Standards of Professional Conduct & Guidance: Integrity of Capital Markets

Test ID: 7440144

Question #1 of 23

Question ID: 412379

Regarding non-public information, which one of the following statements is NOT correct?

✗ **A)** **Disclosing material non-public information would have an impact on the price of a security or be of interest to a reasonable investor.**

✗ **B)** An analyst may use some types of non-public information.

✓ **C)** A member can be summarily suspended for having received material non-public information.

Explanation

All of these are true except that a member can be suspended for having received material non-public information. The member can receive such information as part of their regular duties or by accident. Neither is punishable in and of itself, and penalties only apply if the member trades or causes others to trade on the information. The member may have certain duties, such as trying to disseminate the information after receiving it. An analyst may use *nonmaterial* non-public information.

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Question ID: 412374

The term "material" in the phrase "material nonpublic information" refers to information that is likely to affect significantly the market price of the issuing company's securities or that:

✗ **A)** **is acquired by the financial analyst from a special or confidential relationship with the issuing company.**

✓ **B)** is likely to be considered important by reasonable investors in determining whether to trade a particular security.

✗ **C)** is derived by the financial analyst from direct communication with an issuing company's management.

Explanation

An item of information is material if its disclosure would be likely to have an impact on the price of a security, or if reasonable investors would want to know the information before investing.

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Question ID: 412400

Steve Waters, a CFA Level I candidate, has decided to enter into a long position of Farmco stock. Since Farmco is thinly traded, Waters is concerned the order will overwhelm the liquidity of Farmco and the price will surge. Waters engages in a series of block trades in order to accomplish the purchase. According to Standard II(B), Market Manipulation, Waters has engaged in:

✗ **A)** **both transaction-based manipulation and information-based manipulation.**

✗ **B)** transaction-based manipulation, but not information-based manipulation.

✓ **C)** neither transaction-based manipulation nor information-based manipulation.

Explanation

Waters is not in violation of Standard II(B), Market Manipulation. Transaction-based manipulation includes, but is not limited to, transactions that artificially distort prices or volume. Information-based manipulation includes, but is not limited to, spreading false rumors about a firm in order to induce others to trade.

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Question ID: 412372

Which of the following statements regarding Standard II(A), Material, Nonpublic Information, is *least* accurate?

✗ **A)** **Material, non-public information regarding a tender offer may not be traded on.**

✓ **B)** Information received from an insider who is not breaching his fiduciary responsibility may be traded on.

✗ **C)** If you receive the information in a public forum, it has been disseminated, and you can trade on it.

Explanation

If the information is material and nonpublic, the Member or Candidate cannot trade or cause others to trade. It does not matter if the insider did not breach his fiduciary responsibility. The inside information is still material and nonpublic.

Questions #5-10 of 23

Hunter Harrison, CFA, is president and chief investment officer (CIO) of Ironclad Investments, an investment adviser and pension consultant for medium and large corporate pension clients. Ironclad recently hired a compliance officer to update its compliance manual, which follows the CFA Institute Code and Standards. Harrison serves as a director on several non-profit and corporate boards of directors, some of which have their pension assets managed by Ironclad. Harrison oversees Ironclad's research analysts and portfolio managers, including Michelle Myers, who passed Level II of the CFA examination last year and plans to sign up for next year's Level III exam as soon as registration opens. Myers is a portfolio manager who regularly meets with clients and prospects. Myers is also a partner in a software company that sells retirement and benefit administration services to institutional clients, some of which are also clients of Ironclad. During her correspondence with prospects and clients, Myers includes reference to her status as a "Level III CFA candidate" in her biographical background to increase her prominence in the industry.

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Question ID: 461175

Regarding Myers' references of her status as a candidate in the CFA program, what Standard governs these actions and is she in compliance?

✗ **A)** **Standard I: Professionalism. Compliance: No.**

✗ **B)** **Standard III**: Duties to Clients. **Compliance**: No.

✓ **C)** **Standard VII**: Responsibilities as a CFA Member or CFA Candidate. **Compliance**: No.

