Guidance for Standards I-VII

Test ID: 7440168

Question #1 of 142

Question ID: 461245

Marc Feldman, CFA, is manager of corporate investor relations for a high-tech startup, zippy.com, in Boise, Idaho. Feldman learns that Larry Smith, controller, is altering the accounting records. He decides that any ramifications from such activity is Smith's problem and does not report this fact. According to the CFA Institute Code and Standards he should or is required to do all of the following EXCEPT:

- ✗ **A)** **determine legality, consulting counsel if necessary.**
- ✓ **B)** report the activity to the FASB or other relevant regulatory body.
- ✗ **C)** urge Smith to cease altering the accounting records.

Explanation

As per the *Standards of Practice Handbook* "The Code and Standards do not require that members report legal violations to the appropriate governmental or regulatory organizations, but such disclosure may be prudent in certain circumstances." In this instance, he would likely be better off discussing the matter with the firm's legal counsel and Smith's superiors.

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Question ID: 412644

Greg Allen is a security analyst and visits David Dawson, the Chief Financial Officer of Edmonds Company. Dawson reveals a great deal of nonmaterial financial data to Allen, data that Dawson routinely reveals to all security analysts who visit him. From this data and other industry information, Allen conjectures that Edmonds is likely to make a tender offer for another company in the industry, a fact that if true would be considered material to the value of the company. Allen:

- ✗ **A)** **must not disseminate the information or use it for trading purposes until the tender offer is announced.**
- ✗ **B)** should send a copy of the report to Dawson for verification before disseminating the report to clients.
- ✓ **C)** can publish his conclusion in a research report.

Explanation

While the information that Allen received from the Edmonds CEO may be non-public, we are also told that it is non-material. Because Allen has reached his investment conclusion through an analysis of public information together with items of non-material non-public information (ie. "mosaic theory"), publishing this conclusion is not a violation of the Code and Standards.

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Question ID: 461298

Mike Lang Case Scenario

It is Jan. 29, 2009, and Mike Lang, CFA, is in trouble. Lang manages discretionary accounts for Welshire Capital, a large money management firm in New York. Lang has had some problems with the account of Carol Damon, the widow of a prominent banker who left her a sizable estate.

Damon, age 80, has little tolerance for volatility and does not like to invest in small-cap stocks. However, if her portfolio fails to advance at least 10% in a given year, she calls Lang and yells at him, then writes complaint letters to various Welshire Capital officers. Damon's complaint letters usually end up on the desk of Cynthia Silk, CFA, senior portfolio manager for Stonebridge, who oversees the work of Lang and a dozen other money managers. At a recent meeting, Silk reminded all portfolio managers that company policy is to manage against predetermined benchmarks and all exceptions should be cleared first with her.

Last year, Damon's portfolio lost 25% for the year, versus a 38% decline for the S&P 500 Index, the benchmark Welshire Capital uses for all of its portfolios. Lang tried to explain to Damon that the market had an extremely bad year, and the portfolio beat the benchmark by a wide margin in large measure because Lang primarily selected large-cap stocks for Damon's portfolio that outperformed the market. Damon said that she did not care to listen to these excuses and was not concerned about the market return, only her portfolio's return.

The most recent complaint letter was particularly ruthless, with Damon calling into question Lang's competence and threatening to move her account to another firm. Damon, long-time president of the Nassau County Council, further vowed to persuade four local businessmen to move their accounts as well. In total, Damon and the businessmen she plans to influence represent more than 20% of Welshire Capital's assets under management.

In an effort to fix his relationship with Damon, Lang decides to take four actions:

1. Set up a meeting at Damon's home, at which time he will explain how important her business is to Welshire Capital and discuss changes to her investment policy statement.
2. Prepare quarterly and annual reports that include the rationale for purchasing each stock.
3. Defend himself against her attack on his competence by discussing the grueling studies and difficult examinations required to earn the CFA charter and assure her it gives her every reason to expect the portfolio will perform better in the future.
4. Explain to her that despite the fact that two of the mutual funds in her portfolio pay referral fees to Stonebridge, he feels both funds are excellent investments.

Lang further decides to begin using a different benchmark for Damon's portfolio, one that better reflects the nature of the investments in the portfolio and creates a more accurate perception of portfolio performance.

While Lang is moving to sort out his differences with Damon, Silk, his supervisor, takes action of a different sort. Silk serves with Damon on the Nassau County Council, which takes up a considerable amount of Silk's time, and considers Damon to be a personal friend. She also knows about Damon's volatile temper and irrational expectations. She has historically tried to resolve any animosity Damon has towards Lang.

This time, Silk is concerned that Damon will make good on her threat to take business away from Stonebridge. In a phone call to Damon, Silk says she understands Damon's unhappiness with the poor performance and promises to discuss the situation with Lang and take appropriate action if necessary. She also promises Damon shares on a pro rata basis in an upcoming equity offering the company is handling assuming the stock is suitable for Damon's portfolio.

Later that day, Silk reviews transactions in Damon's portfolio and determines that Lang's poor asset allocation reduced the portfolio's returns by a considerable amount. She then calls Lang into her office. During that closed-door meeting, Silk criticizes Lang's handling of the portfolio and tells him she is giving the portfolio to another analyst with more experience. Before dismissing Lang, she calls the other analyst, John Van Zant, and tells him that he will be taking over Damon's portfolio immediately, adding the warning that if the portfolio does not perform better, Van Zant will not get his bonus this year and he must make up the past under-performance.

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With regard to her meeting with Lang, Silk:

✓ **A) violated the Code and Standards when she threatened Van Zant.**

✗ **B)** did not violate the Code and Standards.

✗ **C)** violated the Code and Standards when she criticized his management of Damon's portfolio.

Explanation

The threats by the supervisor could easily induce the manager to make decisions that are not suitable for the client and take excessive risk hoping to make up for perceived poor past performance. The supervisor is in effect setting up incentives that lead to inappropriate actions.

(Study Session 2, LOS 3.b)

Question #4 of 142

Question ID: 461240

Steve Copper has worked as an independent consultant for the past ten years advising companies on various ways to increase their internal efficiency and thereby increase the firm's stock price as well. Copper recently accepted a job offer from an equity research firm as a senior stock analyst. One of the firms he will be responsible for researching, Johnson Machine Tools (JMT), is also one of his consulting clients. Copper currently has a contract with JMT to provide consulting services for another six months which he plans to honor even though there are no penalties in the contract for early termination on his part. According to CFA Institute Standards of Professional Conduct, which of the following is the *most appropriate* action for Copper to take? Copper should:

✗ **A) disclose the arrangement only if he plans to renew the contract in six months.**

✓ **B)** terminate the contract with JMT prior to issuing any research on the company.

✗ **C)** disclose the consulting arrangement to clients considering JMT as an investment.

Explanation

Standard VI(A) - Disclosure of Conflicts requires members and candidates to inform clients, prospects, and their employers of any situation that may impair their independence and objectivity or interfere with duties owed to the same groups. The Standard notes that best practice is to avoid conflicts of interest when possible. This best practice recommendation is consistent with Standard I(B) - Independence and Objectivity, which requires that independence and objectivity be maintained. The consulting arrangement with JMT, a company about which Copper will write research reports, divides his loyalty between JMT and the clients purchasing Copper's research on the same company. This is a clear conflict of interest which must be disclosed to clients, prospects, and Copper's employer if the conflict cannot be avoided. However, there is no penalty for ending the consulting relationship and best practice would dictate that Copper terminate the contract with JMT.

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Question ID: 412646

Chuck Daniels has just been hired to manage a security analysis group for Aaron Asset Management. Daniels performed a similar function at another firm and finds the compliance system at Aaron inadequate. He develops a system that he feels is appropriate, but senior management tells him he will have to wait six months to implement the system. Daniels should:

✓ **A) decline in writing to accept supervisory responsibility until a satisfactory compliance system is put into place.**

✗ **B)** protest in writing the delay, listing the potential dangers that can occur.

✗ **C)** resign his position immediately.

Explanation

According to the Standard on supervisory responsibilities, Daniels should decline in writing to accept supervisory responsibility until a satisfactory compliance system is put into place.

Question #6 of 142

Question ID: 412665

Paul Drake is employed by a company to provide investment advice to participants in the firm's 401(k) plan. Company stock is one of the investment options in the plan. Drake feels that the stock is too risky for employees to own in their 401(k) plan and starts advising them to pull out of the stock. The Treasurer of the company calls Drake and tells him that he will be fired if he continues making such advice because he is violating his fiduciary duty to the company. Drake should:

✓ **A)** **continue to advise employees to sell their stock.**

✗ **B)** make sell recommendations but point out that the company Treasurer has a differing and valid point of view.

✗ **C)** tell employees that he cannot provide advice on company stock because of a conflict of interest.

Explanation

Although Drake is paid by the company, his fiduciary duty is to the plan participants. His advice cannot be compromised by business considerations, otherwise he will be violating the Standard on loyalty, prudence, and care.

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Question ID: 412688

One year ago, Karen Jason left the employment as a portfolio manager of Howe Advisors. The departure was contentious and both parties threatened legal action. As a result, both parties signed a settlement in which Jason was paid a pro rated bonus, but agreed not to work on the portfolios of any existing Howe client for two years. The terms of the agreement were that both parties agreed to keep all aspects of the agreement confidential, including the fact that there was hostility surrounding the departure. Jason now works for Torre Advisors, who has the Stein Company as a new client. At the time Jason left Howe, Stein was a client of Howe, although Jason did not personally work on the Stein portfolio. Jason's supervisor at Torre wants Jason to work on the Stein portfolio. Jason should:

✓ **A)** **inform her supervisor that she cannot work on the portfolio because of a legal agreement, but cannot tell him why.**

✗ **B)** work on the portfolio because she did not personally work on the portfolio when she was at Howe.

✗ **C)** inform her supervisor that she cannot work on the portfolio because of a non-compete agreement.

Explanation

Jason must inform her supervisor of the conflict, but she cannot violate the terms of the confidentiality agreement and she cannot work on the portfolio.

Question #8 of 142

Question ID: 461269

Steve Wynn, CFA, is an investment advisor and Jennifer Carey has been a client of his for three years. Carey has shown an interest in international stocks, so they agree to consider putting a portion of Carey's portfolio in foreign stocks. Wynn makes sure that Carey is aware of the currency and political risks inherent in foreign investing before proceeding. They jointly agree to purchase a small portfolio of stocks in the country of Bellagio because one of the brokerage houses that Wynn uses has a great deal of fundamental research on companies domiciled there. Six months later it is revealed in the news media that Bellagio has had severe insider trading problems which have contributed to the loss on the portfolio. Wynn has:

✓ **A) violated the Standards by not informing Carey about the insider trading risks, but not by contributing to the problem of insider trading.**

✗ **B)** not violated the Standards.

✗ **C)** violated the Standards by not informing Carey about the insider trading risks and contributing to the problem of insider trading.

Explanation

Wynn should have known about the risks and should have informed Carey of the risks. However, merely investing in a market in which insider trading is prevalent is not a violation of the Standards.

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Question ID: 412676

Jessica French is an individual investment advisor with 200 clients and claims she conforms to Global Investment Performance Standards (GIPS). French includes all of the clients on her books. One of those clients is her father, to whom she charges no fee. However, she manages that portfolio using the same processes as she uses for her paying clients. Another client included in the composite is John Randolph, a wealthy entrepreneur. Randolph is the only client who does not give her discretion over the assets and makes every decision himself, getting suggestions from French and using her to implement decisions. French:

✗ **A) conforms to GIPS, if disclosures are made about the non-fee-paying account.**

✗ **B)** has violated GIPS because it includes her father's account, but not because it includes Randolph's account.

✓ **C)** has violated GIPS because it includes Randolph's account, but not because it includes her father's account.

Explanation

Non-fee-paying clients can be included in the same composite as fee-paying clients as long as it is disclosed. Nondiscretionary clients should not be included in the composite as the clients would not adhere to the investment strategy used by the investment advisor.

Questions #10-15 of 142

Michael Pennington Case Scenario

Michael Pennington is Senior Vice President of equity investments at Alpha Investment Advisors, Inc. (AIA). He manages a team of analysts and portfolio managers and is responsible for maintaining and developing client relationships. AIA is located in Belgium and provides investment management services to high net work individuals. Pennington is also a Level III Candidate for the CFA designation.

One of Pennington's clients is the Flanders family. Pennington had a long relationship with Helmut Flanders. Before Flanders's untimely death, he gave Pennington full discretion over his portfolio based on an investment policy statement that had been refined continuously over the years.

- Flanders was the president of a publicly traded manufacturing company, Allux, and 20% of his portfolio's assets were invested in Allux equity. His contract with Allux prohibited selling his Allux shares while he was employed.
- Flanders had little liquidity needs. His children were grown, and his salary at Allux was sufficient to cover his annual expenditures as well as contribute to his investment portfolio.
- A former accountant, Flanders had been extremely knowledgeable and comfortable with the investment decision-making process.
- Pennington owns 10,000 shares of Allux and serves on Allux's board.
- Pennington played golf with Flanders on a regular basis and, with Flanders's help, developed many client relationships from these outings.

AIA has an agreement with a local brokerage firm, First Brokerage, owned by Pennington's sister to place all AIA trades through First Brokerage.

- Flanders agreed in writing that all trades in his portfolio would be directed to First Brokerage.
- Pennington purchased new carpets for his office with soft dollars. He believes that his managers make better investment decisions when their environment is pleasant and comfortable.
- Pennington attended an industry conference in the Bahamas with soft dollars. The program is devoted to improving management of the investment advisory firm. He believes that a well-run firm makes better investment decisions.
- Pennington consistently uses soft dollars to purchase research reports from an independent research firm that does in-depth analysis of a company's financial reporting. Several of his managers have commented on the quality and usefulness of these reports to their analysis and decision making.

Pennington has an appointment to meet with Flanders's widow, Elise, who, as an artist, left management of their financial assets to her husband. She is meeting with Pennington to better understand her financial position.

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Question ID: 484919

Which of the following Standards is *most* relevant regarding Pennington's meeting with Elise?

✓ **A) Standard III(C), Suitability.**

✗ **B)** Standard III(E), Preservation of Confidentiality.

✗ **C)** Standard III(A), Loyalty, Prudence, and Care.

Explanation

Standard III(C), Suitability, is *most relevant* for Pennington's meeting with Elise. This Standard requires Pennington to make a reasonable inquiry into Elise's financial situation, investment experience, and investment objectives prior to making any recommendations about her portfolio. Pennington must also consider the appropriateness of the existing portfolio and investment policy statement for Elise. Standard III(A) also has some relevance since Pennington is in a position of trust with respect to Elise, and Pennington must ensure that his and AIA's goals do not conflict with Elise's. (Study Session 1, LOS 2.a,b)

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Question ID: 484920

Standard VI(A), Disclosures of Conflicts, requires Pennington to disclose all matters, including beneficial ownership of securities of other investments, that could be expected to impair the member's ability to make unbiased and objective recommendations. Which of the following matters would *least likely* be disclosed to Elise?

- ✗ **A)** **Pennington owns shares in Allux.**
- ✗ **B)** AIA has a soft dollar arrangement with a brokerage firm owned by Pennington's sister.
- ✓ **C)** Pennington played golf with Helmut Flanders on a regular basis and developed client relationships from those golf outings.

Explanation

Pennington playing golf with Elise's husband Helmut Flanders is not a conflict with respect to his relationship with Elsie and he need not disclose to her that he played golf with Flanders. Flanders was his client at the time and there was full disclosure that Pennington developed new client relationships. Al the other matters must be disclosed. (Study Session 1, LOS 2.a,b)

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Question ID: 484921

Which of the following *best* describes Pennington's compliance with the CFA Institute Standards regarding his use of soft dollars? The purchase of:

- ✓ **A)** **research reports is an allowable use of soft dollars.**
- ✗ **B)** both research reports and carpeting are allowable uses of soft dollars.
- ✗ **C)** research reports and attending the conference are allowable uses of soft dollars.

Explanation

Brokerage is commission generated from trades and is an asset of the client not the investment manager. Soft dollars is the use of brokerage to purchase research services that benefit the client in the investment decision-making process. The investment manager has an ongoing responsibility to seek to obtain best execution, minimize transaction costs, and use client brokerage to benefit clients. Consequently, contingent on disclosure of a soft dollar arrangement to clients whose portfolios might be affected, the CFA Institute Standards permit client brokerage only to be used to purchase research; that is, goods and services, the primary use of which directly assists the investment manager in the investment decision making process and not in the management of the firm. (Study Session 1, LOS 2.a,b)

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Question ID: 484922

Pennington would like to continue to direct trades from Elise's portfolio to his sister's brokerage firm. In order to continue with this arrangement and comply with the CFA Institute Standards, which of the following disclosures are required?

- ✓ **A)** **Pennington must disclose policies with respect to all soft dollar arrangements and receive written consent from Elise that she understands the consequences if he is not seeking best price and execution through First Brokerage.**
- ✗ **B)** Pennington must clearly disclose that his duty as the investment manager is to continue to seek to obtain best execution.
- ✗ **C)** Pennington must disclose that directed brokerage arrangements that require the investment manager to commit a certain percentage of brokerage might affect his ability to seek to obtain best execution.

Explanation

Investment managers are required to disclose policies with respect to soft dollar arrangements. Standard III(A), Loyalty, Prudence, and Care, requires Pennington to seek best price and execution with his trades and if he directs trades through a broker in which he may not receive best price and execution he must get a written statement from his clients that they are aware that he is not seeking best price and execution and the consequences for their accounts. (Study Session 1, LOS 2.a,b)

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Question ID: 484923

After determining Elise's risk and return objectives, liquidity needs, tax considerations, and unique circumstances, Pennington has decided the he must reduce Elise's holding of Allux shares. He has several other clients, whom he met through Flanders, who also have significant holdings in Allux. Pennington has also decided to reduce his own holdings in Allux since his term as a director of Allux will be up in June. He does not plan to seek reappointment, but as a member of the audit committee, he is privy to information about a tender offer. Pennington realizes this is a complex situation.
Of the following Standards, **determine** which would *least likely* help Pennington decide what actions with respect to selling shares of Allux would be in compliance with the CFA Institute Standards of Practice.

- ✓ **A)** **Standard III(C), Suitability.**
- ✗ **B)** Standard III(B), Fair Dealing.
- ✗ **C)** Standard VI(A), Disclosure of Conflicts.

