reveals the reason for the lunch. "As you know Reinhold Partners has made an unsolicited cash offer for all outstanding shares of Ellipse Manufacturing. Reinhold has made it clear that I will not be CEO if they are successful. I can assure you that our shareholders will be better off in the long-term if I'm in charge." Caper then shows Telline his projections for a new plan designed to boost both sales and operating margins.

"I know that your firm is the trustee for our firm's Employee Stock Ownership Plan (ESOP). I hope that the trustee will vote in the best interest of our shareholders—and that would be a vote against the takeover offer."

After looking through Caper's business plans, Telline says, "This plan looks good. I will recommend that the trustee vote against the offer."

Caper responds, "I remember my friend Karen Leighton telling me that the Leighton Family's Trust is managed by your firm. Perhaps the trustee could vote those shares against the acquisition as well. Karen Leighton is a close friend. I am sure that she would agree."

Telline responds "The Family Trust is no longer managed by Aiklin." He adds "I understand that the Trust is very conservatively managed. I doubt it that it would have holdings in Ellipse Manufacturing." Telline does not mention that although the Family Trust has changed investment managers, Karen Leighton remains an important client at Aiklin with significant personal holdings in Ellipse.

After lunch, Telline meets with Sydney Brown, CFA, trustee of the Eclipse ESOP. He shows her Caper's plan for improvements. "I think the plan is a good one and Caper is one of the firm's most profitable accounts. We don't want to lose him." Brown agrees to analyze the plan. After thoroughly analyzing both the plan and the takeover offer, Brown concludes that the takeover offer is best for the shareholders in the ESOP and votes the plan's shares in favor of the takeover offer.

A few months later the acquisition of Ellipse by Reinhold Partners is completed. Caper again meets Telline for lunch. "I received a generous severance package and I'm counting on you to manage my money well for me. While we are on the subject, I would like to be more aggressive with my portfolio. With my severance package, I can take additional risk." Telline and Caper discuss his current financial situation, risk tolerance, and financial objectives throughout lunch. Telline agrees to adjust Caper's investment policy statement (IPS) to reflect his greater appetite for risk and his increased wealth.

Back at the office, Telline realizes that with the severance package, Caper is now his wealthiest client. He also realizes that Caper's increased appetite for risk gives him a risk profile similar to that of another client. He pulls a copy of the other client's investment policy statement (IPS) and reviews it quickly before realizing that the two clients have very different tax situations. Telline quickly revises Caper's IPS to reflect the changes in his financial situation. He uses the other client's IPS as a reference when revising the section relating to Caper's risk tolerance. He then files the revised IPS in Caper's file.

The following week, an Aiklin analyst issues a buy recommendation on a small technology company with a promising software product. Telline reads the report carefully and concludes it would be suitable under Caper's new IPS. Telline places an order for 10,000 shares

[4] This case was written by Sarah W. Peck, PhD.

in Caper's account and then calls Caper to discuss the stock in more detail. Telline does not purchase the stock for any other clients. Although the one client has the same risk profile as Caper, that client does not have cash available in his account and Telline determines that selling existing holdings does not make sense.

In a subsequent telephone conversation, Caper expresses his lingering anger over the takeover. "You didn't do enough to persuade Aiklin's clients to vote against the takeover. Maybe I should look for an investment manager who is more loyal." Telline tries to calm Caper but is unsuccessful. In an attempt to change the topic of conversation, Telline states, "The firm was just notified of our allocation of a long-awaited IPO. Your account should receive a significant allocation. I would hate to see you lose out by moving your account." Caper seems mollified and concludes the phone call, "I look forward to a long-term relationship with you and your firm."

Aiklin distributes a copy of its firm policies regarding IPO allocations to all clients annually. According to the policy, Aiklin allocates IPO shares to each investment manager and each manager has responsibility for allocating shares to accounts for which the IPO is suitable. The statement also discloses that Aiklin offers different levels of service for different fees.

After carefully reviewing the proposed IPO and his client accounts, Telline determines that the IPO is suitable for 11 clients including Caper. Because the deal is oversubscribed, he receives only half of the shares he expected. Telline directs 50% of his allocation to Caper's account and divides the remaining 50% between the other ten accounts, each with a value equal to half of Caper's account.

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1. When discussing the Leighton Family Trust, does Telline violate any CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, relating to duties to clients.
   C. Yes, relating to misrepresentation.

2. When deciding how to vote the ESOP shares, does Brown violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to loyalty, prudence, and care.
   C. Yes, relating to diligence and reasonable basis.

3. The Standard *least likely* to provide guidance for Telline when working with the clients' investment policy statements would be the Standard relating to:
   A. suitability.
   B. fair dealing.
   C. loyalty, prudence, and care.

4. Does Telline violate any CFA Institute Standards when he places the buy order for shares in the technology company for Caper's account?
   A. No.
   B. Yes, relating to fair dealing.
   C. Yes, relating to diligence and reasonable basis.

5. Is Aiklin’s policy with respect to IPO allocations consistent with required and recommended CFA Institute Standards?
   A. Yes.
   B. No, because the IPO policy disadvantages certain clients.
   C. No, because the different levels of service disadvantage certain clients.

6. Does Telline violate any CFA Institute Standards in his allocation of IPO shares to Caper’s account?
   A. No.
   B. Yes, because the IPO is not suitable for Caper.
   C. Yes, because he does not treat all his clients fairly.

Discussion Questions:

1. Suppose an investment manager involved in a takeover battle sells the entire position after the record date. How should he use the retained shareholder votes? What are the implications for the client, the manager, the firm, and the capital markets? What if the investment manager works for a hedge fund that is short the stock but retains the voting rights of its borrowed shares? What conflicts emerge?

2. What do you think of Caper’s behavior towards Telline? Is the customer always right? What short-term and long-term ramifications should Telline consider? What choices does Telline have?

Suggested Issues for Discussion Question 1:
Candidates can discuss the potential conflict of having clients, such as Caper and the ESOP plan, with divergent interests. In the situation provided, selling the shares seems to solve the firm’s dilemma. By selling the shares, Brown can vote against the acquisition and possibly capture the market’s anticipation of a takeover premium in the market price for her clients.

Candidates can discuss the conflicts and implications associated with a practice known as ghost voting or empty voting. Hedge funds that are short sellers receive voting rights when they borrow shares for their positions. The hedge fund managers are then in a position to cast votes designed to favor their clients and adversely affect shareholders. The hedge fund’s votes are empty because they do not represent the votes of actual shareholders and may be used in a way that damages shareholders.

Suggested Issues for Discussion Question 2:
Candidates can discuss how they would handle a situation in which a client’s demands conflict with acceptable standards or their own ethics and values. In such situations, they face a difficult decision that may have significant ramifications on their careers.

In the short term, Telline risks losing the Caper account, which could negatively affect his pay, his bonus, and possibly his employment at Aiklin Investments. In the long term, how Telline handles Caper and responds to the pressures he is exerting could have a much more lasting effect on Telline and his career. If Telline succumbs to Caper’s initial pressures, Caper will likely continue to pressure Telline in the future. Telline might find himself violating not only ethical standards but also applicable law. If caught and convicted, Telline could lose more than his current pay, bonus, and employment. He could serve a prison sentence and be permanently barred from the investment industry.

Telline could choose to mollify Caper or he could seek advice. He might seek advice from his supervisor, his compliance officer, the CFA Ethics Hotline, or his own legal counsel.

Reference: "Code of Ethics and Standards of Professional Conduct" Standards of Practice Handbook, 9th edition (CFA Institute, 2005)

Standard III. Duties to Clients

Voser[5]

Adam Craw, CFA, is chief executive officer (CEO) of Crawfood, a European private equity firm specializing in food retailers. The retail food industry has been consolidating during the past two years as private equity funds have closed numerous deals and taken many companies private.