Explanation

The actions of Myers are covered under Standard (VII)-Responsibilities as a CFA Member or CFA Candidate. Standard VII(B)-Reference to CFA Institute, the CFA designation, and the CFA Program requires that CFA candidates appropriately reference their participation in the CFA program, clearly stating their candidate status and not implying the achievement of any type of partial designation. Importantly, to be considered a candidate an individual must be registered to take the next scheduled exam. (Study Session 1, LOS 2.a,b)

Question #6 of 23

Question ID: 461176

All of the following *most likely* apply to Myers' participation as a partner in the software company EXCEPT:

✓ **A)** **Standard IV (B.4)-Priority of Transactions.**

✗ **B)** Standard III (C)-Disclosure of Conflicts to Employer.

✗ **C)** Standard IV (B.5)-Preservation of Confidentiality.

Explanation

Standard VI(B)-Priority of Transactions *most likely* does not apply to Myers' participation in the software company. Standard VI(B) covers priority over transactions in securities or other investments for clients and employers to prevent any instances of "front-running" for the benefit of the member. Myers' software business is not transaction-oriented, and there is no information that describes any instances of the software company having priority in securities transactions over Ironclad or its clients. (Study Session 1, LOS 2.a,b)

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Question ID: 461177

As part of Ironclad's portfolio management activities on behalf of clients, Harrison and Myers maintain relationships with third party soft dollar providers and commission recapture brokers.

- Better Trading Brokerage ("Better Trading"), one of Ironclad's top ten brokers and soft dollar providers, has offered Harrison two round-trip airline tickets anywhere in the U.S. in appreciation for their two-year relationship with Ironclad.
- One of Harrison's clients, Worldwind Travel ("Worldwind"), who participates in commission recapture, has offered Harrison two round-trip airline tickets anywhere in the U.S. or Europe in appreciation for their two-year relationship with Ironclad.

Which of the following *best* describes Harrison's actions under the Code and Standards? Harrison:

✗ **A)** **can accept the offer from both Better Trading and Worldwind.**

✗ **B)** cannot accept the offer from either Better Trading or Worldwind.

✓ **C)** can accept the offer from Worldwind, but cannot accept the offer from Better Trading.

Explanation

Subject to additional disclosure, Harrison can accept the offer from Worldwind, but cannot accept the offer from Better Trading. Harrison's actions are covered by Standard I(B)-Independence and Objectivity. Under Standard I(B), members shall use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. As such, Harrison's acceptance of the offer from Better Trading could be perceived to compromise his independence and objectivity on behalf of his clients, as the broker may be trying to influence Harrison to increase the amount of trading that Ironclad executes on behalf of clients. Since Better Trading is not a client of Ironclad, and its offer could negatively influence Harrison's actions on behalf of Ironclad's clients in violation of the Standard, the offer should be refused. The offer from Worldwind, who is one of Ironclad's clients, if accepted, does not cause Harrison to violate Standard I(B). Gifts from clients are distinguishable from gifts from third parties seeking to influence the activities of an investment manager. Worldwind's offer to Harrison may be accepted, provided it is disclosed to Ironclad in writing as additional compensation or benefits. Standard IV(B)-Additional Compensation Arrangements requires members to disclose in writing any additional compensation or other benefits received for their services in addition those provided by their employer. Harrison is obligated to disclose the offer and abide by any further requirements set forth by Ironclad prior to accepting the tickets. (Study Session 1, LOS 2.a,b)

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Question ID: 472457

Myers has disclosed her partnership interest in the software company to Harrison, including the potential for additional compensation and the possible conflicts of interest.

- One of Myers' software clients, Breakthrough Pharmaceuticals ("Breakthrough"), is a publicly-traded corporation that is also held in portfolios of Ironclad's clients. In the course of their business relationship, Breakthrough's chief executive officer (CEO) informs Myers that the company has been experiencing problems making retirement benefit payments, and its pension plan has recently gone from "overfunded" to "significantly underfunded" as a result of market conditions.
- Breakthrough's CEO indicates to Myers that he is attempting to source additional short-term financing to make retiree benefit payments and will disclose the significant "underfunded status" of the pension plan in the upcoming financial statements.
- Myers, concerned about Ironclad clients holding stock of Breakthrough given the impact on earnings from the current pension troubles and short-term liquidity issues, informs Harrison of the impending disclosure.
- Ironclad sells 1,800,000 shares of Breakthrough for clients, causing the price to drop $4 per share.
- Upon disclosure of the pension troubles, Breakthrough's stock dropped 18%.