Explanation

Standard III(C), Suitability, is least likely to provide Pennington with guidance when he considers selling Elise's holdings of Allux. This standard describes members' responsibilities in developing appropriate recommendations and taking suitable actions. To reach the point where he has decided to sell Elise's shares, Pennington would already have met these requirements. He has determined Elise's and his other clients' requirements and has recommended an appropriate and suitable investment action. His concern is how to implement his recommendation and be in compliance with the Standards of Professional Conduct.

Pennington has several problems with respect to selling shares of Allux from Elise's portfolio and the portfolios of his other clients. First, he must comply with Standard III(B) and deal fairly and objectively with all clients and prospects when taking this investment action. Pennington must disclose his ownership of Allux to all affected clients according to Standard VI(A) and ensure that transactions for clients take precedence over transactions on his own behalf according to Standard VI(B).

(Study Session 1, LOS 2.a,b)

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Question ID: 484924

Since Pennington is a director of Allux and a member of the audit committee, what additional Standard is specifically applicable to Pennington's decision to sell his and his clients' shares of Allux?

- ✗ **A)** **Standard IV, Duties to Employers.**
- ✓ **B)** Standard II, Integrity of Capital Markets.
- ✗ **C)** Standard VII, Responsibilities as a CFA Institute Member or CFA Candidate.

Explanation

As a director and member of Allux's audit committee, Pennington possesses material nonpublic information about a tender offer. Therefore, Pennington must be particularly concerned about complying with Standard II(A), Material Nonpublic Information. (Study Session 1, LOS 2.a,b)

Questions #16-21 of 142

Mary Montpier, CFA, is an equity analyst located in the Malaysia office of World Class Advisers. The firm provides investment advice and financial-planning services globally to institutional and retail clients. The Malaysia office was opened last year to provide additional international investment opportunities for U.S. clients. Montpier covers small-cap stocks in the region. Montpier's supervisor, Rick Reynolds, CFA, works in New York.

Jim Taylor is an analyst in New York who works at World Class Broker-Dealer, a sister company of World Class Advisers. Taylor covers healthcare and biotech stocks for the firm. Taylor recently completed Level I of the CFA examination and is registered for the Level II examination next year. Taylor works for John James, CFA.

Through her interaction with other analysts in Malaysia, Montpier learns that the use of material, nonpublic information is common practice in analyst research reports and recommendations, which is not prohibited by law in Malaysia. Montpier has acquired material, nonpublic information on the research pipeline of Circuit Secrets, a Malaysian semiconductor company. The nonpublic information makes the company seem like a fine investment. After extensive research through traditional means, Circuit Secrets appeared to be fully valued relative to its growth potential until Montpier found the nonpublic information.

In preparation for a client meeting, James asks Taylor to prepare a research report on attractive companies in the healthcare industry. Since Taylor is busy preparing for company conference calls, James tells him to "throw something together." To meet James' request, Taylor obtains reports on Immune Health Care and Remedy Corp., two companies that he likes, but has not researched in depth. Taylor takes the original reports, which were prepared by a small brokerage firm in the Netherlands, adds some general industry information, incorporates World Class's proprietary earnings-growth model, and submits "strong buy" recommendations to James for the stocks. Although written procedures require James to review all analyst reports prior to release, time constraints consistently prevent him from reviewing the reports prior to distribution.

Montpier is proud of her CFA charter. In fact, she often boasts that she is one of the elite members of the CFA Institute that passed all three exams consecutively without failing. Taylor is also proud of the CFA program. He told his friends and family the CFA designation is globally recognized in the field of investment management and research. Furthermore, Taylor states that he believes the program will enhance his portfolio management skills and further his career development.

In her free time, Montpier has begun consultation for members of a local investment club. The club is in the process of developing an appropriate compensation package for her services, which to date have included financial-planning activities and investment research. Montpier informs the investment club that she has a full-time job at World Class Advisers, which offers similar services. The investment club gave Montpier written permission to consult for them despite her full-time work.

To gain insight on biotech stocks, Taylor registers for an upcoming asthma study conducted by Breakthrough Corp., through which he and others will be the subject of testing for the efficacy of several new drugs. On his application, longtime asthma sufferer Taylor indicates that he has the appropriate medical condition for the study and signs a confidentiality agreement. During the study, a researcher shows Taylor a spreadsheet detailing the progress of Breakthrough's research pipeline. Two of the new drugs on which Breakthrough is awaiting regulatory approval have serious negative side effects in patient testing. This information confirms suspicions Taylor had developed after extensive research and conversations with company executives regarding nonmaterial, nonpublic information, though he was not certain about the names of the drugs until he saw the spreadsheet. At the conclusion of the study, Taylor releases a report detailing the drugs' side effects and recommends that clients "sell" Breakthrough Corp.

Over the next two weeks, Breakthrough releases information that the drugs in question have been held up by a regulatory agency pending additional investigation. The stock plunges more than 30% on the news.

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Question ID: 461309

Which of the following is a violation of the Code and Standards?

✗ **A)** **Taylor sends out a resume referring to himself as a Level II CFA candidate and indicating his intention to take the Level II test in June.**

✗ **B)** James has dinner with Taylor and promises to provide Taylor with three weeks off in May to study for the CFA exam and offer some test-taking tips.

✓ **C)** Reynolds approves Montpier's report on Circuit Secrets immediately, but tells his traders to wait a week before buying the stock themselves.

Explanation

An immediate approval of Montpier's report implies that Reynolds did not check the facts or talk to Montpier about the recommendation, which was dependent on the use of insider information. Reynolds violated the Standard relating to supervisory responsibilities. Side work that is not in competition with the intern's firm is not a violation unless the side job interferes with her work for World Class. The statement on Taylor's resume is appropriate, and James' plans to help Taylor are well within the requirements of the Standards. (Study Session 1, LOS 2.a,b)

Question #17 of 142

Question ID: 461310

Which of the following statements about Montpier's analysis of Circuit Secrets is CORRECT?

✓ **A)** **If Montpier prepares a research report for all World Class clients recommending Circuit Secrets as a "buy," but does not reveal the nonpublic information, she has still violated Standard II(A)-Material Nonpublic Information.**

✗ **B)** Montpier's best course of action is to initiate coverage of Circuit Secrets as a "hold," and attempt to get the company to disclose the nonpublic information.

✗ **C)** Montpier could satisfy the requirements of Standard II(A)-Material Nonpublic Information by producing a research report on Circuit Secrets for Malaysian clients, but not making it available to U.S. clients.

Explanation

Standard II(A) prohibits not only the revelation of nonpublic information, but also trading on the basis of that information. The buy rating itself is a product of the nonpublic information, and as such is a violation. Montpier must comply with the Code and Standards regardless of the laxness of regulations in her country. If Montpier believes the stock is a buy, initiating it as a hold would be inappropriate. Analysts cannot be expected to have a recommendation on every stock, so failing to recommend a potentially good stock is not a breach of fiduciary duty. (Study Session 1, LOS 2.a,b)

Question #18 of 142

Question ID: 461311

With regard to Standard VII(B)-Reference to CFA Institute, the CFA Designation, and the CFA Program:

✗ **A)** **neither Montpier nor Taylor is in compliance.**

✓ **B)** only Taylor is in compliance.

✗ **C)** both Montpier and Taylor are in compliance.

Explanation

Both Montpier, as a CFA charterholder, and Taylor, as a CFA candidate, are subject to the Standards. Montpier violated Standard VII(B) by exaggerating the implications of passing the exam in three years. Taylor's comments comply with the Standards. (Study Session 1, LOS 2.a,b)

Question #19 of 142

Question ID: 461312

Which of the following actions could Taylor take to ensure he is not in violation of Standard I(C)-Misrepresentation?

✗ **A)** **Just use excerpts from the original reports, rather than copying the whole reports.**

✗ **B)** Initiate coverage of Immune Health Care and Remedy Corp. as holds, not strong buys, until he has time to do further research.

✓ **C)** Base his report on information from Value Line and Standard & Poor's reports rather than research from rival analysts.

Explanation

Value Line and Standard & Poor's are "recognized financial or statistical reporting services," and as such, can be used as the basis for reports without acknowledgment. Caveat: Those publications are copyrighted, and copying directly from them may be illegal in some circumstances, even if it does not technically violate the plagiarism Standard. Using excerpts is still plagiarism and changing the stock recommendation will not change that fact. It is unlikely that a Dutch research report would not be protected under U.S. copyright, and even if it were not, using the material without attribution still violates the Standard. (Study Session 1, LOS 2.a,b)

Question #20 of 142

Question ID: 461313

Which of the following statements regarding Standard IV(A)-Loyalty to Employer is CORRECT?

✗ **A)** **By accepting compensation for his role in the medical study, Taylor is violating the Standard.**

✗ **B)** Neither Taylor nor Montpier is in violation of the Standard.

✓ **C)** Despite getting written permission from her client to consult, Montpier is not in compliance with the Standard.

Explanation

Montpier needs to get permission from both the client and her employer before she can begin to consult; since she has not received permission from World Class, she is not in compliance. Neither Taylor's use of rivals' research nor his participation in a medical study violate the Standard. Standard IV(A) addresses outside income, not research methods. And while the medical-study payment is certainly income, it is not in competition with his firm, and as such does not violate the Standard. (Study Session 1, LOS 2.a,b)

Question #21 of 142

Question ID: 461314

Taylor's actions regarding Breakthrough Corp.:

✗ **A)** **do not violate Standard II(A)-Material Nonpublic Information because he was only confirming what he already suspected.**

✓ **B)** violate Standard II(A)-Material Nonpublic Information because the information was not in the public domain.

✗ **C)** did not violate Standard I(D)-Misconduct because he did not misappropriate the information.

Explanation

Taylor's use of the material nonpublic information provided to him in confidence by a researcher is a clear violation of Standard II(A). The professional-misconduct Standard prohibits actions that reflect negative on "professional reputation, integrity, or competence." Since Taylor has signed a confidentiality agreement, his violation of the agreement definitely says something about his honesty. Thus, he is in violation of Standard I(D). Standard IV(A) only applies to work in competition with the employer. (Study Session 1, LOS 2.a,b)

Question #22 of 142

Question ID: 412658

While having a conversation with a prospective client, John Henry states that his performance across all of his past clients over the past five years was over 20%, which was 200 basis points higher than his benchmark. He tells the client that while the benchmark may rise or fall over time, his excess performance will remain consistent. Henry violated the Standards of Professional Conduct because:

- ✗ **A)** **he cannot discuss performance without clearly stating that the composite does not conform to GIPS.**
- ✓ **B)** the statement of excess performance is misleading with respect to its certainty.
- ✗ **C)** he cannot discuss prospective future performance in any manner.

Explanation

Guaranteeing performance on investments that are inherently volatile is misleading to clients.

Question #23 of 142

Question ID: 412656

Ned Brenan manages two dozen pension accounts, one of which earned over 25% during the past two years. Brenan tells prospective clients that based on past experience they can expect a 25% return on their funds. Which of the following statements is CORRECT?

- ✓ **A)** **Brenan has violated both Standard of Professional Conduct III(D), Performance Presentation, and Standard I(C), Misrepresentation.**
- ✗ **B)** Brenan has violated Standard of Professional Conduct III(D), Performance Presentation, but Brenan has not violated Standard I(C), Misrepresentation.
- ✗ **C)** Brenan has not violated Standard of Professional Conduct III(D), Performance Presentation, but Brenan has violated Standard I(C), Misrepresentation.

Explanation

Brenan violated Standard of Professional Conduct III(D) by using only one portfolio's results to create a false impression of all the portfolios, and Brenan violated Standard of Professional Conduct I(C) by creating the impression that a certain return was assured (he should have used the words "might" or "could" instead of "can").

Questions #24-29 of 142

In August 2005, the following events occurred related to Aggregate Opportunities, Inc.:

- Aug. 8: The Wall Street Journal reported that Aggregate Opportunities had inflated its 2004 earnings due to questionable accounting practices. The story was based on interviews with unnamed sources within Aggregate and its auditor, Millennium Partners. On that day the stock fell 42 percent to $12.50 from $21.55.

- Aug. 10: At 9 a.m., Aggregate revealed in a conference call to analysts a restatement of earnings for the previous three fiscal years that almost completely erased the reported net income for fiscal years 2002, 2003, and 2004. Aggregate's chief financial officer personally selected the small group of analysts participating in this call. Company officers said the restatement resulted from questionable accounting practices for off-balance sheet limited partnerships. At 1 p.m., the company issued a news release containing the information provided in the conference call. By the end of the trading day the stock had fallen 74 percent to $3.25.
- Aug. 11: At 10 a.m., Aggregate's Chief Financial Officer Buster Lockhart, CFA, publicly announced his resignation, and the Securities and Exchange Commission said it was pursuing an investigation.

During July and August of 2005, the following actions were taken:

- July 20: Michael Cho, CFA, a highly respected analyst with 25 years of experience covering Aggregate's industry, had spent several days reading Aggregate's 10-K and 10-Q documents and other analysis published by some of his competitors at major brokerage houses. Based on his reading and conversations with Aggregate management concerning nonmaterial, nonpublic information, Cho concluded that Aggregate had inflated its earnings. On July 20, Cho issued a detailed research report to his clients and concluded that Aggregate should be sold. He subsequently participated in the Aug. 10 conference call, although it only confirmed what he had already detailed in his July research report.
- Aug. 2: Equity analyst Harold Black, a CFA charterholder, received from his brother information that Aggregate might restate its earnings. Black's brother is a senior partner at Millennium Partners. Based on this information, Black immediately prepared a new research report that advised his clients to sell Aggregate, but did not liquidate his personal holdings in the company.
- Aug. 4: Bob Watkins, a CFA Level II candidate and portfolio manager, was golfing at his club. Approaching the third tee, he heard the chief executive officer and chief financial officer of Aggregate discussing company finances. Concealing himself behind a tree, Watkins overheard them discussing the upcoming Wall Street Journal article and the earnings restatement. Based on this conversation, he immediately sold all Aggregate holdings in his clients' portfolios. Later that day, Watkins told his friend Juan Martinez, CFA, what he learned about Aggregate and how he learned it. Martinez, a subscriber to Cho's research, then read Cho's report on Aggregate. Immediately after finishing Cho's report, Martinez sold the fund's entire stake in Aggregate. Watkins and Martinez were not participants in the Aug. 10 conference call.
- Aug. 8: Barb Henderson, a CFA charterholder, read the Wall Street Journal article in the morning and after going over her research papers, issued a sell recommendation for Aggregate. On Aug. 10, she participated in the conference call and heard the details of the earnings restatement.
- Aug. 10: Lisa Sanders, CFA, participated in the Aggregate conference call. At 10 a.m., she changed her recommendation on Aggregate from hold to sell and informed all of her clients. At 1 p.m., Sanders sold Aggregate from her personal account.

Question #24 of 142

Question ID: 461249

In issuing a sell recommendation for Aggregate, Henderson:

✗ **A)** **violated Standard V(A): Diligence and Reasonable Basis because she lacked sufficient reason to justify the downgrade.**

✗ **B)** violated Standard V(B): Communication with Clients and Prospective Clients because she failed to distinguish between fact and opinion.

✓ **C)** violated none of the Standards.

Explanation

The information published in the *Wall Street Journal* was public information, so Henderson did not violate Standard II(A).

Henderson did check his research papers and relied on the *Journal* which is a credible source. As such, using the story to justify a downgrade did not violate Standard V(A) or Standard V(B). (Study Session 1, LOS 2.a,b)

Question #25 of 142

Question ID: 461250

In selling his clients' holdings in Aggregate, Watkins:

✓ **A)** **violated Standard II(A): Material Nonpublic Information by taking investment action.**

✗ **B)** did not violate Standard II(A): Material Nonpublic Information because there was no breach of duty.

✗ **C)** did not violate Standard II(A): Material Nonpublic Information because the information did not involve a tender offer.

Explanation

Watkins violated the CFA Institute Standards because the information was both material and nonpublic. It does not matter if the information was not misappropriated, not received in a breach of duty or not related to a tender offer. Watkins still cannot trade or cause others to trade. CFA candidates are indeed subject to the CFA Institute Standards. While the misappropriated information did not involve a tender offer, Watkins' use of it still violated the Standards simply because it was material nonpublic information. (Study Session 1, LOS 2.a,b)

Question #26 of 142

Question ID: 461251

In advising his clients to sell Aggregate, Black:

✗ **A)** **violated Standard V(A): Diligence and Reasonable Basis because he did not have sufficient information to spur investment action.**

✗ **B)** violated Standard III(B): Fair Dealing because he did not take his own advice and sell the stock.

✓ **C)** did not violate Standard I(B): Independence and Objectivity, but his supervisor violated Standard IV(C): Responsibilities of Supervisors.

Explanation

Black's conduct does not violate Standard I(B), because a reasonable person would not call his independence into question, even though his ethics are suspect. Black's supervisor should have asked Black where he got the information before the research report was circulated, and the failure to do so means that the supervisor violated Standard IV(C). Black is also clearly in violation of Standard II(A): Material Nonpublic Information, because he would clearly have known that the information received from his Brother was both material and nonpublic. However, Standard II(A) is not one of the choices. Black's failure to follow his own advice does not violate Standard III(B). Ignoring all of the other details, knowledge that an earnings restatement is possible could certainly be considered a reasonable basis to dump a stock, so Black did not violate Standard V(A). Standard VI(A) pertains only when a relationship would impair investment judgment, and that is not the case here. (Study Session 1, LOS 2.a,b)

Question #27 of 142

Question ID: 461252

After changing her recommendation on Aggregate, Sanders:

✗ **A)** **violated Standard VI(B): Priority of Transactions by trading Aggregate from her own account.**

✗ **B)** did not violate Standard II(A): Material Nonpublic Information because the information was disclosed to a select group of analysts.

✓ **C)** violated Standard II(A): Material Nonpublic Information by taking investment action based on information not accessible to the public.

Explanation

The way in which Aggregate handled the conference call was an instance of selective dissemination, Members and Candidates must be aware that disclosure to selected analysts is not necessarily public disclosure. Thus, until the material information is made public, Sanders cannot trade or cause others to trade. Once the information is made public, Sanders must disseminate the information to her clients first, and give them adequate time to act on the recommendation before trading for her own account. In the absence of knowledge of any company policy with stricter requirements, 3 hours is probably sufficient, and we cannot assume she violated Standard VI(B). Standard III(B) does not require equal dissemination of information but rather fair dissemination. Nothing in the question indicated that Sanders disseminated the information unfairly. (Study Session 1, LOS 2.a,b)

Question #28 of 142

Question ID: 461253

In selling his fund's stake in Aggregate, Martinez:

✗ **A)** **violated Standard III(A): Loyalty, Prudence, and Care by using information obtained from Watkins.**

✓ **B)** violated Standard II(A): Material Nonpublic Information by using information obtained from Watkins.