Crawfood recently hired Lillian Voser, a CFA Level II candidate, as a controller. On Voser's first day of work, the head of personnel informs her that by signing the employment contract, Voser agrees to comply with the company's code of ethics and compliance manual. She hands Voser copies of the code and compliance manual without further comment. Voser spends the next hour reading both documents. An excerpt from the compliance manual appears in Exhibit 1.

Exhibit 1
Crawfood Company Compliance Manual
Excerpts

1. Employees 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.
2. Officers have responsibility for ensuring that their direct reports—that is, employees whom they directly supervise—adhere to applicable laws, rules, and regulations.
3. Employees in possession of material nonpublic information should make reasonable efforts to achieve public dissemination of the information if such actions would not breach a duty.
4. Employees shall not trade or cause others to trade in securities of food retailers that may be potential takeover targets of their employer.

When she enters her new office that afternoon, Voser finds a large gift basket sent by her sister. The card reads "Congratulations on your new position." The basket is filled with expensive high-quality food items from Greenhornfood—a local small, publicly-traded food retailer, which produces many delicatessen products under its own brand name.

During the next two weeks, Voser meets with all of Crawfood's upper management, including the CEO. In his office, Craw praises Voser's efforts to complete the CFA program. "The program is demanding, but it is worthwhile." Craw then explains his investment strategy for choosing Crawford's acquisition targets. He points to a large map on the wall with multi-colored pins marking Crawfood's previous takeovers. The map shows acquisitions in all the major cities of Germany with one exception—the home of Crawfood headquarters. Craw remarks, "We are currently in talks for another purchase. Confidentiality prohibits me from discussing it any further, but you will hear more about it soon."

Introduced to Greenhornfood by her sister, Voser quickly becomes a loyal customer. She considers it the best food retailer in the vicinity and she frequently purchases its products.

The following week, the local newspaper features an article about Greenhornfood and its young founders. The article describes the company's loyal and growing customer base as well as its poor quarterly financial results. Voser notes that the stock has steadily declined during the past twelve months. She concludes that the company has an inexperienced management team,

[5] This case was written by Anne-Katrin Scherer, CFA.

but its popular product line and loyal customer base make the company a potential acquisition target. Voser calls her sister and recommends that she purchase Greenhornfood shares because "it would be an attractive acquisition for a larger company." Based on Voser's recommendation, her sister buys €3,000 worth of shares.

During the following two weeks the stock price of Greenhornfood continues to decline. Voser's sister is uncertain of what she should do with her position. She seeks Voser's advice. Voser recommends that her sister wait another few days before making her decision and promises to analyze the situation in the meantime.

While walking by Craw's office the following day, Voser sees a document with Greenhornfood's distinctive logo and overhears the company's name through an open office door. That evening, Voser tells her sister, "with the price decline, the stock is even more attractive." She recommends that her sister increase her position. Based on her recommendation her sister buys an additional €3,000 worth of Greenhornfood shares.

One month later, Crawfood publicly announces the acquisition of Greenhornfood Company at a 20% premium to the previous day's closing price. Following the announcement, Voser's sister boasts about Voser's excellent recommendation and timing to her broker.

Regulatory authorities initiate an investigation into suspicious trading in Greenhornfood shares and options preceding the formal announcement of the acquisition. Craw receives a letter from regulatory authorities stating that he is the subject of a formal investigation into his professional conduct surrounding the acquisition. He learns from the compliance officer that Voser is also under investigation. The compliance officer provides no details and out of respect for Voser's privacy, Craw makes no inquiries.

The situation remains unchanged and the matter is still pending with regulatory authorities several months later when Craw receives his annual Professional Conduct Statement (PCS) from CFA Institute. He reviews the text asking "In the last two years, have you been…the subject of…any investigation…in which your professional conduct, in either a direct or supervisory capacity, was at issue?"

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1. Are Excerpts 2 and 3 of Crawfood's compliance procedures consistent with CFA Institute Standards of Professional Conduct?
   A. Yes.
   B. No, because Excerpt 2 applies only to officers and their direct reports.
   C. No, because Excerpt 3 does not require employees to achieve public dissemination.

2. According to CFA Institute Standards, must Voser obtain permission from her supervisor before accepting the Greenhornfood gift basket?
   A. No.
   B. Yes, because the value of the basket is higher than €50.
   C. Yes, because consent is required by the company's compliance procedures.

3. When making her initial recommendation to purchase Greenhornfood company shares, Voser *most likely* violates the Standard relating to:
   A. loyalty to employer.
   B. integrity of capital markets.
   C. diligence and reasonable basis.

4. When recommending the purchase of additional Greenhornfood company shares, Voser *least likely* violates the Standard relating to:
   A. loyalty to employer.
   B. integrity of capital markets.
   C. diligence and reasonable basis.

5. Does Craw violate any CFA Institute Standards?
   A. No.
   B. Yes, because he passes material nonpublic information to Voser.
   C. Yes, because he does not make reasonable efforts to prevent violations of applicable law.

6. According to CFA Standards, Craw must disclose to CFA Institute the investigation into:
   A. his conduct.
   B. Voser's conduct.
   C. neither his conduct nor Voser's conduct.

Discussion Questions

1. Why should Craw or anyone else report a violation to CFA Institute and/or regulatory authorities? How does the reporting process benefit the profession? The capital markets?

2. Should all types of investigations be reported to CFA Institute? Why or why not? What circumstances would support such disclosure?

Suggested Issues for Discussion Question 1:
Reporting violations to CFA Institute and/or regulatory authorities allows those organizations to both enforce the law and uphold professional standards. Those who report violations contribute to the integrity of the capital markets. Fair, efficient, and open markets attract investors and capital, thus contributing to the effective functioning of the economy.

Suggested Issues for Discussion Question 2:
All legal or regulatory investigations relating to a member's or a candidate's professional conduct should be reported to CFA Institute. Internal compliance or corporate investigations that do not relate to legal or regulatory violations need not be reported unless they involve the violation of any CFA Standard of Professional Conduct.

The Standards are in some circumstances more restrictive than local law and thus support CFA Institute's mission to "lead the investment profession globally by setting the highest standards of ethics." With the assistance of its membership and the investing public, CFA Institute can investigate and, when necessary, sanction members for failure to uphold these standards—even in situations where local law allows the conduct.

Reporting violations of either the law or the Standards helps CFA Institute ensure that its members are adhering to "the highest standards of ethics." The result is an enhanced reputation for every member.

Harvest Financial[6]

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

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

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

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

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

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

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

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

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

[6] This case was written by Dorothy C. Kelly, CFA.

program such as hers. Vanderon reads through the disclosure material provided by Klein and accepts his recommendation.

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

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

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

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

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

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

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1. When recommending Vanderon convert to a PlusAccount, does Klein violate any CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, because he does not have a reasonable basis.
   C. Yes, because the account is unsuitable for Vanderon.

2. When recommending Brown convert to a PlusAccount, does Klein violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to suitability.
   C. Yes, relating to reasonable basis.

3. When meeting with Vanderon, does Klein violate any CFA Standards?
   A. No.
   B. Yes, because he improperly references the CFA designation.
   C. Yes, because he claims enhanced portfolio management skills.

4. When recommending the mutual fund to Vanderon, does Klein violate any CFA Standards?
   A. No.
   B. Yes, relating to suitability.
   C. Yes, relating to referral fees.

5. In the eighteen months following Brown's change in financial situation, Klein is *least likely* to have violated the Standard relating to:
   A. loyalty, prudence, and care.
   B. diligence and reasonable basis.
   C. communication with clients and prospective clients.