According to Standard II-Integrity of Capital Markets, Myers has:

✗ **A)** **not violated the Standard by sharing information with Harrison because the information did not involve a tender offer.**

✓ **B)** violated the Standard.

✗ **C)** not violated the Standard since the information shared with Harrison was used to fulfill Ironclad's fiduciary duty to avoid significant losses.

Explanation

Although the information shared by Myers may have helped Ironclad's clients avoid losses in shares of Breakthrough, the information was material nonpublic information. In this example, Myers' software company owes a duty of loyal and confidentiality to Breakthrough. Information is "material" if its disclosure would have an impact on the stock or if a reasonable investor would want to know the information prior to making an investment decision. Material is "nonpublic" until it has been generally disseminated to the marketplace and investors have had an opportunity to react to the information. The information about Breakthrough's pension difficulties was both material and nonpublic, as the stock dropped significantly upon disclosure of the information in the market. Therefore, Myers had a duty to keep the information confidential and not to trade, or cause others to trade, on the information. (Study Session 1, LOS 2.a,b)

Question #9 of 23

Question ID: 461179

Ironclad owns shares in several research and technology companies, including approximately 4% of the outstanding shares of Advanced DSL ("Advanced"), Internet Connections ("Internet"), and approximately 6% of the outstanding shares of Speedy Chip Technology ("Speedy Chip") and Wavelength Digital ("Wavelength").

- Harrison serves on the board of directors for Internet and Wavelength, while Myers provides consulting services for Speedy Chip. Harrison receives cash compensation and stock options for his services, while Myers receives restricted stock and stock options.
- The investment bank that led the public offering of Internet and Speedy Chip and seven of nine sell-side analysts covering the companies have "sell" ratings on the stocks. Ironclad's analysts have also issued "sell" recommendations on the

companies due to lack of earnings transparency and quality of earnings, among other issues.
- Harrison increases his position in both Internet and Wavelength citing "growth opportunities" and "consensus opinion."

Which of the following Standards were *least likely* violated by Harrison and Myers?

- ✗ **A) Standard III(A)-Loyalty, Prudence, and Care.**
- ✗ **B)** Standard IV(B)-Additional Compensation Arrangements.
- ✓ **C)** Standard II(A)-Material Nonpublic Information.

Explanation

Standard II(A)-Material Nonpublic Information is least likely to apply to both Harrison and Myers in this situation. Given Harrison's role on the boards of directors for Internet and Wavelength, he is in the position to potentially receive material nonpublic information; however, there are no facts presented that would infer that he either received or used material nonpublic information about Internet or Wavelength. Myers, as a benefits consultant for Speedy Chip, also may be in a position receive to material nonpublic information, but there are no facts presented that would infer Myers' receipt or use of material nonpublic information. (Study Session 1, LOS 2.a,b)

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Question ID: 461180

Harrison, as CIO, is chairman of Ironclad's proxy voting committee, while Myers is a voting member. Ironclad, as a discretionary investment manager, votes proxies on behalf of clients.

- Ironclad is currently reviewing proxies for several companies covered in research, including technology companies Advanced DSL ("Advanced"), Internet Connections ("Internet"), Speedy Chip Technology ("Speedy Chip") and Wavelength Digital ("Wavelength"), which have all presented the expensing of employee stock options for vote in their current proxies.
- Investment personnel of Ironclad recently participated in an industry forum in support of increased disclosure for company stock options, which Ironclad believes provides investors with a more accurate perspective of corporate earnings.
- Contrary to committee consensus, Harrison and Myers vote client proxies "against" the expensing of employee stock options for Internet, Wavelength and Speedy Chip.