✗ **C)** violated no standards.

Explanation

Martinez was aware of how Watkins obtained the information; therefore, Martinez violated II(A) by trading on material nonpublic information. Martinez has no fiduciary duty to Watkins, and as such did not violate Standard III(A). It would be difficult to argue that Cho's thorough research is not sufficient reason to trade Aggregate stock, so Martinez did not violate Standard V(A). (Study Session 1, LOS 2.a,b)

Question #29 of 142

Question ID: 461254

Which statement about violations of the Code and Standards is CORRECT?

✗ **A)** **Martinez did not violate the Standard regarding use of material nonpublic information and did not violate the fiduciary-duties standard.**

✓ **B)** Aggregate's CFO violated the fair-dealing Standard, but Black did not violate the fiduciary-duties Standard.

✗ **C)** Henderson violated the reasonable-basis standard, but Sanders did not violate the Standard regarding use of material nonpublic information.

Explanation

Aggregate's selective disclosure did violate the fair-dealing Standard, and while Black violated a number of Standards, his brother's fiduciary duty cannot be imposed on him. Black did not violate the fiduciary-duties Standard. While Cho did not violate the insider-trading standard because he came to his conclusions through the mosaic method, Watkins certainly did because he misappropriated the information. Martinez violated the Standard on material nonpublic information. Henderson did not violate the reasonable-basis Standard. Sanders did violate the insider-trading Standard. (Study Session 1, LOS 2.a,b)

Question #30 of 142

Question ID: 461296

Marc Feldman, a CFA Institute member, is treasurer of zippy.com, and is also Larry Goldman's boss. Feldman is informed of "accounting irregularities of an unknown origin" during an audit by zippy's external accounting firm. There are 3 individuals, including Goldman, handling the accounting function. According to the Code and Standards, Feldman should do all of the following EXCEPT:

✓ **A) terminate the accounting staff immediately and issue a press release describing the situation.**

✗ **B)** conduct a thorough investigation of activities.

✗ **C)** leave the staff in their current jobs and increase supervision while the external auditors complete their work.

Explanation

Standard IV(C) spells out responsibilities of supervisors in the Standards of Practice Handbook. Since the investigation is ongoing, it would clearly be inappropriate to terminate the entire accounting staff until their complicity in the wrongdoing is established.

Question #31 of 142

Question ID: 412668

Lynne Jennings is a chemical industry research analyst for a large brokerage company. That industry is currently seeing an increase in mergers and acquisitions. While flying through Chicago, Jennings sees several senior officers who she knows are from the largest and fourth largest chemical companies walk into a conference room. She concludes that negotiations for an acquisition might be taking place. Jennings:

✓ **A) may use this information to support an investment recommendation.**

✗ **B)** should inform her compliance officer that she has material nonpublic information on firms she covers.

✗ **C)** may not act or cause others to act on this information.

Explanation

The fact that the company officers met is not material nonpublic information. As long as she bases her investment recommendation on her own independent research, Jennings will not violate any Standards if she uses this additional information to support it.

Question #32 of 142

Question ID: 412637

The Konkol Company implements a new methodology for portfolio valuation that is licensed to them by ABC Statistics. Konkol complies with the CFA Institute Code and Standards by:

✗ **A)** **discussing the new methodology with clients only when a change in the security selection process is involved.**

✗ **B)** not discussing the new methodology with clients because there is no need to, as it will not change their risk and yield preferences.

✓ **C)** discussing the new methodology with the clients, in its entirety.

Explanation

Standard V(B), Communication with Clients and Prospects, requires any change in the scope, valuation methodology, or focus of the portfolio to be discussed with clients.

Questions #33-38 of 142

Bella Brown is an experienced generalist securities analyst employed by Lang & Co., a major U.S. brokerage firm whose clients have a high regard for her research and stock selection abilities. She was visited recently by a Lang managing director who said, "Please take a look at SpecChem Inc., the specialty chemical producer. They are going to need an investment banker soon and, because we make a market in their stock, we will be one of the firms considered for this business. I had lunch with SpecChem's Treasurer today, who told me that their European problems are being resolved and that earnings results are definitely looking good. He likes us and is expecting you to call him for details." The managing director then left Brown's office, saying, "It would be great if you could rate the stock a 'Buy'."

In a subsequent hour-long telephone discussion with the Treasurer, Brown obtained some useful information concerning recent company trends and developments as well as SpecChem's overall view of the outlook for sales and earnings during the next several quarters. Brown began thinking quite positively about the company and its prospects. She then reviewed some general source material on the chemical industry and read the Standard & Poor's Stock Guide on SpecChem Inc. That afternoon, she wrote a report recommending purchase of the stock, shown below as Exhibit B. In accordance with Lang's routine procedures for pre-dissemination review of Research Department recommendations, the report has been sent to the firm's Director of Research, who is aware of the circumstances under which it was prepared.

Exhibit B

LANG & COMPANY Company Report

Industrial: Specialty Chemicals Equity Research

Rating: Buy

SpecChem Inc. (NYSE: SCM)

- We are initiating coverage of SpecChem Inc. with this report.
- Earnings, up to 51% in the first quarter, are expected to be up again in the quarter ending June 30. Higher sales, better margins, an improved geographic sales mix, and savings from reduced pension expense are all contributing to this year's gains.
- Although European production is up only modestly year-over-year, successful cost reduction efforts are limiting the adverse effects of weak volume and pricing. A possible plant closure in September could improve plant utilization by 10%, accompanied by potentially dramatic margin improvement. However, a $30 million after-tax special charge could be taken at the time of the closure.
- We expect a moderate increase in second half 2014 sales. Although management looks for European demand to remain

slow, it feels that U.S. sales could be above expectations if auto-related demand strengthens. Management is also optimistic about receiving a sizable U.S. government contract in the next few months.

- Based on the factors noted above, our confidence level concerning earnings levels over the balance of the year is high.
- We think SpecChem stock is undervalued and believe it can easily reach the low 100s on the strength of continuing earnings momentum. The downside is estimated to be in the mid-80s. There is plenty of room for upside earnings surprises if volume and prices improve, which would take the stock up strongly. Purchase is recommended.

Analyst: Bella Brown

Research Department

This report is based upon information which we consider reliable, but we do not represent that it is accurate, and it should not be relied upon as such. We, or persons involved in the preparation or issuance of this material, may, from time to time, have long or short positions in the securities of the company mentioned herein.

Question #33 of 142

Question ID: 461263

Under the CFA Institute Code and Standards, it is the responsibility of the Director of Research, a CFA Institute member to:

✗ **A)** **not knowingly participate or assist in any violation of laws, rules, or regulations.**

✓ **B)** both of these.

✗ **C)** exercise reasonable supervision over those subject to their supervision or authority to prevent any violation of applicable statues, regulations or provisions of the Code and Standards.

Explanation

The Director of Research, as a CFA Institute member, is bound by the Standards of Professional Conduct. Accordingly, "members shall not knowingly participate or assist in any violation of such laws, rules or regulations" (Standard I(A): Knowledge of the Law). This responsibility is applicable under the circumstances. As a supervisor, the director of research has a responsibility to exercise reasonable supervision over subordinates to prevent violations of laws, regulations, and the provisions of CFA Institute Standards of Professional Conduct (Standard IV(C): Responsibilities of Supervisors). (LOS 2.a)

Question #34 of 142

Question ID: 461264

Under the current circumstances, the Director of Research should:

✓ **A)** **require the report to be redone to ensure compliance with CFA Institute Standards.**

✗ **B)** require the report to be redone with a neutral or hold rating pending the outcome of the awarding of the investment banking business.

✗ **C)** allow the report to be distributed, as is.

Explanation

Based on the current circumstances, the supervisor (Director of Research) must not allow the report to be distributed. In this situation the overriding responsibility is to ensure that diligence, thoroughness, and independence be exercised in forming the investment judgment and in preparing the research report. (LOS 2.a)

Question #35 of 142

Question ID: 461265

The research report, as shown, has several aspects which violate CFA Institute Standards of Professional Conduct. Which of the following is NOT an apparent violation of CFA Institute Standards?

- ✗ **A)** **The report does not adequately discuss the factors important to analysis, recommendations, or action.**
- ✓ **B)** The report violates guidelines on investment performance presentation.
- ✗ **C)** The report does not distinguish between fact and opinion.

Explanation

There is no attempt in the report to present data on the firm's performance as an investment manager. Violations relating to the report itself include the following:

- Though SpecChem's current and prospective earnings are mentioned, no real basis of SpecChem's earnings power is discussed, nor are such factors as cash flow, operating strength or financial condition. Brown has violated Standard V(B): Communication with Clients and Prospective Clients.
- The report fails to disclose Lang's market-making activities with SpecChem. This omission violates Standard VI(A): Disclosure of Conflicts.
- Brown is not separating fact from opinion in her comment, "There is plenty of room for upside earnings surprises if volume and prices improve further, which would take the stock up strongly." This is a violation of Standard V(B): Communication with Clients and Prospective Clients. The above-noted comment could also be considered a violation of Standard I(C): Misrepresentation.

(LOS 2.a)

Question #36 of 142

Question ID: 461266

As to the process by which Brown's report in Exhibit B came into being, which of the following is *least likely* a procedural error in violation of CFA Institute Standards of Professional Conduct?

- ✓ **A)** **Brown has violated the Standard relating to the prohibition against plagiarism.**
- ✗ **B)** Brown has violated the Standard relating to independence and objectivity.
- ✗ **C)** Brown has violated the Standard relating to disclosure of basic characteristics.

Explanation

There is nothing to indicate that a violation of the Standard on Prohibition against plagiarism has occurred. The word "process" violations include:

- Brown's report and investment conclusions were influenced by a senior member of her firm. In addition, near total reliance was put on the information supplied by SpecChem's management. She has violated Standard I(B): Independence and Objectivity.
- Brown showed a lack of diligence and thoroughness in forming her investment decision and preparing the report. Her analysis was cursory at best; the report was not objective nor was it based on adequate understanding of company fundamentals. Standard V(A): Diligence and Reasonable Basis was violated by Brown.
- A violation of Standard V(B): Communication with Clients and Prospective Clients has also occurred. Brown failed to investigate SpecChem's basic investment characteristics properly and did not communicate the company's investment characteristics through the research report.

(LOS 2.a)

Question #37 of 142

Question ID: 461267

Brown has been invited to visit the world headquarters of SpecChem. Brown expects that the information that she learns there will help her to flush out some of the fine details in her research on SpecChem's stock. SpecChem plans to pay for all of Brown's expenses trip, including meals, accommodations and lodging. In order to comply with the Code and Standards, which of the following actions should Brown take? Brown should:

✗ **A)** **Accept the reimbursement if she is confident that her report will still be objective.**

✗ **B)** Accept the reimbursement but disclose the total reimbursed expense-paid trip in the report.

✓ **C)** Pay for all her travel expenses.

Explanation

Brown's best solution to comply with Standard I(B)–Independence and Objectivity is to avoid any perception of conflict of interest. Brown's firms should pay for all of her expenses. Disclosing the trip is not enough to avoid a conflict of interest. (LOS 2.b)

Question #38 of 142

Question ID: 461268

Brown submits her report to the Director of Research for review, as required by Lang's procedures. Although the Director of Research supports Brown's general conclusion, he is somewhat more optimistic about SpecChem's near-term prospects, and based on his own thorough investigation believes that the stock could touch $150. The Director of Research changes the report to indicate a target price somewhat higher than originally predicted by Brown. Brown is confident that the Director of Research's conclusion has a reasonable basis, but thinks that $150 is on the high side of what is likely. The Director of Research adds his own name to the report to reflect his contribution.

In order to comply with CFA standards, must Brown request that her name be taken off the report before it is disseminated?

✗ **A)** **Yes, because the Director of Research has misrepresented his contribution.**

✓ **B)** No.

✗ **C)** Yes, because Brown should dissociate from the report.

Explanation

It is natural for different contributors to come to different conclusions based on the same data. In this case, the Director of Research appears to have a reasonable basis for his target price that is higher than Brown's. The Director of Research is free to issue a report that differs somewhat from Brown's conclusions as long as there is a reasonable basis. Brown should not put her name on a report that differs from her opinion. However, when a report is a group effort, not all members of the team may agree with every aspect of the report. Brown could ask to have her name removed from the report, but since she is satisfied that the conclusion has a reasonable basis, she does not have to disassociate from the report. (LOS 2.b)

Question #39 of 142

Question ID: 412634

Susan Nielsen, CFA, works for a rating agency which competes directly with S&P and Moody's. Her friend, Lance Parker, works for the same company but in a different department which is involved in advisory services for structured products. Nielsen frequently receives pressure from Parker to "put a positive face" on client ratings to help him sell advisory services.

She is reluctant to discuss client ratings with Parker and tries to avoid the topic. She consults her company's compliance department and learns that there are no policies or procedures to discourage Nielsen and Parker from sharing information and is encouraged to consider his advice on company ratings. Nielsen should *most likely*:

✓ **A) advise her firm to develop firewalls and protections to allow the different departments to function independently and avoid talking with Parker about client ratings.**

✗ **B)** continue to consult with Parker on company ratings as the compliance department's position is that there is no conflict.

✗ **C)** advise regulators of the potential conflict of interest and seek legal counsel.

Explanation

Nielsen should advise her firm to develop firewalls and protections to allow the different departments to function independently. If Nielsen and Parker are going to remain friends, they should stop talking about client ratings.

Question #40 of 142

Question ID: 412664

Janice Melfi is a portfolio manager for Soprano Advisors. Soprano has developed a proprietary model that has been thoroughly researched and is known throughout the industry as the Soprano model. The model is purely quantitative and screens stocks into buy, hold, and sell categories. The basic philosophy of the model is thoroughly explained to clients. The director of research frequently alters the model based on rigorous research-an aspect that is well explained to clients, although the specific alterations are not continually disclosed. Portfolio managers use the model to assist them in making portfolio decisions, but, based on their own fundamental research, are allowed to purchase securities not recommended by the model. This fact is not disclosed to the clients, because the head of marketing does not think it is relevant. Which of the following statements regarding the portfolio manager's investment decisions is CORRECT?

✓ **A) Soprano is violating the Standards by not disclosing the fundamental research aspect of the investment process.**

✗ **B)** There is no violation of the Standards.

✗ **C)** Melfi is violating the Standards by using two investment processes that are in conflict with each other.

Explanation

Soprano is violating the Standard on portfolio investment recommendations and actions by excluding relevant factors of the investment process. The fundamental research aspect is highly relevant to the process and should be disclosed to clients. It is acceptable for Melfi to use two investment processes that may be in conflict with each other and to use a process that was not developed by her.

Question #41 of 142

Question ID: 461299

Marc Feldman, CFA, is manager of corporate investor relations for a high-tech startup, zippy.com, in Boise, Idaho. Feldman is well-known in the high tech community in Boise, and Dragon.com has asked if he will help them organize their investor relations function on a consulting basis. They offer him an all-expenses-paid two-week holiday for two on Australia's Gold Coast in payment. Regarding this offer as a CFA Institute member Feldman is:

✗ **A) allowed to accept the offer only with written approval from zippy.**

✗ **B)** not allowed to accept such an offer since it effectively places him in competition with his employer.

✓ **C)** allowed to accept the offer only with written approval from zippy and from Dragon.

Explanation

Under Standard IV(A) Loyalty to Employer, and Standard IV(B) Additional Compensation Arrangements, Feldman is allowed to accept the offer, but only with written permission from *both* zippy and Dragon.

Question #42 of 142

Question ID: 461300

All of the following would be effective components of a formal compliance system EXCEPT:

✗ **A)** **the firm prohibits analysts and portfolio managers from using material nonpublic information in making investment recommendations or taking investment action.**

✓ **B)** as a fiduciary under ERISA, the firm will strictly follow pension plan instructions and restrictions, which may include concentrating portfolios in a few securities or industries.

✗ **C)** the investor's objectives and constraints should be maintained and reviewed periodically to reflect any changes in the client's circumstances.

Explanation

According to Standard III(A) - Loyalty, Prudence, and Care, "members shall use particular care in determining applicable fiduciary duty." Under ERISA, a fiduciary has the duty to diversify the plan's investments in order to protect it from the risk of substantial loss. The firm must follow pension plan instructions and restrictions unless they conflict with ERISA or other applicable laws and regulations. Having concentrated portfolios does not constitute effective diversification. An appropriate policy statement would be: " The firm will follow pension plan documents only to the extent that they are consistent with applicable laws and regulations. The firm will diversify plan assets to minimize the risk of loss."

Question #43 of 142

Question ID: 461294

Jake Schmidt Case Scenario

Jake Schmidt, CFA, has worked as a separate accounts manager at Bremen Investment Advisors, a large national asset management firm, for the past 10 years. Bremen offers separately managed accounts that meet the needs of its institutional and individual investors; each separate account is tailored to the client's objectives, risk tolerances, and tax situation.

Schmidt manages portfolios for a broad range of clients, from individual investors to large institutional investors. Several of his largest clients have sufficiently large portfolios that when trades are placed they will often move share prices. In order to avoid negatively impacting his smallest clients, when he trades a particular security for a number of different accounts, Schmidt executes trades in increasing order of size: trades are executed for the smallest accounts first, and the largest institutional investors last.

Schmidt sometimes receives an allocation of oversubscribed initial public offering shares, though often he does not receive enough shares to allow all eligible clients to participate. Rather than distributing an equal number of shares to each client, Schmidt's procedures result in the eligible client with the largest portfolio receiving the greatest number of shares, while smaller clients receive proportionally fewer shares.

Schmidt provides portfolio performance information to his clients only quarterly. However, for clients who pay an additional annual fee, Schmidt provides monthly performance reports. Schmidt commits to all customers that they will receive performance reports "2 to 3 weeks after the end of the period."

New client DeShawn Jackson contacts Bremen to open an account. Schmidt agrees to manage this account, which represents about one-fifth of Jackson's total wealth. As part of the IPS process, Schmidt asks Jackson to disclose details of Jackson's personal financial situation; particularly allocations and balances of investments held with other asset managers. Schmidt proposes to Jackson that the two have a conference call at the beginning of each February to review Jackson's IPS.