6. In her supervisory duties, does Finnegan violate any CFA Standards?
   A. No.
   B. Yes, because she fails to ensure that compliance procedures are enforced.
   C. Yes, because she delegates supervisory authority to her assistant branch manager.

Khadri and Vinken[7]

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

Exhibit 1
Stonebridge Fund
Annual Returns

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

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

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

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

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

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[7] This case was written by David S. Krause, PhD, and Dorothy C. Kelly, CFA.

In the quarterly newsletter, Khadri makes the following statements:

1. “China’s pegging of the yuan to the U.S. dollar will end within the next 12 months which will lead to the yuan increasing in value by more than 40%, supporting our over-weighting of Chinese-related stocks in the Westlake Fund.”
2. “Increased geo-political uncertainty around the globe should keep oil prices above 3-year levels and supports our recommendation for an over-weighting of equities in the small-cap energy sector.”

Khadri also reports:

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

* Additional detailed information available upon request.”

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

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1. In his letter regarding the stock-selection model, does Vinken violate any CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, because he uses simulated performance results.
   C. Yes, because he claims that the new model will yield better performance results.

2. Are the record-retention policies of both Khadri and Vinken consistent with CFA Institute Standards?
   A. Yes.
   B. No, Khadri’s policy is not consistent.
   C. No, Vinken’s policy is not consistent.

3. Are Khadri’s statements regarding compliance with the Global Investment Performance Standards consistent with CFA Institute Standards?
   A. Yes.
   B. No, because Khadri may not claim partial compliance.
   C. No, because Khadri fails to disclose the areas of noncompliance.

4. Are Khadri’s statements in the quarterly newsletter consistent with CFA Institute Standards?
   A. Yes.
   B. No, because statement 1 is opinion, not fact.
   C. No, because statement 2 is opinion, not fact.

5. Are Khadri's newsletter comments regarding annual returns consistent with CFA Institute Standards?
   A. Yes.
   B. No, because Khadri used an inappropriate benchmark.
   C. No, because Khadri did not disclose whether the performance results are before or after fees.

6. When responding to the client complaint regarding Westlake's performance, Khadri *least likely* violates the Standard relating to:
   A. misconduct
   B. misrepresentation.
   C. performance presentation.

REFERENCES: Standard III (D), Performance Presentation, Standard V(B), Communication with Clients and Prospective Clients, and V(C), Record Retention

Omega Financial[8]

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

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

OTC Stocks in which Omega is a Market-Maker

Definitions:

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

Net Trade/Trade on a net basis: a principal transaction in which a market maker, after having received an order, executes the order at one price with another broker-dealer or another customer and then sells to (buys from) the customer at a different price.

Compliance Policies:

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

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

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

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

[8] This case was written by Dorothy C. Kelly, CFA.

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

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

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

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

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

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

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1. For a CFA charterholder, would adhering to Omega's policies regarding riskless principal transactions result in a violation of the CFA Institute Standards of Professional Conduct?
   A. No.
   B. Yes, because Omega disadvantages institutional clients.
   C. Yes, because disclosure of the policy does not relieve Omega of its obligation to treat clients equally.

2. When overseeing the development of the automated-trading system, does Brown violate any CFA Institute Standards?
   A. No.
   B. Yes, because he accepted an assignment for which he was inadequately trained and skilled.
   C. Yes, because he did not ensure that the final system complied with regulatory requirements.

3. With regard to Chen's trades in Xydeo, do the institutional and retail trades both comply with CFA Institute Standards?
   A. Only the retail trades comply.
   B. Only the institutional trades comply.
   C. Neither the retail nor the institutional trades comply.

4. When placing the morning phone call on speakerphone, does Smith violate any CFA Institute Standards?
   A. No.
   B. Yes, his duty to Omega.
   C. Yes, his duty to clients and to Omega.

5. When listening to the Omega squawk box, does Garcia violate any CFA Institute Standards?
   A. No.
   B. Yes, the standard regarding professionalism.
   C. Yes, the standard regarding material nonpublic information.

6. When shorting Tefla stock, does Garcia violate any CFA Institute Standards?
   A. No.
   B. Yes, because he does not have a reasonable basis for the trade.
   C. Yes, because he is in possession of material nonpublic information.

Discussion Questions:

1. What additional steps, if any, should Brown take to comply with his responsibilities as a supervisor?

2. What is meant by best execution? Why might factors other than price determine best execution?

3. When placing the large block trades for Garcia through the trading mechanism, does Smith violate any CFA Institute Standards?

Suggested Issues for Discussion Question 1:
Brown has responsibility for seeing that the trading system complies with all regulatory requirements. Thus, Brown should ensure that the compliance department remains involved in the development of the trading system through its completion. Software programmers do not understand, nor can they be expected to understand, the regulatory implications of their programming changes. Rather than oversee the changes himself, Brown could delegate the task to the compliance department.

Brown should establish procedures requiring the compliance department's approval of changes made by programmers. In addition, Brown could establish a procedure where compliance staff reviewed the comments embedded into the programming code to explain the purpose of particular codes and their intended functions.

Finally, Brown should require full-scale testing of the new software by the compliance department before changing to the new system. The tests should examine the system's ability to handle orders in compliance with current regulatory requirements.

Suggested Issues for Discussion Question 2:
Best execution does not necessarily mean best price. Rather, best execution refers to seeking the most favorable total cost for the client under the particular circumstances at that time. Standard considerations include evaluating the broker's financial responsibility, responsiveness, commission rate or spread involved, and the range of services offered.

In some cases, factors other than price may determine best execution. If market impact is a concern, speed of execution and likelihood of execution may take precedence. A higher quoted price may be offset by the diminished likelihood of executing the trade in a timely fashion.

Suggested Issues for Discussion Question 3:
Yes, when using the trading mechanism for the Garcia trades, Smith violates his duty of loyalty, prudence, and care for his client [Standard III(A)]. Omega has informed third-party brokers that their trades will receive best execution—not best price. While delaying portions of the trade may result in a better overall price, Garcia placed an order at the market and has an expectation that the order will be executed without delay.

Sebastian Riser[9]

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

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

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

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

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

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

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

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

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1. According to the CFA Institute Standards of Professional Conduct, before accepting the position on the board of the subsidiary, Riser should:
   A. receive verbal consent from Swibank.
   B. receive verbal consent from his clients.
   C. disclose to his employer the financial compensation proposed by the subsidiary.

[9] This case was written by Anne-Katrin Scherer, CFA.

2. When participating in the road shows in Switzerland, Riser *least likely* violates the Standard relating to:
   A. Disclosure of Conflicts.
   B. Independence and Objectivity.
   C. Additional Compensation Arrangements.

3. When recommending Komm, does Riser violate any CFA Institute Standards?
   A. No.
   B. Yes, relating to duties to employer.
   C. Yes, relating to disclosure of conflicts.

4. When resigning from Swibank, does Riser violate any CFA Institute Standards?
   A. No.
   B. Yes, because he breaches his duty of loyalty to his employer.
   C. Yes, because he does not resign his position with the Luxembourg subsidiary.

5. In his original purchase of 2,000 shares of the Japanese equity product, Riser *least likely* violates the Standard relating to:
   A. Suitability.
   B. Priority of Transactions.
   C. Integrity of Capital Markets.

6. According to CFA Institute Standards, Riser is not required to disclose to clients his:
   A. holdings of the Japanese equity product.
   B. relationship with the Swibank subsidiary.
   C. compensation from the Swibank subsidiary.

LEV Capital Management[10]
(Specific to Soft Dollars)

Portfolio manager Elsa Wirk, CFA, is a partner at LEV Capital Management, a long-only domestic equity manager. In addition to her portfolio management duties, Wirk is responsible for determining compliance with CFA Institute Soft Dollar Standards. In her morning mail, Wirk receives a notice that the local regulatory agency has issued a new rule about the use of client brokerage. According to the new rule, research to be paid with client brokerage "must include value-added analysis."