All of the following describe Harrison's actions for compliance with the Code and Standards regarding proxy voting EXCEPT:

- ✗ **A) Harrison should vote in accordance with Ironclad's policy and coordinate major proxy issues across all client accounts.**
- ✓ **B)** Harrison should discard all proxies on behalf of Ironclad's clients when there is a conflict of interest.
- ✗ **C)** Harrison should maintain the confidentiality of voting information on behalf of Ironclad's clients.

Explanation

Proxy voting is a plan asset under ERISA and as such, is subject to the fiduciary duty obligations. Ironclad, as a discretionary investment manager, is responsible (unless otherwise stipulated in the client guidelines or agreement) for making informed and reasonable decisions regarding proxy voting on behalf of clients. Among other things, Ironclad should have a proxy voting policy and a process for identifying and reviewing major proxy issues for appropriate clients. Ironclad and Harrison also have an obligation to avoid conflicts of interest when voting proxies. Although Harrison has a conflict of interest in voting issues on behalf of Internet and Wavelength due to his role on their board of directors, proxies should not be discarded under any circumstances, as such action would constitute a breach of fiduciary duty. Harrison should abstain from voting on matters affecting Internet and Wavelength to avoid the appearance of a conflict of interest. Harrison should also ensure proper treatment of any confidential information received in his role on the respective boards of directors. Harrison should maintain confidentiality of voting information on behalf of clients and follow Ironclad's proxy voting policy, coordinating major proxy voting issues across all client accounts. (Study Session 1, LOS 2.a,b)

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Question ID: 412386

A stockbroker who is a CFA Institute member is called on the telephone by the CEO of a large company. The CEO asks to buy shares of the CEO's company for the accounts of the CEO's children. In the course of the conversation, the CEO says this will really pay off when the upcoming takeover goes through. The stockbroker checks her sources and finds no information about the takeover. In this case the broker should:

✗ **A) only execute the order in compliance with Standard III(A), Loyalty, Prudence, and Care. Since the client is buying the stock for the children, there is not a problem.**

✗ **B)** execute the order for all clients as required by Standard III(B), Fair Dealing.

✓ **C)** do neither of the actions listed here.

Explanation

Doing any of these actions would be a violation of Standard II(A), Material Nonpublic Information. Members and Candidates must not act or induce others to act on material nonpublic information.

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Question ID: 461172

Carl Weather, CFA, is the chief financial officer of Talbot Enterprises. Based on inside information about Talbot's favorable prospects, Weather concludes that Talbot's common stock price is substantially undervalued in the market. With the approval of Talbot's Board of Directors, Weather announces a program for his firm to repurchase $100 million of its own stock in the market. Talbot's stock price rises immediately after the announcement of the repurchase program.

Reese Winter, a CFA Institute member, is Weather's assistant. While waiting in Weather's office, Winter reads an internal memo marked "confidential" from Talbot's chief accountant to Weather. The memo states that Talbot sustained an unexpected substantial profit during the past quarter, and its earnings projections show a substantial increase compared with previous estimates. Winter uses her cell phone to call her brother and discloses this information to him. Her brother immediately buys 1000 shares of Talbot's stock.

Did the actions of Weather and Winter violate Standard II(A): Material Nonpublic Information?

	Weather	Winter
✓ **A)**	**No**	**Yes**
✗ **B)**	Yes	No
✗ **C)**	Yes	Yes

Explanation

Weather did not violate Standard II(A) because this prohibition applies to recipients who are not directly or indirectly associated with the firm the material nonpublic information is about. As a corporate insider, Weather can use insider information to benefit his firm's shareholders. Winter violated Standard II(A) because the information is both material and nonpublic and she is required not to trade or cause others to trade on the information.

Question #13 of 23

Question ID: 412393

Klaus Gerber, CFA, is a regular contributor to the Internet site WizeGuy. This past week Gerber has been incorrectly quoted as recommending that investors buy shares in Bradford, Inc. He is unaware that this message has been placed on the site as the quote was placed as a prank by an unknown source. This is the third time this has happened over the past month and each time the stock being mentioned moved in price according to the buy or sell recommendation.