Schmidt takes on Jackson, with a mandate to invest in the common stock of U.S. companies. Schmidt initially invests most of the value of the account in stocks in shares of companies in the basic materials sector. However, at the beginning of the next quarter Schmidt's research about the prospects of basic materials stocks makes him nervous and he reallocates the majority of the portfolio to shares in consumer staples companies. Unfortunately, basic materials stocks perform strongly for the remainder of the quarter, while consumer staples sag, resulting in the account suffering a 2% loss for the quarter. When Jackson notices the shift in sector holdings in his statements at the end of the quarter, he is upset that his portfolio missed the run-up in prices in the basic materials sector.

In order to give clients additional confidence, Schmidt decides to have the portfolio information that he provides to clients reviewed on a regular basis for accuracy and completeness. Rather than hiring staff, Schmidt outsources this function to an outside organization.

One of Schmidt's largest clients, Kiara Williams, has asked Schmidt to sell a very large block of her share holdings in Alpha Corporation, a small niche firm in the biotech industry. Schmidt refrains from initiating sales of Alpha Corporation stock for his other clients. However, he starts to feel downbeat about the prospects of stock of other firms in this niche. He subsequently decides to sell some other clients' holdings in Beta Company which Williams does not own and other than being in the same biotech niche, Alpha Corporation and Beta Company are entirely unrelated.

....

Are Schmidt's policies related to the timing of disclosure of the performance of clients' investments in compliance with the recommendations and requirements of the Asset Manager Code of Professional Conduct?

- ✓ **A) Yes.**
- ✗ **B)** No, with respect to reporting "2 to 3 weeks after the end of the period."
- ✗ **C)** No, with respect to providing monthly reporting to only one group of clients.

Explanation

The Asset Manager Code Recommendations and Guidance (F 4f.) states that managers must disclose the performance of clients' investments on a timely and regular basis, and within 30 days after the end of the period. The Asset Manager Code Recommendations and Guidance (B 3) states that managers must not give preferential treatment to favored clients; however it is permissible to provide a higher level of service to clients that pay for them, provided that other clients aren't disadvantaged.

(Study Session 1, LOS 2.a)

Question #44 of 142

Question ID: 461270

Jim Taylor works as a portfolio manager for Rose Capital and also serves as president of the Little League board of directors in his town. He receives no money from Little League, however the local golf club provides him with a free membership for volunteering his time on the

Little League board. Taylor's involvement with Little League is in his company biography, but the club membership has not been disclosed to Rose or his clients. Taylor has:

- ✗ **A)** **violated the Standards by not disclosing the club membership to Rose, but not by failing to disclose it to clients.**
- ✓ **B)** not violated the Standards.
- ✗ **C)** violated the Standards by not disclosing the club membership to Rose and failing to disclose it to clients.

Explanation

He must disclose any compensation to his employer if it conflicts with his employers/clients interests. However, this relationship does not likely represent any conflict of interest.

Question #45 of 142

Question ID: 461238

Marc Feldman, CFA, is manager of corporate investor relations for a high-tech startup, zippy.com, in Boise, Idaho. Feldman learns that Larry Smith, controller, is altering the accounting records. Knowing the data is incorrect, Feldman releases Smith's financial data to investors. This action:

- ✗ **A)** **constitutes a violation of the Standard concerning duty to employer.**
- ✗ **B)** constitutes a violation of Standard III(D) concerning performance presentation.
- ✓ **C)** constitutes a violation of his fundamental responsibilities under the Code and Standards.

Explanation

As a CFA Institute member, Feldman is bound, under Standard I(A), not to "knowingly participate or assist in any violation of such laws, rules, or regulations." Since it should be clear that releasing bogus financial information is in contravention of laws, rules, and regulations, and since he knows that the data is purposely distorted, he must not release the data to the public. Doing so places him in violation of the Code and Standards.

Question #46 of 142

Question ID: 461287

Jordan Conomos is the new trustee for the Grant Trust, which has both current beneficiaries and remaindermen. Up until now, the trust has been entirely invested in long-term tax-free municipal bonds. Conomos decides to put 30 percent of the assets in common stocks, with the justification that taxes should be the concern of the trust beneficiaries and not the trust, and the trust needs some diversification and growth. Conomos is:

- ✓ **A)** **violating his fiduciary duty by not considering taxes.**
- ✗ **B)** violating his fiduciary duty by not investing solely for the purposes of the current beneficiaries.
- ✗ **C)** not violating his fiduciary duty.

Explanation

The trustee must consider tax liabilities of beneficiaries. However, he should also provide diversification and be concerned with the desires of the remaindermen. (Remaindermen refers to the group that is to receive the remainder of the trust once its term is complete. Of course, some trusts never expire so not every trust has remaindermen.)

Questions #47-52 of 142

Michael Smyth is Senior Vice President of equity investments at Systematic Investment Advisors, Inc. (SIA). He manages a team of analysts and portfolio managers and is responsible for maintaining and developing client relationships. SIA is located in a small European country and provides investment management services to high net worth individuals. Smyth is also a Level III Candidate for the CFA designation.

One of Smyth's clients is the Muller-Durand family. He had a long relationship with Helmut Muller. Before Muller's untimely death, he gave Smyth full discretion over his portfolio based on an investment policy statement that had been refined continuously over the years.

- Muller was the president of a publicly traded manufacturing company, Comax, and 20% of his portfolio's assets were invested in Comax equity. His contract with Comax prohibited his selling his Comax shares while he was employed.
- Muller had little liquidity needs. His children were grown and his salary at Comax was sufficient to cover his annual expenditures as well as contribute to his investment portfolio.
- A former Chartered Accountant, Muller had been extremely knowledgeable and comfortable with the investment decision-making process.
- Smyth owns 10,000 shares of Comax and serves on Comax's board.
- Smyth played golf with Muller on a regular basis and, with Muller's help, developed many client relationships from these outings.

SIA has a soft dollar arrangement with a local brokerage firm, First Brokerage, owned by Smyth's sister.

- Muller had agreed in writing that all trades in his portfolio would be directed to First Brokerage.
- Smyth purchased new carpets for his office with client brokerage. He believes that his managers make better investment decisions when their environment is pleasant and comfortable.
- Smyth attended an industry conference in the Bahamas with soft dollars. The program is devoted to improving management of the investment advisory firm. He believes that a well-run firm makes better investment decisions.
- Smyth consistently uses soft dollars to purchase research reports from an independent research firm that does in-depth analysis of a company's financial reporting. Several of his managers have commented on the quality and usefulness of these reports to their analysis and decision-making.

Smyth has an appointment to meet with Muller's widow, Wilhelmina Durand, who, as an artist, left management of their financial assets to her husband. She is meeting with Smyth to better understand her financial position.

Question #47 of 142

Question ID: 461337

Which of the following Standards is *most* relevant regarding Smyth's meeting with Durand?

✗ **A)** **Standard III(A), Loyalty, Prudence, and Care.**

✓ **B)** Standard III(C), Suitability.

✗ **C)** Standard III(E), Preservation of Confidentiality.

<u>Explanation</u>

Standard III(C), Suitability, is *most relevant* for Smyth's meeting with Wilhelmina Durand. This Standard requires Smyth to make a reasonable inquiry into Durand's financial situation, investment experience, and investment objectives prior to making any recommendations about her portfolio. Smyth must also consider the appropriateness of the existing portfolio and investment policy statement for Durand. Standard III(A) also has some relevance since Smyth is in a position of trust with respect to Durand, and Smyth must ensure that his and SIA's goals do not conflict with Durand's. (Study Session 1, LOS 2.a,b)

Question #48 of 142

Question ID: 461338

Standard VI(A), Disclosures of Conflicts, requires Smyth to disclose all matters, including beneficial ownership of securities of other investments, that could be expected to impair the member's ability to make unbiased and objective recommendations. Which of the following matters would *least likely* be disclosed to Durand?

- ✗ **A) SIA has a soft dollar arrangement with a brokerage firm owned by Smyth's sister.**
- ✓ **B)** Smyth played golf with Muller on a regular basis and developed client relationships.
- ✗ **C)** Smyth owns shares in Comax.

Explanation

Smyth playing golf with Muller is not a conflict with respect to his relationship with Durand and he need not disclose to her that he played golf with Muller. Muller was his client at the time and there was full disclosure that Smyth developed new client relationships. All the other matters must be disclosed. Smyth must get Durand's approval to continue to direct brokerage from her portfolio to his sister's firm. As a director and shareowner of Comax, he has a potential conflict of interest when making a recommendation regarding Durand's Comax shares. (Study Session 1, LOS 2.a,b)

Question #49 of 142

Question ID: 461339

Which of the following *best* describes Smyth's compliance with the CFA Institute Soft Dollar Standards in his use of client brokerage?

- ✗ **A) Purchase of both research reports and carpeting are allowable uses of client brokerage.**
- ✓ **B)** Purchase of research reports is an allowable use of client brokerage.
- ✗ **C)** Purchase of research reports and attending the conference are allowable uses of client brokerage.

Explanation

The primary principles regarding use of client brokerage are (1) brokerage is the property of the client and (2) the investment manager has an ongoing responsibility to seek to obtain best execution, minimize transaction costs, and use client brokerage to benefit clients. Consequently, contingent on disclosure of the soft dollar arrangement to clients whose portfolios might be affected, the CFA Institute Soft Dollar Standards permit client brokerage only to be used to purchase research; that is, goods and services, the primary use of which directly assists the investment manager in the investment decision-making process and not in the management of the firm. Therefore, the only allowable use of soft dollars by Smyth is purchase of the research reports. The purchase of the carpeting to create a more pleasant environment would, at best, only contribute indirectly to the investment manager and use of client brokerage is not permitted. Conferences may sometimes be considered research if their programs are designed to improve the investment decision-making process. In Smyth's case, the conference he attended only had sessions on the management of the investment management firm, not the investment decision-making process. (Study Session 1, LOS 3.b)

Question #50 of 142

Question ID: 461340

Smyth would like to continue to direct brokerage from Durand's portfolio to Smyth's sister's brokerage firm. In order to continue the arrangement and comply with the CFA Institute Soft Dollar Standards, which of the following disclosures are required (and not simply recommended)? Smyth is required to disclose:

- ✓ **A)** **SIA's policies with respect to all Soft Dollar Arrangements.**
- ✗ **B)** that directed brokerage arrangements that require the investment manager to commit a certain percentage of brokerage might affect his ability to seek to obtain best execution.
- ✗ **C)** that his duty as the investment manager is to continue to seek to obtain best execution.

Explanation

Investment managers are required to clearly disclose, with specificity and in "plain language," policies with respect to all Soft Dollar Arrangements. Because brokerage is an asset of the client, not the investment manager, the practice of client-directed brokerage does not violate the CFA Institute Soft Dollar Standards. However, directed brokerage arrangements have no required disclosures beyond those required for other soft dollar arrangements. Several disclosures are recommended. Because directed brokerage may impede the investment manager's ability to seek to obtain best execution, which is one of the investment manager's fundamental responsibilities, it is recommended that investment managers disclose his duty to seek to obtain best execution and that arrangements to commit a certain percentage of brokerage may affect his ability to do so. For all soft dollar arrangements, it is recommended, but not required, that, on request from the client, investment managers provide a description of the product or service obtained through brokerage generated from the client's account. (Study Session 1, LOS 3.b)

Question #51 of 142

Question ID: 461341

After determining Durand's risk and return objectives, liquidity needs, tax considerations, and unique circumstances, Smyth has decided that he must reduce Durand's holdings of Comax shares. He has several other clients, whom he met through Muller, who also have significant holdings in Comax. Smyth has also decided to reduce his own holdings in Comax since his term as a director of Comax will be up in June. He does not plan to seek reappointment but as a member of the audit committee he is privy to information about a tender offer. Smyth realizes this is a complex situation.
Of the following Standards, determine which would *least likely* help Smyth decide what actions with respect to selling shares of Comax would be in compliance with the CFA Institute Standards of Practice.

- ✗ **A)** **Standard VI(A), Disclosure of Conflicts.**
- ✓ **B)** Standard III(C), Suitability.
- ✗ **C)** Standard III(B), Fair Dealing.

Explanation

Standard III(C), Suitability, is the standard least likely to provide Smyth with guidance when he considers selling Durand's holdings of Comax. This standard describes members' responsibilities in developing appropriate recommendations and taking suitable actions. To reach the point where he has decided to sell Durand's shares, Smyth would already have met these requirements. He has determined Durand's and his other clients' requirements and has recommended an appropriate and suitable investment action. His concern is how to implement his recommendation and be in compliance with the Standards of Professional Conduct.

Smyth has several problems with respect to selling shares of Comax from Durand's portfolio and the portfolios of his other clients. First, he must comply with Standard III(B) and deal fairly and objectively with all clients and prospects when taking this investment action. Smyth must disclose his ownership of Comax to all affected clients according to Standard VI(A) and ensure that transactions for clients take precedence over transactions on his own behalf according to Standard VI(B). (Study Session 1, LOS 2.a,b)

Question #52 of 142

Question ID: 461342

Since Smyth is a director of Comax and a member of the audit committee, what additional Standard is specifically applicable to Smyth's decision to sell his and his clients' shares of Comax?

- ✗ **A)** **Standard IV, Duties to Employers.**
- ✓ **B)** Standard II, Integrity of Capital Markets.
- ✗ **C)** Standard VII, Responsibilities as a CFA Institute Member or CFA Candidate.

Explanation

As a director and member of Comax's audit committee, Smyth possesses material nonpublic information about a tender offer. Therefore, Smyth must be particularly concerned about complying with Standard II(A), Material Nonpublic Information. Under this standard, Smyth may not trade nor cause others until the information becomes public. (Study Session 1, LOS 2.a,b)

Question #53 of 142

Question ID: 412701

Travis Brown is a partner in a money management firm. He recently attended a seminar and learned about a quantitative model presented by Dixon. Upon returning to his office, Brown began testing the model and making a few minor alterations. He showed the model to his partners who were impressed and decided to promote the model as proof of the firm's value added. In the firm's next newsletter, Brown included a discussion of the model, the results, and financial data on several stocks selected by the model. These factual data were taken from Standard and Poor's publication. According to the CFA Institute Standards of Professional Conduct, which of the following actions is Brown required to take?

- ✓ **A)** **Brown must credit Dixon, no need to credit S&P.**
- ✗ **B)** Brown must credit S&P, no need to credit Dixon.
- ✗ **C)** Brown must credit both Dixon and S&P.

Explanation

The Standards require members to acknowledge the author of a model, but members are not required to acknowledge information from a recognized statistical and reporting service.

Question #54 of 142

Question ID: 412694

Chuck Thomas is the trustee of a trust of which Jill Wyatt is the main beneficiary. Wyatt's husband is the president of a company. In emptying the recycling bin at home, Wyatt finds some papers that lead her to believe that her husband's company will make a tender offer to acquire another firm. Wyatt takes the information to Thomas, who uses it to purchase shares of the company for the trust, but does not further disclose the information. Thomas has:

- ✗ **A)** **violated the Standards concerning loyalty, prudence, and care.**
- ✗ **B)** not violated any Standards.
- ✓ **C)** violated the Standards concerning material nonpublic information.

Explanation

Thomas cannot act or cause others to act on material nonpublic information.

Question #55 of 142

Question ID: 412693

Jack Stevens is employed by a company to provide investment advice to participants in the firm's 401(k) plan. One of the investment options is a stable value fund run by the company. Stevens' research indicates that the fund is far riskier and less liquid than the typical stable value fund and has a fundamental asset value lower than book value of the assets. He tells Jessica Cox, the head of employee benefits, about his research, and indicates that he will advise new employees to not invest in the fund and will advise employees who already own the fund to reduce their holdings in the fund. Cox points out that the fund is not in any current danger because there are very few redemptions requested of the fund. Cox also states that a sell recommendation may become a self fulfilling prophecy, causing investors to redeem their shares and forcing the fund to liquidate, which in turn will cause the remaining investors to receive less than their promised value. Stevens agrees with this assessment and feels his fiduciary duty is to all employees. Stevens should:

✗ **A) tell investors he cannot give advice on the fund because of a conflict of interest.**

✗ **B)** continue to recommend that new investors do not invest in the fund, but not advise existing investors to reduce their holdings.

✓ **C)** continue to recommend that new investors do not invest in the fund and existing investors reduce their holdings.

Explanation

The employees to whom Stephens owes fiduciary duty are the ones who are seeking his advice, even if acting on that advice hurts other employees who might eventually become clients.

Question #56 of 142

Question ID: 412663

Brenda Simone is a money manager and the Blue Streets Pension Fund is one of her clients. The director of the pension fund calls Simone and asks her to use a particular broker so that the fund can obtain some research services with the soft dollars from that broker. Simone believes that the desired broker will provide the same price and execution as the normal broker that Simone uses. Simone does as the client wishes. Simone has:

✗ **A) not violated the Standards as long as the research provided by the broker will benefit Blue Streets.**

✓ **B)** not violated the Standards as long as the research provided by the broker will benefit the plan beneficiaries.

✗ **C)** violated the Standards.

Explanation

Simone must ensure that the research benefits the parties to whom she owes fiduciary duty, which are the plan participants.

Question #57 of 142

Question ID: 412709

Scott Andrews, CFA, is a stockbroker selling an oversubscribed stock issue. Which of the following *best* describes Andrews' actions regarding this sale? Andrews:

✗ **A)** **cannot offer an oversubscribed issue of stock to any clients.**

✗ **B)** can only offer this security to clients for which it is appropriate on a first come first serve basis.

✓ **C)** can offer this security on a prorated basis to all clients for which the security is appropriate.

Explanation

Standard III(B), Fair Dealing, applies. When new issues or secondary offerings are available or are being offered by the firm or if the firm is part of a selling syndicate, all clients for whom the security is appropriate are to be offered a chance to take part in the issue. *If the issue is oversubscribed, then the issue is to be prorated to all subscribers.*

Question #58 of 142

Question ID: 412711

Member compliance on issues relating to corporate governance or to soft dollars is primarily addressed by the Standard concerning:

✗ **A)** **Disclosure of Referral Fees.**

✓ **B)** Loyalty, Prudence, and Care.

✗ **C)** Disclosure of Conflicts to Clients and Prospects.

Explanation

Fiduciary duty on issues relating to corporate governance or to soft dollars is primarily addressed by Standard III(A), Loyalty, Prudence, and Care.

Question #59 of 142

Question ID: 461295

Harold Klein, CFA, is an expert on ethical conduct in the investment banking industry and has been asked by an association of investment bankers to give a presentation on interpreting codes of ethics and standards of practice such as the CFA Institute Code of Ethics and Standards of Professional Conduct. In his presentation, Klein makes two key points:

1. Sound ethical judgment requires careful and thoughtful application of ethical standards which are precise and exacting in nature
2. An ethical professional must begin the ethical decision making process by determining the applicable code and standards that govern the situation.