As part of her compliance duties, on a periodic basis Wirk evaluates the various brokers and research services used by LEV. Her assistant develops a worksheet of the brokerage firms' quoted commission rates for domestic stock trades. In addition, Wirk studies trading reports on each firm showing the average spread for all trades for each of the past 12 months and ranks the firms on an aggregate basis. Finally, Wirk evaluates research and other services available through soft dollars. Several firms offer proprietary and third-party research arrangements which LEV believes are valuable to the firm and its clients. Wirk polls staff members on the value of the services provided. After completing the research, Wirk develops a list of "preferred brokers" based on their commission structure, execution history, and research services. She instructs the firm's trading desk to direct trades to the preferred brokers whenever possible.

Babbit Financial is one of Wirk's preferred brokers. Babbit charges commissions of $0.05 per share and offers a variety of products and services including proprietary research. For firms that generate a minimum dollar amount of brokerage commissions, Babbit offers a subscription service that provides raw data feeds of historic price and economic information. Wirk is confident that the amount of brokerage directed to its preferred brokers will exceed the required minimum. LEV will be able to use the raw data feeds for research activities as well as valuing client portfolios.

Norton Investments, which recently launched a new hedge fund, is also a preferred broker. Norton charges commissions of $0.06 per share and provides third-party research including reports from Anderson Financial. Anderson produces excellent research in the area of derivatives and Wirk believes its reports will be useful to LEV in developing proprietary structured products.

Wirk is planning a meeting with a prospective client. The prospective client, a pension fund, requires that its advisers comply with CFA Institute Soft Dollar Standards. In preparation, Wirk sends the pension fund a packet containing the following information:

> **Soft Dollar Arrangements**
>
> LEV engages in soft dollar arrangements with brokers in which commission dollars generated by client trades pay for investment research and brokerage products and services. The commission paid to such brokers may be higher than the commission another broker would charge for the same transaction. The research purchased with brokerage benefits all clients and not only those whose trades generated the brokerage.
>
> LEV uses commissions on securities purchased or sold in client accounts to pay for the following services:

[10] This case was written by Sarah W. Peck, PhD, and Dorothy C. Kelly, CFA.

Research Provider	Broker	Description of Service
Alpha Financial	ABC	Stock market quotations and monitoring
Statbase	LMN	Statistical database
Mod-Allocator	ABC	Asset allocation modeling
Performance Analyst	PQR	Asset allocation backtesting

At the meeting, the pension fund trustees inform LEV that, by law, 20% of the fund's brokerage must be directed to three local minority-owned brokers. Wirk tells the pension fund board that "We have a fiduciary duty to seek best execution for all client trades. The requirement to commit 20% of brokerage to specific firms may affect our ability to seek and obtain best execution. It may also adversely affect our ability to obtain adequate research for the fund."

The trustees respond that they "will continue to increase diversity by using minority-owned brokers and to support the regional economy by using local brokers." They also inform Wirk that they have entered into commission recapture programs with all three minority-owned firms. The commission recapture programs provide the pension fund with cash rebates that the pension fund uses to pay certain administrative expenses.

Wirk replies that to comply with the trustees' request, she will need written instructions identifying the eligible brokers, the approximate target percentage to be directed to each, and procedures for monitoring the arrangements. The pension fund soon signs a contract with LEV naming Wirk as portfolio manager.

The following month, Wirk directs the trading desk to purchase 10,000 shares of a mid-capitalization stock for the pension fund. The trading desk has three choices. Babbit would execute the trade on a principal basis rather than charge its normal commission. Norton would charge its normal commission of $0.06 to execute the trade. Framer, an agency broker that is not on Wirk's list of preferred brokers, specializes in the stock and would charge a commission of $0.05 per share. The head trader believes that Framer will execute the shares with minimal market impact.

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1. Is directing brokerage to Wirk's preferred brokers consistent with both the required and recommended CFA Institute Soft Dollar Standards?
   A. Yes.
   B. Only if the preferred broker offers best execution.
   C. Only if the preferred broker offers research services of appropriate value.

2. According to the CFA Institute Soft Dollar Standards, is it permissible for Wirk to pay for some portion of Babbit's subscription service with client brokerage?
   A. Yes.
   B. No, because the service does not include value-added analysis.
   C. No, because the service requires a minimum dollar amount of transactions.

3. Is the purchase of Anderson reports with client brokerage consistent with both the required and recommended CFA Institute Soft Dollar Standards?
   A. Yes.
   B. No, because the reports are from a third-party.
   C. No, because the reports do not support the investment decision-making process.

4. Is the written information that Wirk provides to its potential client consistent with both the required and recommended CFA Institute Soft Dollar Standards?
   A. Yes.
   B. No, because it does not address whether trades generating brokerage involve transactions conducted on a principal basis.
   C. No, because it does not indicate that all soft dollar arrangements comply with the CFA Institute Soft Dollar Standards.

5. Are Wirk's oral statements about the pension fund's proposed directed brokerage arrangement consistent with both the required and recommended CFA Institute Soft Dollar Standards?
   A. Yes.
   B. No, because Wirk should disclose the information in writing.
   C. No, because Wirk was misrepresenting the facts—the arrangement will not affect Wirk's ability to obtain adequate research.

6. Are the written instructions that Wirk requests from the pension plan consistent with recommended practices of the CFA Institute Soft Dollar Standards?
   A. Yes.
   B. No, because Wirk should also request written instructions that relieve LEV of responsibility to seek best execution.
   C. No, because Wirk should also request written instructions that restate LEV's responsibility to seek best execution.

Discussion Questions:

1. Discuss the conflicts that can arise from the use of soft dollars.

2. Can Wirk accept the directed brokerage arrangement proposed by the pension fund and still comply with both the required and recommended CFA Institute Soft Dollar Standards? Discuss the problems that might arise from such a client-directed brokerage arrangement.

3. Assume that LEV uses some of Norton's third-party research in the decision-making process. What must the adviser consider before placing block trades with Norton?

4. Assume that you are LEV's trader and are obligated to comply with the CFA Soft Dollar Standards. With which broker would you likely to place the 10,000 share trade? Why?

Suggested Issues for Discussion Question 1:
The adviser may have a conflict of interest in directing client brokerage because the soft dollars generated by the client's trades can be used to purchase products and services that may benefit the advisor rather than the client. The products and services may include research reports and other information about specific companies or industries; economic surveys and analyses; recommendations of specific securities; financial publications; portfolio evaluation services; financial database software and services; computerized news, pricing, and order-entry services; quotation equipment; and other benefits. Using client brokerage to pay for these valuable products and services reduces costs for the adviser and may assist the adviser in procuring new

clients rather than benefit the client who generated the commission. Brokerage, including soft dollars, is the property of the client, yet the services and products obtained through soft dollars may benefit the advisor and other clients.

In soft dollar arrangements, advisers face a conflict between their interest in receiving research services and the client's interest in receiving the lowest total cost. To access valuable benefits, advisers may select a specific broker to execute client transactions—even when the commission or spread charged by that broker may be higher than the adviser might otherwise be able to negotiate for the client elsewhere. In addition, the desire to acquire additional benefits, particularly those that require a minimum amount of brokerage, may encourage advisers to trade more frequently than is optimal for the client.

Suggested Issues for Discussion Question 2:
Yes, Wirk can accept the directed brokerage arrangement proposed by the pension fund and still comply with both the required and recommended CFA Institute Soft Dollar Standards. Brokerage is an asset of the client, not the investment manager. As such, client-directed brokerage arrangements do not necessarily violate any investment manager duty or Soft Dollar Standards.