Fritz Fox, CFA, maintains and updates the WizeGuy site and has learned how to determine if the quotes being attributed to Gerber are actually valid. Several days later, he observes an investment recommendation, posted on the site, to buy Gresham, Inc. The investment recommendation is purported to be from Gerber, but Fox actually knows it to be bogus. He immediately sells 1,000 Gresham short and e-mails Gerber to inform him of the bogus recommendation. Gerber immediately issues a rebuttal, and Gresham falls by 14%. Fox's action is:

- ✗ **A)** **a violation of the Standard concerning fiduciary duties.**
- ✓ **B)** a violation of the Standard concerning use of material nonpublic information.
- ✗ **C)** not in violation of the Code and Standards.

Explanation

Even though the information is false, this fact is known only to Fox and is thus nonpublic information. Since such recommendations have in the past had a significant affect on the price of the security in question, the information is clearly material. Fox is in violation of Standard II(A) Material Nonpublic Information.

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Question ID: 412387

A CFO who is a CFA Institute member is careful to make his press releases-some of them containing material and previously undisclosed information-clear and understandable to his readers. While writing a new release, he often has his current intern proofread rough drafts. He also sends electronic copies to his brother, an English teacher, to get suggestions concerning style and grammar. With respect to Standard II(A), Material Nonpublic Information, the CFO is:

- ✓ **A)** **violating the standard by either showing the pre-release version to his intern or sending it to his brother.**
- ✗ **B)** not in violation of the Standard.
- ✗ **C)** only in violation by e-mailing the pre-release version to his brother but not the intern, because the intern is in essence an employee of the firm.

Explanation

Standard II(A), Material Nonpublic Information, says that a member must be careful about handling material non-public information. As a member of CFA Institute, the CFO must limit the people who see important information before it is released. It would not be appropriate to involve an intern or a relative in the process.

Question #15 of 23

Question ID: 412373

Andrea Waters is an investment analyst who has accumulated and analyzed several pieces of nonpublic information through her contacts with drug firms. Although no one piece of the information she collected is "material," Waters correctly concluded that the earnings of one of the drug companies would be unexpectedly high in the coming year. According to CFA Institute Standards of Professional Conduct, Waters:

✓ **A) can use the information to make investment recommendations and decisions.**

✗ **B)** cannot legally invest or make recommendations based on this information.

✗ **C)** may use the information, but only after approval from a compliance officer or supervisor.

Explanation

Members who can piece together items of nonmaterial nonpublic information with public information can, based upon the mosaic theory, use such information for trading purposes.

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Question ID: 412382

An analyst provides services for a charitable organization and in return gets free membership in the organization. Part of her job is to manage the liquid assets of the organization, and those assets include stocks. Her supervisor in the organization calls her and tells her to buy a certain stock for the portfolio based upon insider information from a board member in the organization. The analyst objects, but the supervisor says this is what they have always done and sees no reason for changing now. The analyst complies with the request. With respect to Standards IV(A), Loyalty to Employer, and II(A), Material Nonpublic Information, the analyst violated:

✓ **A) only Standard II(A) that prohibits insider trading.**

✗ **B)** only Standard IV(A) requiring duty of loyalty.

✗ **C)** both Standards IV(A) and II(A).

Explanation

An employee/employer relationship does not necessarily mean monetary compensation for services. Complying with the request is a violation of II(A) which prohibits trading on insider information. Standard IV(A) Loyalty deals with going into business for yourself, leaving an employer and continuing to act in the employer's best interest until their resignation becomes effective, and whistleblowing which means that the member's interests and their firm's interests are secondary to protecting the integrity of capital markets and the interests of the clients.

Question #17 of 23

Question ID: 412384

Which one of the following *least* accurately describes the CFA Institute Standard about using material nonpublic information?

✓ **A) An analyst using material nonpublic information may be fined by CFA Institute.**

✗ **B)** An analyst may use nonmaterial nonpublic information as long as it has been developed under the Mosaic Theory.

✗ **C)** An analyst may violate this Standard by passing information to others even when it has been obtained from outside the company.