Determine whether Klein's statements are correct or incorrect and state your conclusion.

	Statement 1	Statement 2
✓ **A)**	**Incorrect**	**Correct**
✗ **B)**	Correct	Correct
✗ **C)**	Incorrect	Incorrect

Explanation

Statement 1 is incorrect. Ethical standards and codes of conduct are not mathematically precise and exacting but are ambiguous and open to interpretation. This characteristic requires wisdom and a mature approach on the part of the professional. Statement 2 is correct. In deciding what course of action is ethically sound, a professional must first determine the applicable code and standards and assess their requirements in light of the circumstances.

Question #60 of 142

Question ID: 412669

Milton Baker, CFA, prepares a research report on the dynamics of a stock price. In his study, he uses a considerable number of information sources, both outside sources and his company's own research papers, prepared for both internal and public use. The report will first be distributed at the monthly department meeting and then later will be published on the company's Internet site. He thinks that he may have neglected to mention some of his sources in his reference list but decides that he needs to be concerned about full disclosure of his sources only for the public version of the report, so he will wait to revise his work until after the monthly meeting but before it is published on the internet site. Which Standards does Baker NOT comply with?

- ✗ **A)** **Standard I(C), Misrepresentation, only.**
- ✓ **B)** Standard I(C), Misrepresentation, and I(A), Knowledge of the Law.
- ✗ **C)** Standard I(C), Misrepresentation, I(B), Independence and Objectivity, and I(A), Knowledge of the Law.

Explanation

Baker has some doubts but does not initiate any action presuming they only apply to the publicly disclosed report. The lack of action is a violation of Standard I(A), Knowledge of the Law. He also violates Standard I(C), Misrepresentation, by failing to properly disclose the sources of his information, where necessary.

Question #61 of 142

Question ID: 412707

Preston Partners is an investment management firm that adopted the Code and Standards as part of its policy manual. Gerald Smithson, CFA, has recently added the stock of Utah Biochemical Company and Norgood PLC to all his client's investment portfolios. Shortly afterwards Utah Biochemical and Norgood announced a merger that increased the share price of both companies. Smithson contends he saw the president of Utah Biochemical dining with the chairman of Norgood, but did not overhear their conversation. Smithson researched both companies extensively and determined that each company was a good investment. He put in a block trade for shares in each company. Preston's policies were not clear in this area as he allocated the shares by starting with his largest client accounts and working down to the small accounts. Some of Smithson's clients were very conservative personal trust accounts, others were pension funds who had aggressive investment objectives. Which standard was NOT broken?

- ✗ **A)** **Standard IV(C)--Responsibilities of Supervisors.**
- ✓ **B)** Standard V(A)--Diligence and Reasonable Basis.
- ✗ **C)** Standard III(C)-- Suitability.

Explanation

Standard V(A)-Diligence and Reasonable Basis was not broken because Smithson conducted thorough and diligent research. Standard III(C)-- Suitability, Smithson failed to consider the needs of his conservative and aggressive clients. Standard IV(C)-- Responsibilities of Supervisors, Preston Partners didn't have policies explaining how to allocate shares among clients.

Question #62 of 142

Question ID: 461297

Mike Lang Case Scenario

It is Jan. 29, 2009, and Mike Lang, CFA, is in trouble. Lang manages discretionary accounts for Welshire Capital, a large money management firm in New York. Lang has had some problems with the account of Carol Damon, the widow of a prominent banker who left her a sizable estate.

Damon, age 80, has little tolerance for volatility and does not like to invest in small-cap stocks. However, if her portfolio fails to advance at least 10% in a given year, she calls Lang and yells at him, then writes complaint letters to various Welshire Capital officers. Damon's complaint letters usually end up on the desk of Cynthia Silk, CFA, senior portfolio manager for Stonebridge, who oversees the work of Lang and a dozen other money managers. At a recent meeting, Silk reminded all portfolio managers that company policy is to manage against predetermined benchmarks and all exceptions should be cleared first with her.

Last year, Damon's portfolio lost 25% for the year, versus a 38% decline for the S&P 500 Index, the benchmark Welshire Capital uses for all of its portfolios. Lang tried to explain to Damon that the market had an extremely bad year, and the portfolio beat the benchmark by a wide margin in large measure because Lang primarily selected large-cap stocks for Damon's portfolio that outperformed the market. Damon said that she did not care to listen to these excuses and was not concerned about the market return, only her portfolio's return.

The most recent complaint letter was particularly ruthless, with Damon calling into question Lang's competence and threatening to move her account to another firm. Damon, long-time president of the Nassau County Council, further vowed to persuade four local businessmen to move their accounts as well. In total, Damon and the businessmen she plans to influence represent more than 20% of Welshire Capital's assets under management.

In an effort to fix his relationship with Damon, Lang decides to take four actions:

1. Set up a meeting at Damon's home, at which time he will explain how important her business is to Welshire Capital and discuss changes to her investment policy statement.
2. Prepare quarterly and annual reports that include the rationale for purchasing each stock.
3. Defend himself against her attack on his competence by discussing the grueling studies and difficult examinations required to earn the CFA charter and assure her it gives her every reason to expect the portfolio will perform better in the future.
4. Explain to her that despite the fact that two of the mutual funds in her portfolio pay referral fees to Stonebridge, he feels both funds are excellent investments.

Lang further decides to begin using a different benchmark for Damon's portfolio, one that better reflects the nature of the investments in the portfolio and creates a more accurate perception of portfolio performance.

While Lang is moving to sort out his differences with Damon, Silk, his supervisor, takes action of a different sort. Silk serves with Damon on the Nassau County Council, which takes up a considerable amount of Silk's time, and considers Damon to be a personal friend. She also knows about Damon's volatile temper and irrational expectations. She has historically tried to resolve any animosity Damon has towards Lang.

This time, Silk is concerned that Damon will make good on her threat to take business away from Stonebridge. In a phone call to Damon, Silk says she understands Damon's unhappiness with the poor performance and promises to discuss the situation with Lang and take appropriate action if necessary. She also promises Damon shares on a pro rata basis in an upcoming equity offering the company is handling assuming the stock is suitable for Damon's portfolio.

Later that day, Silk reviews transactions in Damon's portfolio and determines that Lang's poor asset allocation reduced the portfolio's returns by a considerable amount. She then calls Lang into her office. During that closed-door meeting, Silk criticizes Lang's handling of the portfolio and tells him she is giving the portfolio to another analyst with more experience. Before dismissing Lang, she calls the other analyst, John Van Zant, and tells him that he will be taking over Damon's portfolio immediately, adding the warning that if the portfolio does not perform better, Van Zant will not get his bonus this year and he must make up the past under-performance.

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Silk's service on the Nassau County Council is *most likely* to violate:

- ✗ **A)** **Standard III(B) Fair Dealing.**
- ✓ **B)** Standard IV(A) Loyalty.
- ✗ **C)** Standard IV(B) Additional Compensation Arrangements.

Explanation

Standard IV(A) Loyalty in part states that Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities. This includes any activities outside of work such as a large time commitment that would deprive their employer of the members' services. A seat on the County Council by itself should not be in conflict with her employment but in this case the County Council position takes up a considerable amount of time which if it interfered with Silk's job at Wilshire Capital could be a violation of Standard IV(A). Standard IV(B) applies to compensation that competes with the employer's interest.

(Study Session 2, LOS 3.b)

Question #63 of 142

Question ID: 412645

Brenda Clark is an investment advisor. Two years ago Clark decided to stop calculating a return composite because of the time required to make those calculations. A prospective client asks Clark what she thinks her performance would have been over the past two years. Clark:

- ✓ **A)** **cannot answer the question because it would be misleading.**
- ✗ **B)** can answer the question orally but cannot state the numbers in writing.
- ✗ **C)** cannot answer the question, nor can she discuss potential future market returns with the prospective client.

Explanation

Any discussion of past performance would imply that Clark had made some calculations, which would be misleading. However, Clark need not calculate historical performance to be an advisor. She can also talk about her view on the future of capital markets.

Question #64 of 142

Question ID: 412653

Scott LaRue is a portfolio manager for Washington Advisors. Washington has developed a proprietary model that has been thoroughly researched and is known throughout the industry as the Washington model. The model is purely quantitative and screens stocks into buy, hold, and sell categories. The basic philosophy of the model is thoroughly explained to clients. The director of research frequently alters the model based on rigorous research-an aspect that is well explained to clients, although the specific alterations are not continually disclosed. Portfolio managers then make specific sector and security holding decisions, purchasing only securities that are indicated as "buys" by the model. La Rue feels the model would be improved by adding some factors but he has not fully tested this new version of the model. LaRue discloses his model to his own clients but not to his supervisor. LaRue is:

✗ **A)** **not violating the Standards.**

✓ **B)** violating the Standards by not having a reasonable and adequate basis for his investment recommendation.

✗ **C)** violating the Standards by not considering the appropriateness of the recommendations to clients.

Explanation

The ad hoc model is not part of the formal research process and does not formulate an adequate basis for a recommendation.

Question #65 of 142

Question ID: 412654

Maggie McCarthy is an individual investment advisor who uses mutual funds for her clients. She typically chooses from a list of 40 funds that she has thoroughly researched. The Figgs, a married couple that are a client, asked her to consider the Boilermaker fund for their portfolio. McCarthy had not previously considered the fund because when she first conducted her research three years ago, Boilermaker was too small to be considered. However, the fund has now grown in value, and after doing thorough research on Boilermaker, she found the fund was by far the most outstanding large company value fund in her list of funds. She puts the fund in the Figgs' portfolio, and in all new clients portfolios, but not in any of her other clients' portfolios. Her reasoning is that her existing clients were comfortable with their current holdings, and she did not want to risk disturbing their comfort. Has McCarthy violated any Standards? McCarthy has:

✗ **A)** **not violated the Standards.**

✗ **B)** violated the Standards by not having a reasonable and adequate basis for making the recommendation.

✓ **C)** violated the Standards by not dealing fairly with clients.

Explanation

The fund should have been considered for the existing clients' portfolios. There may have been reasons not to add the fund to their portfolios, such as tax consequences or a lack of suitability, but disturbing their comfort is not sufficient.

Question #66 of 142

Question ID: 461292

Bill Jackson, CFA, has established his own investment management firm. Jackson uses cost-benefit analysis to determine when to vote proxies, and he informs his clients and prospects of this policy. Is Jackson in compliance with the Code and Standards?

✓ **A)** **Yes.**

✗ **B)** No, because he has violated his duty of loyalty to clients by failing to vote some proxies.

✗ **C)** No, because he must also disclose the details of his cost-benefit analysis.

Explanation

If the costs of voting certain proxies exceed the benefits, the member or candidate can establish a policy to not vote all proxies. The member or candidate is required to inform clients of the proxy voting policy. Jackson has met these requirements and has not violated any Standards.

(Study Session 1, LOS 1.b,c; Study Session 1, LOS 2.a,b,c)

Question #67 of 142

Question ID: 412698

Caroline Turner, an analyst for Lansing Asset Management, just completed an investment report in which she recommends changing a "buy" to a "sell" for Gallup Company. Her supervisor at Lansing approves of the change in recommendation. Turner wonders about whether she needs to disseminate this investment recommendation to Lansing's clients and if so, how to distribute this information. According to CFA Institute Standards of Professional Conduct, Turner is:

✗ **A)** **required to disseminate the change in a prior investment recommendation to all clients and customers on a uniform basis.**

✓ **B)** required to design an equitable system to disseminate the change in a prior investment recommendation.

✗ **C)** not required to disseminate the change of recommendation from a buy to a sell because the change is not material.

Explanation

Standard III(B) - Fair Dealing requires dealing fairly and objectively with all clients and prospects when disseminating material changes in prior investment recommendations. Note that the standard requires the dissemination be fair, but not necessarily equal due to the impossibility of contacting all clients simultaneously. A change of recommendation from "buy" to "sell" is generally material.

Question #68 of 142

Question ID: 412648

Rachel Young, CFA, is making preparations to start a competitive business before terminating her relationship with her employer, a large money management company. Young asks Dot Wiggins, CFA, to consider joining her. In subsequent discussions with Young, Wiggins learns that Young has not disclosed to her employer ownership of stocks that Young recommended. She also learns that Young has used excerpts from research reports by others with only a slight change in wording without acknowledging the source. Wiggins declines Young's offer to join the new business but does not dissociate herself from the violations. According to CFA Institute Standards of Professional Conduct, which of the following statements is NOT correct?

✗ **A)** **Young violated Standard I(C) Misrepresentation, because she did not acknowledge the source of excepts that she used in research reports.**

✓ **B)** Young violated Standard IV(A) Loyalty to Employer, because she was making preparations to start a competitive business before terminating her relationship with her employer.

✗ **C)** Wiggins violated Standard I(A) Knowledge of the Law, because she did not dissociate herself from the violations.

Explanation

Young did not violate Standard IV(A) Loyalty to Employer because such preparations are permitted provided that they do not breach Young's duty of loyalty to her employer. Breaches that would violate Standard IV(A) include soliciting clients or taking records or files while still working for the current employer.

Question #69 of 142

Question ID: 412638

Using as his universe all companies in the steel industry, Reynold Anderson analyses the performance of stock prices for the industry. He succeeds in developing a regression model with excellent statistical control measures. The extrapolation from the model shows low risk variance of the securities in this industry. Without the inclusion of non-steel stocks in the portfolio, Anderson concludes that, based on these results, every portfolio can use the steel industry securities to diversify and lower its risk. He persuades his clients to change their current portfolios. Anderson states that, as the model's results show, some particular industries, such as car manufacturers, have underpriced stocks, and investors should take advantage of it. Anderson has violated the Standards because he:

✓ **A) does not distinguish the opinion, based on his model, from the fact.**

✗ **B)** is not clear enough about the model results.

✗ **C)** does not consider the suitability of the investment.

Explanation

While any of the answers can be shown to violate CFA Institute Standards, this cannot be determined conclusively from the information given. However, the scenario clearly indicates that Anderson does not distinguish between opinion and fact in communicating to his clients. Therefore, he violates the Standards on this basis.

Question #70 of 142

Question ID: 412699

Brendan Duval works as a research analyst for Toby Securities. Duval recommends changing a recommendation from "sell" to "buy" on Dalton Company. His firm, which manages several mutual funds, may be interested in buying Dalton's stock. He also manages the retirement account that his parents established with Toby. Duval wants to buy shares of Dalton's stock because it is an appropriate investment for his parent's retirement account and obtains approval from his employer to do so. Duval is also thinking about personally investing in Dalton stock. According to CFA Institute Standards of Professional Conduct, which of the following *best* describes the priority of transactions? Duval should give:

✗ **A) priority of transactions to Toby's clients, followed by his employer, then his parent's retirement account, and finally his personal account.**

✓ **B)** Toby's clients and his parent's account equal priority, followed by his employer, and then his personal account.

✗ **C)** priority to Toby's clients and his employer concurrently, followed by his parent's retirement account, and finally his personal account.

Explanation

According Standard VI(B) Priority of Transactions, Duval should give transactions for clients and employers priority over his personal transactions. Because his parent's retirement account represents a client account at Toby, Duval should treat this account just like any other firm account. His parent's retirement account should neither be given special treatment nor disadvantaged because of an existing family relationship with Duval. If Duval treats his parent's retirement account differently from other accounts at Toby, he would breach his fiduciary duty to his parents.

Question #71 of 142

Question ID: 412685

The following information pertains to the Galaxy Trust, a trust established by Stephen P. House and managed by Gamma Investment LLC:

- At the time the trust was established House provided $5 million in cash to fund the trust, but Gamma was aware that 93% of his personal assets were in the form of Oracle stock.
- Gamma has been asked to view his funds and the trust as a single entity for planning purposes, since House's will stipulates that all of his estate will pass to the trust upon his death.
- The investment policy statement, developed in September 1996, stipulates that the trust should maintain a short position in Oracle stock and use the proceeds to diversify the trust more adequately.
- House was able to sell all of his Oracle shares back to the corporation in January 1999 for cash.
- The policy statement redrawn in September 1999 continues to stipulate that the trust hold a short position in Oracle stock.
- House has given the portfolio manager in charge of the trust an all expenses paid vacation package anywhere in the world each year at Christmas. The portfolio manager has reported this fact in writing to his immediate supervisor at Gamma.

Which of the following is *most* correct? The investment manager is:

✗ **A) not in violation of the Code and Standards for not properly updating the investment policy statement in light of the change in the circumstances and is not in violation with regard to the acceptance of the gift from House.**

✓ **B)** in violation of the Code and Standards by not properly updating the investment policy statement in light of the change in the circumstances but is not in violation with regard to the acceptance of the gift from House.

✗ **C)** in violation of the Code and Standards by not properly updating the investment policy statement in light of the change in the circumstances and is in violation with regard to the acceptance of the gift from House.

Explanation

The investment manager is in violation of the Standard requiring him to make a reasonable inquiry into the client's financial situation and update the investment policy statement since such a dramatic change in the client's circumstances would undoubtedly alter the investment policy statement and would probably eliminate the need to hold a short position in Oracle. The investment manager is not in violation of the Standard concerning additional compensation, since the gift has been reported to his supervisor and has come from a client. If there was a failure to report such a gift, if the firm had a rule in place against the acceptance of gifts from clients, or if the gift had come from a non-client, there would be a violation of the standard.

Question #72 of 142

Question ID: 461246

Anna Nichols is a research analyst preparing a report on Enterprise Company. In order to ensure accuracy in her report, she sends portions of the report to the Chief Financial Officer (CFO) of Enterprise to allow him to check for factual errors. The CFO makes some corrections, which Nichols checks and agrees with. The CFO also sends Nichols several pages of market analyses that appear favorable for Enterprise. Nichols checks the analyses for accuracy and includes a summary of them in her report, pointing out that the data came from Enterprise. Nichols has:

- ✗ **A) violated the Standards of Professional Conduct by including the data from the CFO in the report.**
- ✓ **B)** not violated the Standards of Professional Conduct but may have violated Research Objectivity Standards.
- ✗ **C)** violated the Standards of Professional Conduct by sending the report to the CFO before sending it to her clients.

Explanation

It is acceptable to send the report to management to check for factual errors and to use careful judgment in including the data provided by Enterprise (note that this was disclosed). Although Nichols has not violated the Standards of Professional Conduct, the Research Objectivity Standards would prohibit Nichols from sending the full report to the CFO. To comply with the Research Objectivity Standards, Nichols should only send the sections of the report containing facts about the company for verification.