Clients and trustees should be aware that, as Wirk points out, such client-directed brokerage arrangements can affect the adviser's ability to obtain best execution and may negatively impact the performance of the fund. In addition, clients with client-directed brokerage arrangements may not have the same access to initial public offerings as the adviser's other clients.

In a client-directed brokerage arrangement, the broker has agreed to charge a specified commission but at the same time has agreed to rebate part of that commission or otherwise use part of the commission to benefit the customer directly. In these arrangements, the clients receive the products, services or cash rebates generated by their own commissions. These commissions may be used, for example, to pay consultant fees. Clients should beware that they do not pay more through the soft dollar arrangement than they would if they simply paid consultant fees in hard dollars. In addition, clients should inquire about referral fees and whether the consultant recommends advisers who then direct brokerage that pays the consultant referral fees.

As fiduciaries, pension plan trustees must use any services, products, and cash rebates from client-directed brokerage for the sole benefit of the plan beneficiaries rather than the trustees or the plan sponsor.

Finally, trustees must be aware of the potential conflict between their instructions and the adviser's fiduciary responsibility. Some advisers might ignore client-directed brokerage arrangements when they feel such arrangements conflict with their fiduciary responsibility to seek to obtain best execution.

Suggested Issues for Discussion Question 3:
First and foremost, the investment adviser must evaluate Norton's ability to provide best execution. Best execution refers to executing client transactions so that the client's total cost is the most favorable under the particular circumstances at that time. Standard considerations include evaluating the broker's financial responsibility, responsiveness, commission rate or spread involved, and the range of services offered by the broker. The adviser must also recognize that market impact may have a greater effect on total cost than the commission or spread charged by an individual broker.

Although Norton has a history of providing best execution, the trader should consider that Norton has recently launched a hedge fund and thus has a new conflict of interest. For example, Norton could use the information of LEV's block trade to its hedge fund's advantage (and the pension fund's detriment). Depending on the liquidity of the stock in question, the trader may seek to execute the trade through an agency broker or electronic crossing network that offers the necessary level of liquidity and anonymity to minimize market impact.

Suggested Issues for Discussion Question 4:
LEV has an ongoing duty to seek to obtain best execution. In evaluating a broker's capability to provide best execution, LEV should consider the commission rate or spread involved, the range of services offered by the broker, the broker's responsiveness and other components to obtain the most favorable total cost under the particular circumstances at that time. In this case, the trader must consider the spread charged by Babbit, the expected commissions charged by the other firms, and the expected market impact. If the minority-owned firm can offer best execution, the trader may direct the order in compliance with the pension fund's request. Note that in this case, Framer's commission structure is competitive and the trader believes that Framer will execute the trade with the least amount of market impact. Low market impact and a competitive commission structure will likely yield the most favorable total cost for the client.

Reference: "CFA Institute Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage" (CFA Institute, 2004)

Bornelli Asset Management[11]
(Specific to Asset Manager Code of Conduct)

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

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

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

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

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

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

[11] This case was written by Dorothy C. Kelly, CFA, and Anne-Katrin Scherer, CFA.

gains, unrealized appreciation, and net investment income from all securities held by the Fund.

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

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

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

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

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

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

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1. Are the three compliance procedures reviewed by Campanelli consistent with both the required and recommended standards of the CFA Institute Asset Manager Code of Professional Conduct?
   A. No, the procedures regarding record retention are inconsistent.
   B. No, the procedures regarding portfolio review are inconsistent.

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

2. Is Bornelli's disaster recovery plan consistent with both the required and recommended standards of the Asset Manager Code?
   A. Yes.
   B. No, because the plan lacks a backup plan for monitoring, analyzing and trading investments.
   C. No, because the plan only provides for contacting and communicating with clients during periods of extended disruption.

3. Are the firm's disclosures regarding management fees consistent with the required and recommended standards of the Asset Manager Code?
   A. Yes.
   B. No, because they do not use plain language.
   C. No, because they do not include the average or expected expenses or fees clients are likely to incur.

4. Are the performance reporting procedures described by the fund's administrator consistent with the required disclosure standards of the Asset Manager Code?
   A. Yes.
   B. No, because the AMC requires firms to report performance to all clients on a monthly basis.
   C. No, because the AMC requires firms to provide performance on a monthly basis when requested by clients.

5. To comply with both the required and recommended standards of the Asset Manager Code, must Bornelli honor Rossi's telephone request regarding an itemization of fees?
   A. Yes.
   B. No, because the firm is not required to disclose the amount of incentive fee charged to an individual client.
   C. No, because unless the firm claims compliance with the Soft Dollar Standards, it is not required to disclose the amount of commissions paid on clients' behalf.

6. Are the policies of the alternative assets fund consistent with the required and recommended standards of the Asset Manager Code?
   A. Yes.
   B. No, the frequency of reporting is inconsistent with the Code.
   C. No, the use of internal valuation models is inconsistent with the Code.

Discussion Questions:

1. What are the benefits and shortcomings of incentive fees such as Bornelli's for managers and investors? What, if any, conflicts or ethical dilemmas might arise from Bornelli's incentive fees? How might a firm deal with these conflicts?

2. What might explain the differences in Bornelli's valuations and those of the other management firm? Discuss the benefits and short-comings of the different valuations methodologies employed by Bornelli.

Suggested Issues for Discussion Question 1:
In theory, the most compelling benefit of incentive fees is that they help align the interests of clients and advisors. The better performance a manager provides a client, the higher the compensation received.

Properly designed incentive fees reward managers for superior performance, but not all performance-based fees are designed the same. Bornelli's incentive fee is calculated on a basis that includes unrealized capital gains. Its incentive fee may be higher than it would be if it were based solely on realized gains. Bornelli's incentive fee also lacks a hurdle rate or minimum benchmark return. Some clients prefer to reward only superior performance. They pay incentive fees that are calculated on the amount of return exceeding the benchmark.

Although they are often accepted as beneficial for aligning the interests of managers and clients, incentive fees also have shortcomings. The right to an incentive fee may induce Bornelli to select investments that are riskier than those it might select if it were paid only an asset-based management fee. The promise of an incentive fee could also give Bornelli an incentive to select a higher fair value for the fund's investments than it might otherwise. In Bornelli's case, the incentive fees are determined by year-end valuations, thus the firm could face a conflict when determining the valuation of portfolio holdings.

Firms charging incentive fees should disclose the conflicts that such performance-based fees may present including the incentive to invest in more speculative investments or select higher fair values for reporting purposes.

Suggested Issues for Discussion Question 2
Bornelli may be using a different pricing service or different valuation methodologies than the other management firm. Disclosure of valuation methods allows clients to compare performance and determine whether different valuation sources may explain differences in performance.

Bornelli's use of the last available closing price is generally accepted as an appropriate valuation for publicly traded securities, but the last available closing price does not always reflect current value. Foreign securities, for example, may be difficult to value during the domestic trading day (when the foreign market is closed). Infrequently traded micro-caps may also have out-of-date or stale prices.

Obtaining quotes from broker-dealers may help value certain holdings, but managers must work to obtain quotes that are fair and accurate rather than favorable prices (sometimes referred to as accommodation quotes) from friendly brokers.

The use of internal models to value certain holdings is acceptable when properly disclosed. Managers should employ widely accepted valuation methods and techniques, applying the models consistently and in good faith.

Changing market conditions may challenge the usefulness of certain methodologies and the accuracy of certain valuations. Disclosure of the methodologies by asset class provides clients with the information necessary to make asset allocation and other investment decisions.