Explanation

There is no provision for CFA Institute to issue fines to members. Members may not use material nonpublic information for trading purposes. Nonmaterial, nonpublic information may be used together with analysis of public information under the Mosaic Theory.

Question #18 of 23

Question ID: 412389

An analyst is allowed to trade on information that he has predicted, such as a corporate action or event, using perceptive assembly and analysis of material public information or nonmaterial, non-public information. This is called the:

✗ **A)** **assessment theory.**

✓ **B)** mosaic theory.

✗ **C)** deduction theory.

Explanation

This deductive reasoning is legal (does not constitute trading with inside information) and is called the mosaic theory.

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Question ID: 412376

A brokerage firm has a trading department and an investment-banking department. Often the investment-banking department receives material non-public information that would be valuable in advising the firm's brokerage clients. In order to comply with the Standards, the firm:

✗ **A)** **should record the exchange of information between the investment-banking department and the brokerage department.**

✓ **B)** should restrict employee trading in securities for which the firm is in possession of material non-public information.

✗ **C)** must divest one of the departments.

Explanation

Restricting employee trading in stocks for which the firm has material non-public information is the best answer. Recording the exchange of information between the two departments is not the best option because there should be no exchange of information between these two departments. Divesting a department is not a suitable method for addressing this potential problem.

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Question ID: 412399

Mark Williamson is "bearish" on ABC Manufacturing Company. Williamson is so convinced that ABC is overpriced, two weeks ago, he shorted 100,000 shares. Today, Williamson is "surfing" several popular investment bulletin boards on the internet and posting false derogatory comments about company management. According to Standard II(B), Market Manipulation, Williamson has engaged in:

- ✗ **A) both transaction-based manipulation and information-based manipulation.**
- ✗ **B)** transaction-based manipulation, but not information-based manipulation.
- ✓ **C)** information-based manipulation, but not transaction-based manipulation.

Explanation

Williamson is in violation of Standard II(B), Market Manipulation, by engaging in information-based manipulation. Information-based manipulation includes, but is not limited to, spreading false rumors about a firm in order to induce others to trade.

Question #21 of 23

Question ID: 412391

The *mosaic theory* is the idea that an analyst can:

- ✗ **A) make investment recommendations on the basis of several pieces of nonpublic information as long as the aggregate information remains nonmaterial.**
- ✗ **B)** base his recommendations on nonpublic material information only for the clients of the company, but not for the general public.
- ✓ **C)** make recommendations or trade based on several pieces of public or nonpublic information, each piece by itself being nonmaterial, but when compiled the information becomes material.

Explanation

The mosaic theory permits an analyst to make recommendations based upon several pieces of public or nonmaterial information, even though the complied result is both material and nonpublic.

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Question ID: 412377

A stockbroker who is a member of CFA Institute has a part-time housekeeper who also works for the CEO of Festival, Inc. One day the housekeeper mentions to the broker that she saw the CEO of Festival having a conversation at his home with John Tater, who is a nationally known corporate lawyer and consultant. The stockbroker is restricted from trading on this information:

- ✗ **A) only if the broker knows that the meeting is non-public information.**
- ✗ **B)** for both of the reasons listed here.
- ✓ **C)** if the housekeeper says the meeting concerned a tender offer and the broker knows that it is non-public information.

Explanation

Standard II(A), Material Nonpublic Information, states "a member cannot trade or cause others to trade in a security while the member possesses material nonpublic information" A tender offer would certainly be material nonpublic information. Knowing that the meeting took place, and nothing else, does not restrict the broker. A reasonable investor would need to know more to determine if the information was material.

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Question ID: 412385

Don Benjamin, CFA, is the compliance officer for a large brokerage firm. He wants to prevent the communication of material nonpublic information and other sensitive information from his firm's investment banking and corporate finance departments to its sales and research departments. The most common and widespread approach that Benjamin can use to prevent insider trading by employees is the:

- ✗ **A)** **legal list.**
- ✓ **B)** fire wall.
- ✗ **C)** Wall Street Rule.

Explanation

To comply with Standard II(A), a fire wall provides an information barrier that prevents communication of material nonpublic information and other sensitive information from one department to another within a firm.