Question #73 of 142

Question ID: 412649

Denise Weaver is a portfolio manager who manages a mutual fund and has pension clients. When Weaver receives a proxy for stock in the mutual fund, she gives it to Susan Griffith, her administrative assistant, to complete. When the proxy is for a stock owned in a pension plan, she asks Griffith to send the proxy on to the sponsor of the pension fund. Weaver has:

- ✗ **A) violated the Standards by her policy on mutual fund proxies, but not her policy on pension fund proxies.**
- ✓ **B)** violated the Standards by her policy on mutual fund and pension fund proxies.
- ✗ **C)** not violated the Standards.

Explanation

Proxies should be taken seriously, and although it is likely that Griffith can understand some of the issues, it is likely that she is not capable of making responsible decisions on all potential proxy issues. Proxies for a pension plan should be voted in the best interests of the beneficiaries, not the plan sponsor. The sponsor's interests will not always be the same as the beneficiary's interest.

Question #74 of 142

Question ID: 412689

Judy Gonzales is a portfolio manager with Brenly Capital and works on Johnson Company's account. Brenly has a policy against accepting gifts over $25 from clients. The Johnson portfolio has a fantastic year, and in appreciation, the pension fund manager sent Gonzales a rare bottle of wine. Gonzales should:

- ✗ **A) inform her supervisor in writing that she received additional compensation in the form of the wine.**
- ✗ **B)** present the bottle of wine to her supervisor.
- ✓ **C)** return the bottle to the client explaining Brenly's policy.

Explanation

By not returning the bottle she would be violating the Standard on disclosure of conflicts to the employer, which states that employees must comply with prohibitions imposed by their employer.

Questions #75-80 of 142

Joan Platt, CFA, operates an investment firm in New York, but maintains an office in Xania. Platt's firm invests on its clients' behalf in both domestic and international stocks and bonds. Platt's employees include two analysts, Paula Linstrom, CFA, and Hershel Wadel, a member of the CFA Institute. Both analysts report to Platt directly. Thorvald Knudsen, CFA, manages the international bond portfolio.

Xania recently established a stock market, which is not very efficient. None of the Xanian stocks trade in the U.S. market. Xania legally permits the use of material inside information. Platt believes that using inside information would help her compete against other Xanian investment advisers, and also help some of her Xanian clients reach their investment objectives.

Platt instructs Wadel to write a research report on Gamma Company. Wadel's wife inherited 500 shares of Gamma Company from her father when he died five years ago. Gamma stock currently sells for $35 a share. Wadel does not believe that informing Platt about his wife's inheritance is necessary.

Doris Black, one of Wadel's long-time clients, verbally promised Wadel that he could use her vacation home in Aspen, Colo., for a week during skiing season if the return on her portfolio exceeded its benchmark by two percentage points during the next year. Black also promised to reimburse Wadel for his travel expenses. Because Wadel is the sole manager of Black's portfolio, he says nothing to Platt about his arrangement with Black.

Platt instructs Linstrom to write a research report on Delta Enterprises. Delta's stock is widely held by institutional and individual investors. Linstrom does not own any Delta shares, though one of her friends owns 100 shares of Delta. Linstrom does not believe that informing Platt about her friend's ownership of Delta shares is necessary.

Linstrom has a client, Mandy Miller, with a large account. Miller has set a return goal for her portfolio, promising Linstrom that if the portfolio exceeded the target return, she would let Linstrom use her time-share in St. Maarten in December. Linstrom sent an e-mail to Platt describing Miller's promise to her. Platt promptly replied to her email granting her permission to enter the agreement.

In February, Linstrom was able to arrange for the purchase of Brady Company bonds at a significant discount to market value. The purchase was made in three blocks at 13%, 15%, and 12% discounts to market value. Linstrom allocated the 15% discount block to Miller's account and the balance to her remaining clients.

Knudsen's uncle, Gustaf Jensen, owns a construction firm that has extra cash. When Jensen saw Knudsen at a family event last November, he asked Knudsen to give him advice about purchasing domestic bonds for the construction firm. In exchange for the advice, the construction firm would pay Knudsen $5,000 per year. At the same event, Knudsen's aunt, Hanna Jorgensen, approached Knudsen and asked if he would manage Jorgensen's apartment building for a fee of 10% of the gross rents. Knudsen agreed to both Jensen's and Jorgensen's proposals. Knudsen informed Platt of Jensen's request, but not about the Jorgensen arrangement.

Platt suspects that one of the firm's unpaid interns has violated a federal securities regulation.

Question #75 of 142

Question ID: 461281

Regarding their research reports, which of the following statements about Linstrom and Wadel's conduct is CORRECT?

✓ **A) Wadel violated Standard VI(A)-Disclosure of Conflicts, and Linstrom did not violate Standard VI(A).**

✗ **B)** Wadel did not violate Standard VI(A)-Disclosure of Conflicts, and Linstrom did violate Standard VI(A).

✗ **C)** Both Linstrom and Wadel violated Standard VI(A)-Disclosure of Conflicts.

Explanation

Wadel violated Standard VI(A) by not disclosing his wife's holdings. Linstrom is not in violation of the Standard because a friend's ownership of the shares should not be expected to impair her ability to make objective decisions. (Study Session 1, LOS 2.a,b)

Question #76 of 142

Question ID: 461282

What is the obligation, if any, to disclose Wadel's arrangement with Black?

✓ **A) Wadel must disclose the arrangement to Platt but is not required to disclose the arrangement to his other clients.**

✗ **B)** Wadel need not disclose anything to his clients or to Platt because he is violating no fiduciary duty.

✗ **C)** Wadel must disclose the arrangements to his clients and to Platt only if he believes it will create a conflict with his responsibilities to other clients.

Explanation

Wadel is required to disclose the arrangement between him and Black under Standard IV(B)-Additional Compensation Arrangements, regardless of whether or not the compensation is cash or noncash. Under Standard I(B)-Independence and Objectivity, members may accept bonuses or gifts from clients, so long as they disclose them to their employers, because gifts in a client relationship are deemed less likely to affect a member's objectivity and independence than gifts in other situations. Token gifts need not be disclosed. (Study Session 1, LOS 2.a,b)

Question #77 of 142

Question ID: 461283

Knudsen violated:

✗ **A) Standard IV(B)-Additional Compensation with relation to the Jorgensen deal.**

✓ **B)** Standard IV(B)-Additional Compensation with relation to the Jensen deal, but did not violate the Standard with relation to the Jorgensen deal.

✗ **C)** no Standards with regard to both the Jensen and Jorgensen deals.

Explanation

Notifying Platt about the Jensen deal is not enough. He needs permission in writing from both parties before accepting the work. Thus, Knudsen violated Standard IV(B) with relation to the Jensen matter. However, it does not appear that the work performed for Jorgensen is in competition with Platt's employer, so this aspect is not in violation of Standard IV(B). (Study Session 1, LOS 2.a,b)

Question #78 of 142

Question ID: 461284

The handling of the Miller account:

✗ **A)** **did not violate the Code and Standards because the appropriate disclosures were made.**

✓ **B)** violated Standard III(B)-Fair Dealing, but not Standard IV(B)-Additional Compensation Arrangements.

✗ **C)** violated Standard IV(B)-Additional Compensation Arrangements, Standard III(B)-Fair Dealing, and Standard IV(C)-Responsibilities of Supervisors.

Explanation

Linstrom did not violate Standard IV(B) because she disclosed Miller's offer to Platt. However, her allocation of the best lot of bonds to Miller's account violated Standard III(B). (Study Session 1, LOS 2.a,b)

Question #79 of 142

Question ID: 461285

According to the Standards, how must Platt deal with the intern's alleged illegal activity?

✗ **A)** **Report the intern's behavior to the appropriate regulatory authority.**

✗ **B)** Tell the intern to stop the conduct.

✓ **C)** Initiate an investigation and place limits on the intern's activities pending the outcome.

Explanation

Platt must initiate an investigation, and must also take steps to ensure that additional violations do not occur during the investigation. The investigation could be handled internally by the firm's compliance officer, or could involve outside legal counsel. Simply instructing the intern to stop the conduct is not sufficient-the Standards require a more proactive response. Reporting the intern to the authorities is not appropriate because Platt is not sure the intern is violating the law. The fact that the intern is not paid does not absolve Platt or her company from liability for the intern's actions. (Study Session 1, LOS 2.a,b)

Question #80 of 142

Question ID: 461286

Platt is considering adopting local investment practices in Xania. According to the Standards, Platt may:

✗ **A)** **use material inside information when trading in Xania only if the information does not relate to a tender offer.**

✗ **B)** not use material inside information unless trading Xanian stocks.

✓ **C)** not use material inside information when trading in Xania.

Explanation

Standard II(A)-Material Nonpublic Information does not allow the use of material nonpublic information in investment decisions. Platt is bound by the law of the land if it is stricter than the Standards, and by the Standards if they are stricter than the law. Since the Standards are stricter than Xanian law, Platt's Xanian operations are governed by the Standards. Thus, she cannot use material nonpublic information under any circumstances. (Study Session 1, LOS 2.a,b)

Question #81 of 142

Question ID: 412660

Lee Roth, who is an investment advisor, is riding in a taxi and finds a file of information labeled "Genco Valuation." The folder contains a great deal of financial data, projections and nonpublic information concerning the food products industry that lead Roth to believe that Genco will be worth 50% more than its current stock value. Roth also finds some correspondence that leads him to believe that the file belonged to Tom Hagan. Roth tries to find out where Hagan works so he can return the file. Roth can recommend Genco to his clients unless Hagan works for:

✗ **A) the equity research department for a brokerage firm.**

✓ **B)** Roth cannot recommend Genco to his clients at this time.

✗ **C)** the corporate finance department for Genco.

Explanation

The information is material and nonpublic; therefore, Roth cannot act or cause others to act at this time.

Question #82 of 142

Question ID: 412661

Patricia Hoolihan is an individual investment advisor who uses mutual funds for her clients. She typically chooses funds from a list of 40 funds that she has thoroughly researched. The Burns, a married couple that are a client, asked her to consider the Hawkeye fund for their portfolio. Hoolihan had not previously considered the fund because when she first conducted her research three years ago, Hawkeye was too small to be considered. However, the fund has now grown in value, and cursory research uncovers no fundamental flaws with the fund. She puts the fund in the Burns' portfolio but not in any of her other clients' portfolios. The fund ends up being the best performing fund on her list. Hoolihan has:

✗ **A) not violated the Standards.**

✗ **B)** violated the Standards by not dealing fairly with clients.

✓ **C)** violated the Standards by not having a reasonable and adequate basis for making the recommendation.

Explanation

Despite the fact the addition of the fund was successful, Hoolihan acted improperly in not conducting the same degree of research as she did for the other funds on her list.

Questions #83-88 of 142

Rajiv Singh, a CFA charterholder, works as an equity analyst with Horizon Investments, a large broker/dealer. After ski-resort developer HighLife misses a quarterly earnings target, Singh changes his recommendation on HighLife from buy to hold. Singh has been following HighLife for years. In several previous research reports on HighLife, Singh told clients that, based on his detailed analysis of the financial statements and market position, he believed HighLife had stopped picking up market share. He had mentioned concerns about HighLife several times in his reports and said in the most recent report that he would downgrade the stock if it missed quarterly earnings.

Singh had produced his monthly report on HighLife just a week before the earnings announcement, and because he had just written about his intention to downgrade the stock, he felt he did not need to inform clients of his recommendation change until the next monthly report.

On the same day that the HighLife report was released, Singh initiated coverage on another company with a buy rating, the convenience store operator QuickStop. His research report is distributed that afternoon. A client sends Singh a sell order for

QuickStop via e-mail the same day the new recommendation is being disseminated to all Singh's clients and prospects.

John Womack, a Level II CFA candidate, is a trader at Horizon. Womack, walking past the conference room during an investment meeting, learns of the initiation of the buy rating on QuickStop. Prior to the dissemination of the buy rating to Horizon's clients, he buys up a large block of QuickStop shares for Horizon's account in anticipation of clients' interest in the stock. When the rating is released to the firm's customers, he fills the incoming customer orders out of Horizon's inventory, generating a modest profit for the company.

Horizon is drafting trade-allocation guidelines for companywide use. Five regulations the company is considering are listed below:

1. Regular orders are processed and executed on a pro-rata basis.
2. Shares in initial public offerings will be allocated on a pro-rata basis to the firm's portfolio managers according to advance indications of interest from the managers.
3. When the full amount of a block order is not executed, partially executed orders are allocated on a first-in, first-out basis.
4. Orders must be recorded in writing and stamped with the time of the order and the execution.
5. All clients participating in block trades are give the same execution price, and all clients are charged the same commission.

Question #83 of 142

Question ID: 461256

When Singh receives the sell order for QuickStop, he should:

✓ **A)** **tell the client about the buy rating and advise him not to sell the stock.**

✗ **B)** ask the client to delay the order until he sees the new research report.

✗ **C)** process the sell order immediately to fulfill his fiduciary duty to the client.

Explanation

Standard III(B)-Fair Dealing requires analysts to inform clients of rank changes before accepting the order. Delaying the order or asking a client to wait without explanation could violate the fair dealing Standard as well as the Standard relating to fiduciary duties. (Study Session 1, LOS 2.a,b)

Question #84 of 142

Question ID: 461257

Womack's trading actions are a violation of:

✗ **A)** **Standard III(E)-Preservation of Confidentiality and Standard VI(B)-Priority of Transactions.**

✓ **B)** Standard III(A)-Loyalty, Prudence, and Care and Standard VI(B)-Priority of Transactions.

✗ **C)** Standard IV(A)-Loyalty to Employer and Standard III(B)-Fair Dealing.

Explanation

Womack's actions violate the Standards related to fair dealing, priority of transactions, and fiduciary duties. (Study Session 1, LOS 2.a,b)

Question #85 of 142

Question ID: 461258

With regard to his coverage of HighLife stock, Singh:

✗ **A)** **violated the reasonable basis Standard by downgrading a stock because it missed one quarterly earnings estimate.**

✗ **B)** violated the research reports Standard because he failed to differentiate between facts and opinions.

✓ **C)** did not violate the Standards for reasonable basis or research reports.

Explanation

Singh reported a series of facts that led him to draw a conclusion, and identified the conclusion as his own. No nonpublic information was used in the HighLife analysis. While Singh did say that missing an earnings target would spur a downgrade, he made it clear that he had broader concerns about the firm's market share. Missing an earnings target would simply be confirmation of his concerns, and thus be the catalyst to his change of opinion. (Study Session 1, LOS 4.b)

Question #86 of 142

Question ID: 461259

After Singh changed his investment recommendation for HighLife from a "buy" to a "hold," he violated:

✗ **A)** **Standard I(C)-Misrepresentation by not exercising diligence and thoroughness in his research.**

✗ **B)** Standard V(A)-Loyalty, Prudence, and Care by not exercising reasonable care and prudent judgment in his research.

✓ **C)** Standard III(B)-Fair Dealing by not telling clients about the downgrade of HighLife in the wake of his promise to downgrade the stock if it missed estimates.

Explanation

A change in stock rating is always material, and must always be disclosed to clients. Thus, Singh violated Standard III(B). Singh did not violate a fiduciary duty to his clients because he did not put anyone's interest above theirs. As an analyst, Singh's job is to assess the appeal of an investment, not make investment decisions for individual accounts. As such, he did not violate Standard III(C); Standard I(C) relates to misrepresenting qualifications or guaranteeing investment returns, and is not relevant to this situation. (Study Session 1, LOS 2.a,b)

Question #87 of 142

Question ID: 461260

Horizon's proposed IPO allocation procedures are:

✗ **A)** **a violation of Standard-Loyalty, Prudence, and Care and Standard VI(B)-Priority of Transactions.**

✗ **B)** not a violation of Standard III(B)-Fair Dealing if they are disclosed to all clients and prospects.

✓ **C)** not a violation of Standard I(B)-Independence and Objectivity.

Explanation

Independence and objectivity has not been violated. According to Standard III(B), allocation of new issues according to advance indications of interest should be done on a pro-rata basis by client, rather than by portfolio manager. Therefore, Horizon's policy is not fair and equitable. Disclosure of this inequitable allocation method does not relieve Horizon of its obligation that the allocation method be fair and equitable. While the policy may violate fiduciary duty as required by Standard III(A), it does not violate either Standard III(C), which addresses investment suitability, or Standard VI(B), which relates to the priority of transactions. (Study Session 1, LOS 2.a,b)

Question #88 of 142

Question ID: 461261

Which of the following trade allocation procedures being considered for Horizon's trade allocation policy would NOT be consistent with Standard III(B)-Fair Dealing?

✓ **A)** **When the full amount of a block order is not executed, partially executed orders are allocated on a first-in, first-out basis.**

✗ **B)** All clients participating in block trades are give the same execution price and are charged the same commission.

✗ **C)** Regular orders are processed and executed on a pro-rata basis.

Explanation

All orders should be allocated on a pro-rata basis based on order size, not on a first-in, first-out basis. The other regulations satisfy the fair-dealing Standard. (Study Session 1, LOS 2.a,b)

Question #89 of 142

Question ID: 412702

While visiting the CSI Company, Mark Ramsey, CFA, overheard management make comments that were not public information, but were not really meaningful by themselves. However, when this information is combined with his own analysis and other outside sources, Ramsey decides to change his recommendation on CSI from buy to sell. According to CFA Institute Standards of Professional Conduct, Ramsey should:

✗ **A)** **not issue his report until these comments are made public.**

✗ **B)** report these events to his immediate supervisor and legal counsel, since they have become material in combination with his analysis.

✓ **C)** issue his sell report because the facts are nonmaterial, but maintain a file of the facts and documents leading to this conclusion.

Explanation

The use of security analysis combined with nonmaterial nonpublic information to arrive at significant conclusions is legal and is called the mosaic theory.

Question #90 of 142

Question ID: 412705

In the course of reviewing the Corn Co., an analyst has received comments from management that, while not meaningful by themselves, when pieced together with data he has accumulated from outside sources, lead him to recommend placing Corn Co. on his firm's sell list. What should the analyst do?

✗ **A)** **Show his report to his own manager and counsel for their review since this information has become material once it was combined with his analysis.**

✓ **B)** The comments are non material and the report can be issued as long as he maintains a file of the facts as supplied by management.

✗ **C)** Not issue the report until the comments are publicly announced.

Explanation

This is an example of the mosaic theory where separate pieces of nonmaterial information are pieced together to make an investment recommendation.