SOLUTIONS

Acertado Solutions

1. C is correct. Boswin, as an employee, developed the model on behalf of Greenfield. Therefore, Greenfield, not Boswin, is the owner of the model. Acertado violates Standard IV(A) Duties to Employers: Loyalty when he downloads the model without proper written permission from Greenfield Financial. Acertado is misappropriating employer assets.

2. C is correct. Acertado is least likely to violate Standard II(A) regarding Material Nonpublic Information when using the model at Smith and Garner. Acertado likely violated Standard IV(A), Loyalty, when he used the model. The Standard prohibits members who leave an employer from taking records or files—such as the model—without the written permission of the employer. Acertado also likely violated Standard I(C) Misrepresentation when he failed to correct his supervisor's impression that the investment idea and the model were Acertado's creation.

3. C is correct. Acertado violates Standard II(A) Material Nonpublic Information. He has a reasonable belief that the conversation that he overhears is from a reliable source and would have a material impact on security prices. According to CFA Standards, he must not act, nor cause others to act on the information. Acertado does not violate the Standard relating to Diligence and Reasonable Basis because he bases the recommendation on a reliable model and checks his inputs prior to making the recommendation.

4. A is correct. Acertado least likely violates Standard III(C) which relates to suitability during his phone conversation with Boswin. According to the Standard, members in an advisory relationship with a client must determine an investment's suitability within the context of the client's portfolio. The Standard also requires that members make reasonable inquiries into a client or prospective client's investment experience; risk and return objectives; and financial constraints prior to making investment recommendations. Boswin is neither a client nor a prospective client, thus Acertado is not bound by the Standard of Suitability during their conversation. Acertado is, however, in jeopardy of violating other Standards—specifically those relating to Integrity of Capital Markets and Preservation of Confidentiality by revealing material nonpublic information about a Smith & Garner client. According to Standard II(A), Acertado, who is in possession of material nonpublic information, must not act, nor cause others to act on the information. According to Standard III(E), members must keep information about current, former, and prospective clients confidential.

5. A is correct. Boswin uses her usual process in researching Country Industries. She is not in possession of material nonpublic information and she maintains her objectivity. Her use of the model provides a reasonable basis for the decision not to pursue additional research or make an investment recommendation regarding Country Industries.

6. A is correct. Blogs and company websites are in the public domain and thus do not constitute inside information. Acertado's use of blog sites to supplement his current research process is acceptable.

Apfelbaum Kapital Solutions

1. B is correct. The CFA logo is a certification mark intended to identify individual charterholders and may not be incorporated into a company's name or logo. Standard VII(B) indicates that the use of the CFA logo is appropriate on the business card or letterhead of an individual CFA charterholder.

2. A is correct. Grohl exercised diligence, independence, and thoroughness in analyzing the company and its competitors. Brecksen provided his research reports for Grohl's use and using the reports as a guide was appropriate. Standard V(A) requires that members distinguish between fact and opinion in communicating investment recommendations to clients. The Standard does not apply to investment recommendations communicated to supervisors or internal investment committees.

3. A is correct. Brecksen does not consider the multi-factor analysis a critical component of the analysis or the resulting investment recommendation and thus, under Standards V(A) and (C), is not required to maintain a record of the analysis within the completed report.

   Apfelbaum uses traditional "top-down" fundamental analysis in the investment process. The report followed the traditional format of previous reports on the same company. It contained a complete fundamental analysis and recommendation—indicating diligence and reasonable basis. The report also contained a multi-factor analysis—which is a quantitative analysis tool. If quantitative analysis were the basis of the investment recommendation, it would constitute a change in the general investment principles used by the firm. According to Standard V(B) Communications with Clients and Prospective Clients, Brecksen and Grohl would be required to promptly disclose those changes to clients and prospective clients.

4. A is correct. Removing the multi-factor analysis from the research report does not constitute a violation. Grohl diligently prepared the internal document according to the firm's traditional format with a complete fundamental analysis and recommendation—indicating diligence and a reasonable basis for his recommendation. It would be wise for Grohl to retain records of the multi-factor analysis but he need not retain the analysis in the research report to comply with Standards V(A) Diligence and Reasonable Basis or V(C) Record Retention.

5. A is correct. According to Standard V(A) Diligence and Reasonable Basis, research report conclusions or recommendations may represent the consensus of a group and not necessarily the views of the individual members listed. If the member believes that the consensus opinion has a reasonable basis, then he need not dissociate from the report.

6. B is correct. Zardt violated the Standard relating to Performance Presentation because he did not verify the accuracy of the return information before its distribution. According to Standard III(D), analysts may promote the success or accuracy of their recommendations, but they must make reasonable efforts to ensure that the information is fair, accurate, and complete. In addition to providing attribution, Zardt should take steps to ensure the accuracy of the data prior to distributing the material.

Telline Solutions

1. B is correct. Telline has a duty to preserve the confidentiality of current, former, and prospective clients. Telline violates Standard III (E) Preservation of Confidentiality when he reveals that the firm managed the assets of Leighton Family Trust.

2. A is correct. Brown conducts an independent and careful analysis of the plans' benefits for shareholders as well as the takeover offer. In doing so she puts the client's interests ahead of the firm's. Brown's actions are consistent with Standard III (A) Loyalty, Prudence, and Care; Standard V (A) Diligence and Reasonable Basis; and Standard III (B) Fair Dealing.

3. B is correct. Telline is not likely to receive appropriate guidance on developing or revising investment policy statements from the Standard relating to Fair Dealing. Standard III(B) provides members with guidance on treating clients fairly when making investment recommendations, providing investment analysis, or taking investment action. Telline could obtain guidance from the Standards relating to Loyalty, Prudence, and Care and Suitability. Both Standard III(A) and (C) provide guidance for members in determining client objectives and the suitability of investments.

4. A is correct. Telline determines that the other client does not have the cash available in his account and selling existing holdings does not make sense. Moreover, Telline is careful to consider the investment's suitability for Caper's account. Telline's actions are consistent with CFA Institute Standards III (A) Loyalty, Prudence, and Care and III(B) Fair Dealing.

5. B is correct. The firm violates Standard III(B) Fair Dealing. Under Aiklin's policy, some clients for whom an IPO is suitable may not receive their pro-rata share of the issue. CFA Standards recommend that firms allocate IPOs on a pro-rata basis to clients, not to portfolio managers.

6. C is correct. Telline violates Standard III (B) Fair Dealing by over-allocating shares to Caper. Telline carefully reviews both the proposed IPO and his client accounts to determine suitability. He fails to allocate the IPO shares on a pro-rata basis to all clients for whom the investment is suitable.

Voser Solutions

1. B is correct. Excerpt 2 is inconsistent with CFA Standards because it addresses only officers and only their direct reports, that is, employees whom they directly supervise. Standard IV (C) states that "any investment professionals who have employees subject to their control or influence" exercise supervisory responsibility. According to *The Standards of Practice Handbook*, "members and candidates who supervise large numbers of employees cannot personally evaluate the conduct of their employees on a continuing basis. Although these members…may delegate supervisory duties, such delegation does not relieve them of their supervisory responsibility." Excerpt 3 is consistent with CFA Standards. It is based on a quote from the *Standards of Practice Handbook* stating that "if a member or candidate determines that information is material, the member... should make reasonable efforts to achieve public dissemination." Members are not required to achieve public dissemination and those bound by a duty of loyalty or a duty to preserve confidentiality would refrain from doing so because it would breach their duty.

2. A is correct. According to Standard I (B) Independence and Objectivity, members must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Although it was sent to Voser's office, the gift basket is a private gift from Voser's sister and not likely to affect Voser's professional activities. According to Excerpt 4 of the Crawfood compliance manual and Standard IV (B) Additional Compensation Arrangements, employees must obtain permission from their employer before accepting gifts, compensation, or other benefits that compete with, or might create a conflict of interest with, the employer's interests. The gift basket does not create a conflict or compete with the employer's interests.