Questions #91-96 of 142

Hunter Harrison, CFA, has recently been promoted to 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 is consistent with 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. As part of his new job duties, Harrison will oversee Ironclad's research analysts and portfolio managers, including Michelle Myers, who passed the Level II CFA examination last year and is registered for the next exam. 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 to whom Myers has recommended the software company. Myers has disclosed her partnership interest in the software company to Ironclad, including the potential for additional compensation and the possible conflicts of interest, but not to her clients.

In her correspondence with prospects and clients, Myers normally refers to her status as a candidate in the CFA Program. Her latest brochure includes a reference to her status as a "Level III CFA candidate" in her biographical background to increase her prominence in the industry. Her targeted marketing efforts using these brochures have led to several new accounts in the last few years.

One of Myers' software clients, Breakthrough Pharmaceuticals (Breakthrough), is a publicly traded corporation that is also held in many of Ironclad's client portfolios. In the course of their business relationship, Breakthrough's CEO informs Myers that the company has been having difficulty 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 that Breakthrough's current pension troubles and short-term liquidity issues will negatively affect its earnings and consequently the performance of the company's stock, informs Harrison of the impending disclosure. Harrison allows Myers to sell 1,800,000 shares of Breakthrough stock for clients, causing the price to drop by 5%. When the pension troubles are later disclosed in the company's financial statements, Breakthrough's stock price drops an additional 18%.

As part of Ironclad's portfolio management activities on behalf of its clients, Harrison and Myers maintain relationships with third-party soft dollar providers and commission recapture brokers. Better Trading Brokerage (BTB), 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 its 2-year relationship with Ironclad. One of Harrison's pension clients, Worldwind Travel Inc. (WTI), participates in commission recapture and has offered Harrison two roundtrip airline tickets anywhere in the U.S. or Europe in appreciation for its 2-year relationship with Ironclad. Harrison has disclosed both offers to Ironclad in writing but has not yet responded to either offer because he has been busy with proxy voting duties.

Harrison, as CIO, is chairman of Ironclad's proxy voting committee. Myers is also a member of the committee. Ironclad, as a discretionary investment manager, votes proxies through the proxy voting committee on behalf of clients. Ironclad is currently reviewing proxies for several companies covered in research, including technology companies Advanced DSL (Advanced), InterConnect Inc. (InterConnect), Speedy Chip Technology (Speedy Chip), and Wavelength Digital (Wavelength). Each company's current proxy contains voting proposals pertaining to employee stock option expensing methods. This issue is particularly important to Ironclad because several of its investment personnel recently participated in an industry forum that supported increased disclosure for company stock options. The panel concluded that such disclosure will provide investors with a more complete estimate of corporate earnings. Ironclad, through its clients, owns approximately 4% of the outstanding shares of Advanced and InterConnect and approximately 6% of the outstanding shares of Speedy Chip and Wavelength.

Harrison serves on the board of directors for InterConnect 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 InterConnect 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, among other issues, lack of earnings transparency and low earnings quality. Contrary to committee consensus, Harrison and Myers vote client proxies "against" the expensing of employee stock options for InterConnect, Wavelength, and Speedy Chip. Harrison increases his clients' positions in both InterConnect and Wavelength, citing "growth opportunities" and "consensus opinion." Neither Harrison nor Myers has disclosed these compensation arrangements to Ironclad.

Question #91 of 142

Question ID: 461330

Is it *likely* that Myers violated any CFA Institute Standards of Professional Conduct in her reference to her candidacy in the CFA program?

✓ **A)** **No.**

✗ **B)** Yes, by inappropriately using her candidate status to recruit new clients.

✗ **C)** Yes, by stating her candidate status using language that is inconsistent with the Standards.

Explanation

The actions of Myers are consistent with Standard VII(B), which requires that 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. Additionally, to be considered a candidate, an individual must be registered to take the next scheduled exam. Since Myers completed Level II last year and has registered for the next exam, she is in compliance with the Standard. There is also no indication that she has exaggerated the meaning of implications of her candidacy in the CFA program in the promotional brochure by, for example, over promising her competency or future investment results. (Study Session 1, LOS 2.a,b)

Question #92 of 142

Question ID: 461331

Is it *likely* that Myers violated any CFA Institute Standards of Professional Conduct with respect to her disclosure of the partnership interest in the software company or did Harrison violate any standards with respect to the sale of Breakthrough stock?

	Partnership interest	Breakthrough sale
✗ **A)**	**Yes**	**No**
✗ **B)**	No	Yes
✓ **C)**	Yes	Yes

Explanation

Standard VI(A) - Disclosure of Conflicts, is applicable since Myers is a portfolio manager with fiduciary responsibility for institutional clients of Ironclad who may also be clients of her software company, thereby potentially compromising her ability to make unbiased and objective investment recommendations. Myers should disclose the potential conflict to her clients and to

Ironclad and abide by any restrictions imposed by the firm. Myers has not disclosed the conflict to clients and has therefore violated the Standard. Harrison has violated Standard IV(C) - Responsibilities of Supervisors by failing to prevent Myers from trading on material nonpublic information. He has a responsibility as a supervisor to make reasonable efforts to detect and prevent violations of the Standards by his employees. (Study Session 1, LOS 2.a,b)

Question #93 of 142

Question ID: 461332

Is it *likely* that Myers violated any CFA Institute Standards of Professional Conduct by selling the Breakthrough stock for her clients' accounts?

✓ **A)** **Yes.**

✗ **B)** No, because she fulfilled her fiduciary duty to her clients by avoiding significant losses.

✗ **C)** No, because she first made her supervisor aware of the information upon which the trade was based and received approval for the trade.

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. 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. Information 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. By sharing the information with Harrison and trading on that information, Myers violated Standard II(A) - Material Nonpublic Information. (Study Session 1, LOS 2.a,b)

Question #94 of 142

Question ID: 461333

In order to maintain compliance with CFA Institute Standards of Professional Conduct, is it *appropriate* for Harrison to accept, or is he required to reject, the offers of appreciation from BTB and WTI, assuming Ironclad consents to both?

	BTB	WTI
✗ **A)**	**Accept**	**Reject**
✓ **B)**	Reject	Accept
✗ **C)**	Reject	Reject

Explanation

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 and Standard IV (B) - Additional Compensation Arrangements. Under Standard I(B), members shall use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment actions. Harrison, as a fiduciary to his investment clients, has an obligation to act in their best interest and must maintain his independence and objectivity when making investment decisions. Harrison's relationship with Better Trading is, among other things, to execute trades in return for soft dollar services for Ironclad. Soft dollars involve the use of client brokerage by an investment manager to obtain products and services that aid the manager in the research and investment decision-making process. 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. 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. Standard IV(B) - Additional Compensation Arrangements, requires members to disclose in writing any additional compensation or other benefits received for their services in addition to those provided by their employer. (Study Session 1, LOS 2.a,b)

Question #95 of 142

Question ID: 461334

With respect to Harrison's directorships with InterConnect and Wavelength and Myers' consulting arrangement with Speedy Chip, is it *likely* that any CFA Institute Standards of Professional Conduct have been violated?

	Harrison's directorships	Myers' consulting arrangements
✓ A)	**Yes**	**Yes**
✗ B)	Yes	No
✗ C)	No	No

Explanation

Standard IV(B) - Additional Compensation Arrangements, applies to both Harrison and Myers, as they both receive compensation for their respective outside services in the form of cash, stock, and stock options. There is no indication that either of them have disclosed their compensation arrangements to Ironclad, which constitutes a violation of Standard IV(B). Standard I(B) - Independence and Objectivity also applies to this situation, as both Harrison and Myers have outside activities that have the appearance of compromising their independence and objectivity regarding Ironclad's clients. Harrison's role on the boards of directors for InterConnect and Wavelength and Myers' role as a consultant for Speedy Chip appear to drive their proxy voting decisions, on behalf of Ironclad's clients, regarding the expensing of stock options. Thus both Harrison and Myers have also violated Standard I(B). Harrison and Myers may have also violated Statement VI(A) - Disclosure of Conflict by failing to disclose the conflicts of interest that exist as a result of Harrison's directorships with Interconnect and Wavelength and Myers' consulting arrangement with Speedy Chip. Such conflicts (whether actual or potential) are required to be disclosed prominently and in clear language to clients, prospects, and employers according to Standard VI(A) (Study Session 1, LOS 2.a,b).

Question #96 of 142

Question ID: 461335

Which of the following *least* accurately describes Harrison's actions necessary for compliance with the Code and Standards regarding proxy voting? Harrison should:

✗ A) **abstain from voting on matters affecting Internet and Wavelength to avoid conflicts of interest.**

✓ B) discard all proxies on behalf of Ironclad's clients when there is a conflict of interest.

✗ C) disclose all proxy voting policies to Ironclad's clients including the treatment of routine and nonroutine issues.

Explanation

According to Standard III(A) - Loyalty, Prudence, and Care, 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 InterConnect and Wavelength due to his role on their board of directors, proxies on non-routine matters 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 InterConnect 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. Clients must be made aware of the firm's policies on voting routine and non-routine proxy issues. (Study Session 1, LOS 2.a,b).

Question #97 of 142

Question ID: 461271

June Bird is a pension consultant asked to advise on the Backwater County Pension Plan. Bird notices that 20 percent of the plan's assets are invested in privately held local businesses. Bird is concerned about the lack of liquidity and diversification caused by such an investment. She learns that state law allows investing in local businesses and county law requires at least one-fifth of the plan's assets to be dedicated to investing in local businesses. Bird:

✓ **A) can continue to advise the pension plan as best she can with the restrictions.**

✗ **B)** should recommend that the trustees resign or risk being sued for violating the Prudent Expert Rule.

✗ **C)** should file a written complaint to the Department of Labor pointing out that the law is in conflict with the Employee Retirement Income Security Act (ERISA).

Explanation

According to Standard III(A), Loyalty, Prudence, and Care, Bird can continue to serve as a consultant to the plan, but must follow the applicable law.

Question #98 of 142

Question ID: 412684

Ken James has been an independent financial advisor for 15 years. He received his CFA Charter in 1993, but did not feel it helped his business, so he let his dues lapse this year. He still has several hundred business cards with the CFA designation printed on them. His promotional materials state that he received his CFA designation in 1993. James:

✓ **A) must cease distributing the cards with the CFA designation, but can continue to use the existing promotional materials.**

✗ **B)** must cease distributing the cards with the CFA designation and the existing promotional materials.

✗ **C)** can continue to use the existing promotional materials, and can use the cards until his supply runs out-his new cards cannot have the designation.

Explanation

Use of the CFA designation must be stopped immediately, however, the receipt of the Charter is a matter of fact.

Question #99 of 142

Question ID: 461242

Mike Lang Case Scenario

It is Jan. 29, 2009, and Mike Lang, CFA, is in trouble. Lang manages discretionary accounts for Welshire Capital, a large money management firm in New York. Lang has had some problems with the account of Carol Damon, the widow of a prominent banker who left her a sizable estate.

Damon, age 80, has little tolerance for volatility and does not like to invest in small-cap stocks. However, if her portfolio fails to advance at least 10% in a given year, she calls Lang and yells at him, then writes complaint letters to various Welshire Capital officers. Damon's complaint letters usually end up on the desk of Cynthia Silk, CFA, senior portfolio manager for Stonebridge, who oversees the work of Lang and a dozen other money managers. At a recent meeting, Silk reminded all portfolio managers that company policy is to manage against predetermined benchmarks and all exceptions should be cleared first with her.

Last year, Damon's portfolio lost 25% for the year, versus a 38% decline for the S&P 500 Index, the benchmark Welshire Capital uses for all of its portfolios. Lang tried to explain to Damon that the market had an extremely bad year, and the portfolio beat the benchmark by a wide margin in large measure because Lang primarily selected large-cap stocks for Damon's portfolio that outperformed the market. Damon said that she did not care to listen to these excuses and was not concerned about the market return, only her portfolio's return.

The most recent complaint letter was particularly ruthless, with Damon calling into question Lang's competence and threatening to move her account to another firm. Damon, long-time president of the Nassau County Council, further vowed to persuade four local businessmen to move their accounts as well. In total, Damon and the businessmen she plans to influence represent more than 20% of Welshire Capital's assets under management.

In an effort to fix his relationship with Damon, Lang decides to take four actions:

1. Set up a meeting at Damon's home, at which time he will explain how important her business is to Welshire Capital and discuss changes to her investment policy statement.
2. Prepare quarterly and annual reports that include the rationale for purchasing each stock.
3. Defend himself against her attack on his competence by discussing the grueling studies and difficult examinations required to earn the CFA charter and assure her it gives her every reason to expect the portfolio will perform better in the future.
4. Explain to her that despite the fact that two of the mutual funds in her portfolio pay referral fees to Stonebridge, he feels both funds are excellent investments.

Lang further decides to begin using a different benchmark for Damon's portfolio, one that better reflects the nature of the investments in the portfolio and creates a more accurate perception of portfolio performance.

While Lang is moving to sort out his differences with Damon, Silk, his supervisor, takes action of a different sort. Silk serves with Damon on the Nassau County Council, which takes up a considerable amount of Silk's time, and considers Damon to be a personal friend. She also knows about Damon's volatile temper and irrational expectations. She has historically tried to resolve any animosity Damon has towards Lang.

This time, Silk is concerned that Damon will make good on her threat to take business away from Stonebridge. In a phone call to Damon, Silk says she understands Damon's unhappiness with the poor performance and promises to discuss the situation with Lang and take appropriate action if necessary. She also promises Damon shares on a pro rata basis in an upcoming equity offering the company is handling assuming the stock is suitable for Damon's portfolio.

Later that day, Silk reviews transactions in Damon's portfolio and determines that Lang's poor asset allocation reduced the portfolio's returns by a considerable amount. She then calls Lang into her office. During that closed-door meeting, Silk criticizes Lang's handling of the portfolio and tells him she is giving the portfolio to another analyst with more experience. Before dismissing Lang, she calls the other analyst, John Van Zant, and tells him that he will be taking over Damon's portfolio immediately, adding the warning that if the portfolio does not perform better, Van Zant will not get his bonus this year and he must make up the past under-performance.

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The Code and Standards was *most likely* violated by:

- ✗ **A)** **Lang's management of Damon's portfolio.**
- ✓ **B)** neither Lang's management of the portfolio nor Silk's attempts to resolve any animosity.
- ✗ **C)** Silk's attempts to resolve any animosity for Lang.

Explanation

Even though Damon may be a difficult client to work with, neither Lang nor Silk committed any violation of the Code and Standards by the way the portfolio was managed or by Silk's attempt to reduce the animosity between Lang and Damon.

(Study Session 2, LOS 3.b)

Question #100 of 142

Question ID: 461243

Futura Investments Co. decides to diversify its current portfolio with stocks from three companies in a new segment of the biotechnology industry. William Burgin, CFA, is an analyst at Futura and had previously bought shares of the same three companies for his own portfolio, well before his employer started researching them. Burgin has already disclosed the composition of his personal portfolio to Futura Investments, to be in compliance with the Code & the Standards. Which of the following actions should Burgin take?

- ✗ **A)** **Open an account that will be managed by someone else but will allow him to maintain his investment preferences.**
- ✓ **B)** Hire a full discretionary power or blind trust manager for his portfolio.
- ✗ **C)** Diversify his personal portfolio so, in this way, these stocks will no longer represent a substantial portion of the portfolio.

Explanation

Burgin followed Standard VI(A) and informed his employer about the potential conflict of interest. He needs to follow the CFA Institute Standards in the best interest of his employer. To prevent any future problems with conflict of interest, his best option is to discontinue the active management of his personal portfolio and use a blind trust.

Question #101 of 142

Question ID: 412667

Betsy Fox is an investment advisor who has a client, Don Gordon, who is an employment lawyer. At lunch, Fox noticed Gordon and the Chief Financial Officer of Blue Star Company at the next table. She overhears them talking and ascertains that Blue Star is about to announce higher than expected earnings. Before the earnings release, Gordon contacts Fox and asks her to purchase 3,000 shares for his portfolio. Fox:

- ✗ **A)** **can only purchase shares for her personal account after informing all of her clients about the potential of the increase in earnings.**
- ✓ **B)** must refuse to purchase shares for Gordon.

✗ **C)** can purchase shares for Gordon, but cannot ever purchase shares for her personal account.

Explanation

According to Standard II(A), Material Nonpublic Information, Fox cannot act or cause others to act on material nonpublic information until the information is made public. The information overheard at lunch was material and nonpublic; therefore, Fox must wait until the information is made public before accepting Gordon's order.

Question #102 of 142

Question ID: 461244

Perley & Sons is an investment advisor company that just signed a contract with full discretionary power for the management of assets for Bright Future, a charitable fund. Without consultation, portfolio manager Martin Brown, CFA, decides to trade the funds' assets through a brokerage firm that provides, as an additional benefit, research reports for companies in the microchip industry. These companies represent the main investment interest for most of the Perley & Sons clients. The Bright Future portfolio does not hold any equities in the microchip industry, and, because of its risk profile, is unlikely to ever do so. Which of the following activities represents a possible breach with the CFA Institute standards?

✗ **A)** **Lack of action in consulting with the client before choosing the brokerage firm.**

✓ **B)** Exercising a selection principle that does not comply with the idea of best trade price and execution.

✗ **C)** Accepting research reports from the brokerage firm that do not benefit client portfolios.

Explanation

The problem refers to the fiduciary duties of the analyst and brokerage contracts involving soft money. Trades placed with a broker that provides the firm with research are implicitly paying for the research. In a competitive marketplace, it is probable that the trades could have been as effectively placed with a broker that was able to provide research that would apply to the holdings of Bright Future. According to Standard III(A) Loyalty, Prudence, and Care, it is permissible to direct trades of the client portfolio through a broker who provides research that does not directly benefit the client portfolio, but the client should be informed about the situation.

Question #103 of 142

Question ID: 412683

Which of the following statements about a member's use of client brokerage commissions is NOT correct? Client brokerage commissions:

✓ **A)** **may be directed to pay for the investment manager's operating expenses.**

✗ **B)** should be used by the member to ensure that fairness to the client is maintained.

✗ **C)** should be commensurate with the value of the brokerage and research services received.

Explanation

Brokerage commissions are the property of the client and may only be used for client benefit.

Question #104 of 142

Question ID: 412680

Randal Brooks is the chief economist for a large brokerage firm. In the aftermath of a national tragedy, Brooks feels that it is very possible that the stock market will drop significantly and not recover for several years. However, he does not believe that this is the most likely scenario but merely that the risk of investing in equities has increased. He decides to write a market commentary to the brokerage clients that discusses the reasons why the market will remain stable and talks about why he, as a private citizen, feels patriotic. He does not mention the increase risk in equities. Brooks has:

✗ **A) violated the Standards by not including all of the relevant factors in the research report and making patriotic statements.**

✓ **B)** violated the Standards by not including all of the relevant factors in the research report, but not by making patriotic statements.