3. A is correct. Voser most likely violated the Standard relating to loyalty to employer, Standard IV(A). While Voser used public information to develop the recommendation to purchase Greenhornfood shares, the company compliance guide states that she should not trade or cause others to trade in securities of companies that may be potential takeover targets. Voser's recommendation caused her sister to trade in Greenhornfood, violating the company's compliance policies, and possibly harming her employer in its attempt to acquire Greenhornfood.

   By advising others to invest in a food retailer that she considered an attractive acquisition target, Voser deprived her employer of the advantage of her skills and abilities and may have caused harm to her employer. Voser could have recommended Greenhornfood to Craw rather than her sister as an acquisition target. Although the sister's trade in Greenhornfood was small, a large trade might have moved the stock price and caused harm to Crawfood in terms of additional cost.

4. C is correct. Voser least likely violated the Standard relating to diligence and reasonable basis. Voser initially applied the mosaic theory and had a reasonable basis for the trade as required by Standard V(A). Eventually, she came into possession of material nonpublic information (corporate logo on a document, overheard conversation). According to Standard II(A), once in possession of material nonpublic information, she is prohibited from acting or causing others to act. Voser also violated her duty of loyalty to her employer, Standard IV(A), by encouraging others to trade in Greenhornfood and possibly harming Crawfood's attempts to acquire the smaller company at an attractive price.

5. C is correct. Craw did not adequately fulfill his responsibilities as a supervisor. While he may have delegated supervisory duties to Voser's immediate supervisor, such delegation does not relieve him of his supervisory responsibility. As stated in the *Standards of Practice Handbook*, members and candidates with supervisory responsibility also must understand what constitutes an adequate compliance system for their firms and make reasonable efforts to see that appropriate compliance procedures are established, documented, communicated to covered personnel, and followed. "Adequate" procedures are those designed to meet industry standards, regulatory requirements, the requirements of the Code and Standards, and the circumstances of the firm. Once compliance procedures are established, the supervisor must also make reasonable efforts to ensure that the procedures are monitored and enforced. According to Standard IV (C) Responsibilities of Supervisors, adequate compliance procedures require that once a violation is discovered, Craw conduct a thorough investigation to determine the scope of wrongdoing.

6. A is correct. As stated on page ix of the *Standards of Practice Handbook,* "Members and candidates must self disclose on the annual Professional Conduct Statement all matters that question their professional conduct, such as involvement in civil litigation, a criminal investigation, or being the subject of a written complaint." Standard VII (A) Conduct as Members and Candidates in the CFA Program prohibits conduct that compromises the reputation of the CFA Designation including misrepresenting information on the Professional Conduct Statement. Members are encouraged but not required to report violations of others. At a minimum, Craw should remind Voser of her duty to report the investigation.

Harvest Financial Solutions

1. A is correct. Klein does not violate CFA Standards of Professional Conduct when recommending a PlusAccount to Vanderon. His actions comply with Standard III(A) Loyalty, Prudence, and Care; Standard III(C) Suitability; and Standard V(A) Diligence and Reasonable Basis. As required, Klein discloses the fee structure associated with the PlusAccount. Based on the fee structure and Vanderon's trading activity, the PlusAccount appears to be a suitable investment vehicle. By converting to PlusAccount status, Vanderon will incur an annual fee of $1,000 and eliminate approximately $1,800 in annual brokerage commissions. The potential savings of approximately $800 provides a reasonable basis for recommending PlusAccount status.

2. A is correct. Klein does not violate CFA Standards when recommending a PlusAccount to Brown. His actions comply with Standard III(A) Loyalty, Prudence, and Care; Standard III(C) Suitability; and Standard V(A) Diligence and Reasonable Basis. As required, he discloses the fee structure. Based on the fee structure and Brown's annual commissions, the PlusAccount appears to be a suitable investment vehicle. By converting to PlusAccount status, Brown will incur an annual fee of $5,750 and save approximately $6,400 in annual brokerage commissions. The potential savings of approximately $650 provides a reasonable basis for recommending PlusAccount status.

3. B is correct. Klein improperly references the CFA designation when he states "As a CFA charterholder, I am the best qualified to manage your investments." He is in violation of Standard VII (B), Reference to CFA Institute, the CFA Designation, and the CFA Program.

4. C is correct. Klein violates Standard VI (C) relating to Referral Fees because he fails to provide appropriate disclosure. The Standard states that members must disclose the nature of the consideration or benefit—for example, whether flat fee or percentage basis; one-time or continuing benefit; based on performance—together with the estimated dollar value. Although Klein acknowledges receipt of referral fees from the fund, he does not disclose an estimated dollar value or the nature of the consideration.

5. C is correct. In the months following Brown's change in financial status, Klein is least likely to violate Standard V(B) relating to communication with clients because he disclosed the basic format and other pertinent information regarding PlusAccounts and he distinguished between fact and opinions. During the time period, Klein does not make any new recommendations to Brown and thus is least likely to violate the Standard relating to Communication with Clients and Prospective Clients. During the period, Klein is in jeopardy of violating several other standards including those relating to Loyalty, Prudence, and Care; Suitability; and Diligence and Reasonable Basis. Because of the fee structure, PlusAccount status is not suitable for a client who trades infrequently. Klein neglects his duty of loyalty, prudence, and care by maintaining the PlusAccount Status for more than one year after Brown's change in trading activity. A diligent review of the account would indicate whether a client has a reasonable basis for maintaining PlusAccount status. Thus, Klein is most likely to violate Standards III(A), III(C), and V(A) during the period in question.

6. B is correct. Finnegan violates Standard IV (C), Responsibilities of Supervisors, by failing to ensure that compliance procedures are enforced. As she informed her staff, Harvest "must

review each account on an annual basis to determine whether PlusAccount status remains appropriate." Had Brown's account been reviewed annually in accordance with compliance procedures, it would have been clear that the PlusAccount was no longer suitable for Brown. Delegating supervisory authority to another individual does not violate the Standards.

Khadri Solutions

1. A is correct. Vinken does not violate any CFA Standards of Professional Conduct in his letter. In accordance with Standard III(D) Performance Presentation, he presents fair, accurate, and complete information when he identifies actual and simulated performance results. Also in accordance with the Standard, he does not guarantee superior future investment returns. In accordance with Standard V(B) Communication with Clients and Prospective Clients, Vinken describes to his clients and prospective clients the process and logic of the new investment model. By providing the basic details of the model, Vinken provides his clients the basis for understanding the limitations or inherent risks of the investment strategy.

2. A is correct. The policies of both Khadri and Vinken are consistent with Standard V(C), Record Retention, which states that members and candidates must develop and maintain appropriate records to support their investment analyses, recommendation, actions, performance and other communications with clients and prospective clients. The records required to support recommendations and/or investment actions depend on the role of the member or candidate in the investment decision-making process. Records can be maintained either in hard copy or electronic form. Even though they use different methods, Khadri and Vinken each maintain the appropriate records and have adequate systems of record control.

3. B is correct. Khadri is in violation of Standard III(D). When claiming compliance with GIPS, firms must meet all the requirements. GIPS standards, while voluntary, only apply on a firm-wide basis. Neither a firm nor a fund can claim partial compliance with GIPS standards.

4. B is correct. Standard V(B), Communications with Clients and Prospective Clients, requires the member or candidate to separate and distinguish "facts from opinions" in the presentation of analyses and investment recommendations. Statement 1 in the newsletter states that "China's pegging of the yuan to the US dollar *will* end within the next 12 months which *will* lead to the yuan increasing in value by over 40%, supporting our over-weighting of Chinese-related stocks in the portfolio," Khadri does not clearly differentiate between opinion and fact. The statement about the future of oil pricing is not as questionable because Khadri uses the term **"**should**"** which helps clients understand that this is an opinion and not a certainty. Members may communicate opinions, estimates, and assumptions about future values and possible events but they must take care to differentiate fact from opinion.

5. C is correct. Khadri violates the Standard relating to Performance Presentation because he does not disclose whether the performance results are before or after fees. Standard III(D) requires that members make reasonable efforts to ensure that investment performance information is "fair, accurate, and complete." According to the guidance provided in the *Standards of Practice Handbook*, members should include disclosures that fully explain the performance results (for example, whether the performance is gross of fees, net of fees, or after tax).

6. C is correct. As Khadri provides the corrected information in her letter to the client, she is least likely to violate the Standard relating to performance presentation. She is more likely to violate the Standards relating to Misconduct and Misrepresentation because she knowingly misrepresents the cause of the error. Standard I(D) Misconduct requires that members not

engage in any professional conduct involving dishonesty. Standard I(C) prohibits members from knowingly making any misrepresentation relating to investment actions and professional activities.

Omega Solutions

1. A is correct. Mark-ups and mark-downs in net trades are considered fees paid by clients. Standard III(B), Fair Dealing, requires that members treat all clients fairly in light of their investment objectives and circumstances. Treating institutional and retail investors differently is not a violation. According to the Standards, members can differentiate their services to clients but different levels of service must be disclosed and should not negatively affect clients. Omega has made the appropriate disclosures to its clients in compliance with legal and regulatory requirements as well as the Standards.

2. C is correct. Brown is in violation of Standard IV(C), Responsibilities of Supervisors, because he did not ensure that the final system complied with regulatory requirements. According to the Standard, Brown has a responsibility to make reasonable efforts to detect and prevent violations of applicable laws, rules, and regulations. Alerted to potential problems by the compliance department, he had a responsibility to ensure that the modifications corrected the potential problems without introducing new problems.

3. B is correct. Only the institutional trades comply with CFA Institute Standards. All the trades were processed on a net basis. Because the firm disclosed that institutional orders may be executed on a net basis, the institutional trades did not result in a violation. The firm disclosed to clients that in riskless principal trades, retail clients will receive the same execution price without mark-up. Executing the retail orders on a net basis with a $.01 mark-up resulted in a violation of Standards I(C) and III(B) relating to misrepresentation and fair dealing.

4. C is correct. Smith violated his duties to both clients and Omega by not protecting confidential information. By providing Garcia access to confidential information such as changes in recommendations and information regarding block trades, Smith provided Garcia the opportunity to front-run, which could cause harm to both Omega and its clients. Thus, Smith's actions violate his duty of loyalty, prudence, and care to his clients and his duty of loyalty to his employer, Standards III(A) and IV(A), respectively.

5. B is correct. Garcia violated the Standard of Professionalism by engaging in eavesdropping on confidential information including changes in analyst recommendations and pending block trades. According to Standard I(D) members must not engage in professional conduct involving dishonesty, deceit, or fraud or commit any act that reflects adversely on their professional reputation, integrity, or competence. Garcia engages in deceitful conduct in obtaining information from the squawk box. His actions reflect adversely on his professional reputation and integrity and thus violate Standard I(D). Garcia is not in violation of Standard II(A), Material Nonpublic Information, although he listens to the material nonpublic information on pending block trades. Possession of such material nonpublic information is not a violation of the Standard, which prohibits acting on the information.

6. C is correct. Garcia is in possession of material nonpublic information and acted on it in violation of Standard II(A). After the analyst's recommendation has been issued and/or distributed publicly, Garcia would be free to make the trade.

Sebastian/Riser Solutions

1. C is correct. According to Standard IV (B), members must not accept compensation that competes with their employers' interest unless they obtain written consent from all parties involved. Thus Riser must receive written, not verbal, consent from his employer before accepting the position on the subsidiary's board. According to the recommended procedures for compliance, Riser should make an immediate written report to his employer specifying the terms of the agreement; the nature of the compensation; the approximate amount of the compensation; and the duration of the agreement. The Standards do not require that members receive permission from clients before accepting board positions.

2. C is correct. Riser least likely violates Standard IV(B) Additional Compensation Arrangements when participating in the road shows. The Standard provides guidance regarding the acceptance and disclosure of compensation that might conflict with an employer's interests. Participating in the road shows and receiving compensation from the subsidiary do not appear to conflict with his employer's interests.

   When participating in the road shows, Riser may violate Standards I(B) Independence and Objectivity and VI(A) Disclosure of Conflicts. The Standard relating to Independence and Objectivity requires that members use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Riser's role as board member could jeopardize his objectivity and create a conflict of interest. Standard VI (A) Disclosure of Conflicts requires that members make full and fair disclosure of all matters that could reasonably be expected to impair the independence and objectivity or interfere with respective duties to the clients, and prospective clients. Full disclosure allows clients to judge motives and possible biases for themselves. Riser does not appear to make adequate disclosure.

3. A is correct. No violation occurred. Riser's recommendation is based on his knowledge of Komm and the firm's "well-managed proprietary funds." He does not have a conflict when he makes the recommendation.

4. A is correct. No violation occurred. Riser is not required to resign his position with the subsidiary. Riser did not engage in any activities that would conflict with his employer's interest before his resignation became effective.

5. A is correct. Riser least likely violates Standard III(C) relating to suitability when purchasing shares for his own account. Riser may violate Standard II (A) Material Nonpublic Information and possibly Standard VI (B) Priority of Transactions when making the purchase. If, when trading for his own account, Riser knows that he will place a large block trade for Komm clients, he may be in possession of material nonpublic information. Standard VI (B) covers the activities of all members who have knowledge of pending transactions that may be made on behalf of their clients or employers. Riser has accepted the position of managing partner, has recommended the manager for the product, and knows, or should know, that he will purchase the product for at least some Komm clients once he begins work at Komm. His purchase ahead of Komm's clients might be front-running. Best practice would be to delay his private account purchase until after he purchases shares for clients.

6. C is correct. Standard VI(A) Disclosure of Conflicts requires that members and candidates make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and their employer. Riser's holdings of the Japanese equity product and his position on the board of the subsidiary could impair his objectivity and must be disclosed to clients. He need not disclose his compensation from the subsidiary because it is not a referral fee.

LEV Solutions

1. B is correct. According to the general principles of the CFA Institute Soft Dollar Standards, LEV has an ongoing duty to ensure the quality of transactions made on its behalf including seeking to obtain best execution.

2. B is correct. Compliance with the Soft Dollar Standards does not absolve Wirk of her responsibility to comply fully with applicable law. According to the local regulatory authority, permissible research must include value-added analysis. Raw data feeds of historical prices would not qualify as permissible research according to the regulatory agency's rules.

3. C is correct. According to the Standards, research paid by client brokerage must directly assist the investment manager in investment decision-making. Anderson's research on structured products will not assist LEV, a long-only domestic equity manager, in its current investment decision-making, but more likely will benefit new product development.

4. B is correct. The Standards require that an investment manager disclose its policies with respect to soft dollar arrangements to both clients and potential clients. The disclosure must address whether trades generating brokerage involve transactions conducted on a principal basis.

5. A is correct. In cases of client-directed brokerage, the Standards recommend that the manager disclose its duty to continue to seek to obtain best execution; that the client-directed brokerage arrangement may affect the manager's ability to seek to obtain best execution.

6. C is correct. In a client-directed brokerage arrangement, the Standards recommend that investment managers request written instructions that restate the manager's continuing responsibility to seek to obtain best execution.

Bornelli Solutions

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

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

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

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

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

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