✗ **C)** not violated the Standards.

Explanation

By not mentioning the increased risk of the market, Brooks has violated the Standard on using reasonable judgment in a research report. However, the patriotic statements do not violate the Standards.

Questions #105-110 of 142

Greg Hartsburg, a CFA charterholder, is a leading health-care industry analyst for Reynolds and Co., a New York-based brokerage firm. He has ten years of industry experience and has appeared on the *Wall Street Journal's* roster of all-star analysts for four straight years.

Hartsburg initiates coverage on Northern Lights Medical Equipment, a Minnesota-based company that designs medical equipment. Hartsburg owns shares of Northern Lights in his personal trading account, a stake of which his company is aware.

Maria Voltaire, a junior analyst working under Hartsburg, has asked the senior analyst to help her prepare for the 2009 Level III CFA exam. He makes himself available to answer her questions on specific topics during the course of her study and gives her two days off, with pay, to study during the week before the exam. He also discusses with her in detail his recollection of the topical areas covered on the 2007 Level III exam, which he took and passed.

One of Reynolds' traders tells Hartsburg that he believes Voltaire is trading in her own account based on information she gathers from research reports written by analysts in the office before the reports are publicly released.

Hartsburg attends an analysts' conference in Toronto. At dinner he is seated close to a table that includes a number of leading analysts in the health-care industry. Hartsburg overhears parts of the conversation, in which the group discusses new trends in the health-care industry as a result of the changing political climate in Washington. The consensus at the table is that trends in the industry are favorable over the next four or five years.

Hartsburg has been in the process of preparing his own detailed industry analysis in which he reaches similar conclusions. The conversation he overhears confirms his own analysis, though one of the analysts, Phil Houston, makes some points about competition in the medical-device area that Hartsburg had not considered. On the plane home that evening, Hartsburg rereads the financial statements of two companies he covers, then concludes that Houston's points about competition are correct.

When he returns home, Hartsburg completes his industry report. In the report he wants to use Houston's ideas. But Houston works for a rival firm, and as a matter of policy, Reynolds does not refer to rival companies in its reports. So Hartsburg pulls some numbers from 10-K reports for context, starts with Houston's premise, and makes a similar point in his own words.

Hartsburg is planning to leave Reynolds at the end of the month to take a position as a portfolio manager at Lone Pine Investments. He has disclosed to Reynolds, in the form of an e-mail message to his supervisor, his intention to take with him to his new position a fundamental factor model that he developed before coming to Reynolds and further refined during his time at Reynolds.

He also discloses plans to take with him three sample client investment policy statements (with the client names eliminated) to use as templates in the development of policy statements for his new clients at Lone Pine. In the e-mail to his supervisor, Hartsburg promises he will not solicit the business of these three clients.

Reynolds hires an outside firm to create a company website. Hartsburg is featured in promotional materials touting the firm's performance. The material reads, in part, "Greg Hartsburg is a Chartered Financial Analyst (CFA) with 10 years of experience in the investment industry. He has appeared on the *Wall Street Journal's* roster of all-star analysts for four years in a row."

Question #105 of 142

Question ID: 461274

In order to conform to the Code and Standards with relation to Northern Lights stock, Hartsburg MUST:

✗ **A)** **ask the company to assign another analyst to cover the stock in an effort to avoid the conflict of interest.**

✗ **B)** sell the shares before issuing the report.

✓ **C)** directly disclose his holdings or have his company issue a generic disclaimer about analyst stock ownership.

Explanation

If the brokerage uses language related to the analysts' potential stock ownership, that should satisfy the requirements of Standard VI(A): Disclosure of Conflicts. The other answers would satisfy the Standard, but are not REQUIRED. Requiring the selling of shares or requesting another analyst is overkill, as analysts are not prohibited from owning stocks they cover. (Study Session 1, LOS 2.a,b)

Question #106 of 142

Question ID: 461275

Hartsburg's efforts to help Voltaire pass the CFA exam:

✗ **A)** **conform to all relevant standards.**

✗ **B)** violate both Standard I(D): Misconduct and Standard VII(A): Conduct as Members and Candidates in the CFA Program.

✓ **C)** conform to Standard I(D): Misconduct, but violate Standard VII(A): Conduct as Members and Candidates in the CFA Program.

Explanation

Hartsburg violated Standard VII(A) when he discussed with Voltaire in detail his recollection of the topical areas covered on the 2007 Level III exam. (Study Session 1, LOS 2.a,b)

Question #107 of 142

Question ID: 461276

With respect to the allegation that Voltaire is front-running research recommendations, Hartsburg's first priority, under CFA Institute Standard IV(C) concerning supervisory responsibilities, should be to:

✓ **A)** **promptly initiate an investigation.**

✗ **B)** report the situation to his supervisor.

✗ **C)** freeze Voltaire's trading account and begin documenting her conduct as a precursor to possible termination.

Explanation

Standard IV(C) calls for supervisors to "prevent any violation of applicable statutes, regulation, or provisions of the Code and Standards." While reporting the situation to a superior and discussing the situation with Voltaire are good ideas, he should first investigate the situation to see if these actions are warranted. Freezing Voltaire's trading account is premature, as Hartsburg has not yet investigated the situation to find out whether a violation is actually taking place. (Study Session 1, LOS 2.a,b)

Question #108 of 142

Question ID: 461277

Regarding Hartsburg's report on the health-care industry, his actions:

✓ **A) conform to Standard I(C) concerning misrepresentation; and conform to Standard II(A) concerning the use of nonpublic information.**

✗ **B)** fail to conform to Standard II(A) concerning the use of nonpublic information; and conform to Standard V(A) concerning diligence and reasonable basis.

✗ **C)** fail to conform to Standard I(C) concerning misrepresentation; but conform to Standard V(A) concerning diligence and reasonable basis.

Explanation

While Hartsburg used Houston's ideas in his report, he did not quote or paraphrase Houston. That is not a violation of the plagiarism standard. Houston's statement was innocently overheard in a public place, and as such is not material nonpublic information. Hartsburg has a reasonable basis for his research, and the conversation he overheard merely confirmed his own analysis. The independence standard does not apply in this situation. (Study Session 1, LOS 2.a,b)

Question #109 of 142

Question ID: 461278

Which statement about Hartsburg's actions prior to his leaving Reynolds is *most* accurate? His actions regarding the factor model:

✗ **A) conform to Standard IV(A): Loyalty to Employer, as do his actions regarding the investment-policy statements.**

✓ **B)** do not conform to Standard IV(A): Loyalty to Employer, nor do his actions regarding the investment-policy statements.

✗ **C)** do not conform to Standard IV(A): Loyalty to Employer, but his actions regarding the investment-policy statements do.

Explanation

According to Standard IV(A): Loyalty to Employer, Hartsburg cannot, without the consent of Reynolds, his current employer, take with him any property that rightfully belongs to Reynolds. Merely disclosing to his supervisor his intention to take the model and the investment policy statements with him does not constitute consent on the part of Reynolds, and as such could be considered misappropriation. Therefore his actions regarding both the model and the policy statements fail to conform to Standard IV(A). (Study Session 1, LOS 2.a,b)

Question #110 of 142

Question ID: 461279

Reynolds' promotional material conforms to:

✗ **A)** **Standard I(C) regarding misrepresentation, but not Standard III(D) concerning performance presentation.**

✓ **B)** Standard I(C) regarding misrepresentation and Standard III(D) concerning performance presentation, but violates at least one other standard.

✗ **C)** all Standards.

Explanation

The material fails to conform to Standard VII(B), Reference to CFA Institute, the CFA Designation, and the CFA Program. The Chartered Financial Analyst designation should always be used as an adjective, never as a noun. It would be proper, for instance, to print, "Greg Hartsburg is a CFA charterholder." The statements about industry experience and the all-star analyst list are statements of fact. Reynolds has not misrepresented the services the company or Hartsburg is capable of performing, its qualifications, or Hartsburg's professional credentials. Hence they conform to Standard I(C). The statement also does not contradict Standard III(D) concerning performance presentation in any way. (Study Session 1, LOS 2.a,b)

Question #111 of 142

Question ID: 412692

Victor Logan is a portfolio manager for McCoy Advisors, and Jack Brisco is the Director of Research for McCoy. Brisco has developed a proprietary model that has been thoroughly researched and is known throughout the industry as the McCoy model. The model is purely quantitative and screens stocks into buy, hold, and sell categories. The basic philosophy of the model is thoroughly explained to clients. Brisco frequently alters the model based on rigorous research-an aspect that is well explained to clients, although the specific alterations are not continually disclosed. Portfolio managers then make specific sector and security holding decisions, purchasing only securities that are indicated as "buys" by the model. Logan has conducted very thorough research on his own, using the same process that Brisco uses to validate his findings. Logan feels the model is missing some key elements that would further reduce the list of acceptable securities to purchase, however, Brisco has refused to look at Logan's research. Frustrated by this, Logan applies his own version of the model, with the justification that he is still only purchasing securities on the buy list. Because of the conflict with Brisco, he does not disclose the use of the model to anyone at McCoy or to clients. Which of the following statements regarding Logan and Brisco is CORRECT? Logan is:

✓ **A)** **not violating the Standards by applying his version of the model, but is violating the Standards by not disclosing it to clients. Brisco is not violating the Standards.**

✗ **B)** violating the Standards by applying his version of the model and by not disclosing it to clients. Brisco is violating the Standards by failing to consider Logan's research.

✗ **C)** violating the Standards by applying his version of the model and by not disclosing it to clients. Brisco is not violating the Standards.

Explanation

Because the research is thoroughly conducted, and Logan has authority to make individual security selection decisions, Logan is not violating the Standards by applying his model. However, Logan is violating the Standard on communication with clients and prospective clients by excluding relevant factors of the investment process. The use of his model is an important aspect of the investment process and should be disclosed to clients. Brisco is not violating the Standards by not considering Logan's research.

Question #112 of 142

Question ID: 412697

Dick Charles is a security analyst with a large brokerage company. Sean Donaldson is a money manager. They both listen in on a conference call for security analysts with the president of Stoppard, Inc., who states that in two days the company will be holding a press conference announcing a new product. Both Charles and Donaldson feel the news will increase the value of Stoppard.

✓ **A) Charles must wait until after the press conference to disseminate the information to clients, and Donaldson must wait until after the press conference to purchase the stock for his clients.**

✗ **B)** Charles must wait until after the press conference to disseminate the information to clients, but Donaldson can purchase the stock for his clients immediately.

✗ **C)** Charles can disseminate the information to clients, and Donaldson can purchase the stock for his clients immediately.

Explanation

By waiting until after the press conference the information would then be considered public information and can then be disseminated to clients and traded on without there being any issues of insider trading.

Questions #113-118 of 142

William Fleming is an investment advisor for GlobalBank, a large, multinational financial corporation. He is based in the New York office, and his client base consists of medium to large institutional accounts in the United States and Western Europe. Roughly three-quarters of his clients pay performance-based fees, while the remaining one-quarter pay fees based on assets. GlobalBank's investment banking division is an industry leader, and Fleming is able to offer his clients the opportunity to participate in some of the hottest initial public offerings (IPOs) and secondary offerings brought to market. GlobalBank's compliance department formulated and distributed to its employees and clients its policy on how to allocate trades among clients.

The policy states that in order to reward customer loyalty, customers that utilize the services of GlobalBank's divisions other than investment advisory will receive allocations on all trades (including IPOs and secondary offerings) based on the relative size of their order, before clients that utilize only investment advisory services. After filling orders for multi-relationship clients, clients that only utilize investment advisory services will receive trade allocations on all trades, including IPOs and secondary offerings, based on the relative size of their order. This policy reflects GlobalBank's long-term goal of being a full-service provider of financial products and services to all of its clients.

One of Fleming's accounts, Waverly Capital Partners, has contacted him regarding an upcoming secondary offering by DCH Corp., for which GlobalBank will serve as lead underwriter. Waverly has already performed its due diligence on the offering and is interested in purchasing a substantial position in the secondary offering in order to employ the company's current surplus of cash. Waverly's representative tells Fleming over the phone that they would like to purchase 5,000 shares of the offering but gives no other details of its analysis of the offering. Fleming has not read the prospectus for the offering yet and is not familiar with the details, but because he has confidence in Waverly's investment expertise, he tells them that he too believes they should participate in the offering. Because Waverly does a significant amount of business with GlobalBank's other divisions, Fleming assures them that they will be able to obtain their desired allocation of the offering and takes the order.

After taking the purchase order for the Waverly account, Fleming thoroughly reads the prospectus and marketing materials for the offering, as well as past research reports on the issuing company. He determines that DCH shares would be a suitable investment for one of his other clients, The Crockett Foundation. He contacts the Chief Investment Officer (CIO) of the foundation, explains how an investment in DCH would fit with its current risk and return objectives as detailed in the foundation's investment policy statement (IPS) and provides her with the prospectus for the offering. Fleming tells her that GlobalBank was the lead underwriter for DCH's initial public offering three years ago and that since then, the stock has outperformed the S&P 500 by at least 15% every year. Fleming also states that the company's financial position is now even stronger and that the shares will perform at least as well as the lowest return earned on the IPO shares in the last three years. He then proceeds to tell her, "If the foundation is interested in the offering, you should place an order immediately because the issue may be oversubscribed due to strong interest in the offering from Waverly Capital Partners and other clients." This information is enough to motivate Crocket's CIO to call a meeting with the foundation's investment committee.

After a quick meeting with Crockett's investment committee, the CIO calls Fleming to say that the foundation is interested in the offering and would like to place a purchase order. Crockett does not currently conduct any additional business through GlobalBank's other divisions. Because of GlobalBank's trade allocation policy, coupled with the high probability that the offering will be oversubscribed, Crockett is unlikely to be allocated as many shares of the offering as they would like to purchase. In order to obtain the desired number of shares for the client, Fleming devises a plan. He plans to add the Crockett Foundation's order to Waverly's order, and once the order is filled he will re-allocate the extra shares back to the foundation's account at the end of the day. He feels that his action is justified because Crockett has maintained its account with Fleming and GlobalBank for over ten years. In addition, Fleming has traders at GlobalBank sell large blocks of DCH over several days in order to push the stock price lower. The drop in value causes smaller investors at GlobalBank, who are not Fleming's clients, to withdraw their orders for shares of DCH's secondary offering. Fleming determines that the fewer number of purchase orders and the plan to piggyback on Waverly's order will allow Crocket to acquire its desired allocation of shares in DCH's secondary offering. Having achieved his goal, Fleming allows GlobalBank's traders to repurchase the firm's shares of DCH.

Twelve months pass, and the shares of DCH's secondary offering have declined in price by nearly 20%. The CIO of the Crockett Foundation calls a meeting with Fleming to discuss the poor performance of the security and to review the basis upon which Fleming recommended the investment. Fleming prepares Crockett's file to take with him to the meeting. The file contains Crockett's IPS, a detailed account of the purchase order and all conversations held between Fleming and the CIO. In accordance with his own established procedures, however, Fleming maintained the original analysis supporting the purchase of shares in DCH's secondary offering for nine months after the investment was made.

Question #113 of 142

Question ID: 461316

Did GlobalBank's trade allocation policy violate the CFA Institute's Standards of Professional Conduct?

✓ **A) Yes, because the policy favors one group of clients over another and will disadvantage those clients that do not have multiple relationships with the firm.**

✗ **B)** No, because the firm is allowed to offer different levels of service to its clients as long as they are disclosed and available to all clients.

✗ **C)** No, because the firm fully disclosed its allocation policy to all clients and employees.

Explanation

The actions of GlobalBank are covered under Standard III(B)-Fair Dealing. According to Standard III(B), members must deal fairly and objectively with all clients. Trade allocation procedures must be fair and equitable to ensure that investment opportunities are available to all clients. A firm may offer different levels of service to its clients, but a policy may not favor clients that have multiple relationships with the firm over those that do not. The Standards also recommend that a pro rata system, rather than an ad hoc system, be utilized in order to avoid conflict of interest. (Study Session 1, LOS 2.a,b)

Question #114 of 142

Question ID: 461317

According to the CFA Institute's Standards of Professional Conduct, Fleming's execution of Waverly's trade order after confirming the appropriateness of the trade is *most likely* in violation of:

- ✗ **A)** **Standard I(C)-Misrepresentation for not disclosing to Waverly that he did not read the marketing materials, but is not in violation of Standard III(C)-Suitability because the client analyzed the investment thoroughly.**
- ✓ **B)** Standard V(A)-Diligence and Reasonable Basis for not exercising diligence and thoroughness in his analysis of the investment and Standard III(C)-Suitability for recommending an investment before determining if the investment was appropriate for the client.
- ✗ **C)** Standard V(B)-Communication with Clients and Prospective Clients for not separating fact from opinion, but is not in violation of Standard I(C)-Misrepresentation because his guarantee of future investment performance was not a written representation.

Explanation

Fleming violated Standard V(A)-Diligence and Reasonable Basis because he was not familiar with the specifics of the investment, but made an investment recommendation based upon his confidence in Waverly's investment expertise. Fleming is also in violation of Standard III(C)-Suitability because his agreement with Waverly's investment decision was not based upon the suitability of the offering within the context of Waverly's total portfolio. Standard I(C)-Misrepresentation was also violated when Fleming confirmed that Waverly should purchase shares in DCH's secondary offering, but failed to inform the client that he had not analyzed the investment in any way. Waverly would reasonably expect Fleming to analyze an investment prior to its recommendation and was therefore misled. (Study Session 1, LOS 2.a,b)

Question #115 of 142

Question ID: 461318

According to CFA Institute Standards of Professional Conduct, which of the following of Fleming's actions is *most likely* a violation of Standard I(C)-Misrepresentation? Fleming:

- ✓ **A)** **tells the CIO of the Crockett Foundation that DCH's secondary offering will earn at least the lowest return earned on its IPO shares over the last three years.**
- ✗ **B)** executes the trades on DCH Corp. per Waverly's instructions without first referring to Waverly's IPS.
- ✗ **C)** tells the CIO of Crocket Foundation that shares of DCH's IPO outperformed the S&P 500 by at least 15% in each of the last three years since the offering.

Explanation

Standard I(C)-Misrepresentation prohibits members and candidates from making any untrue statements or omissions of facts that may be false or misleading. Guaranteeing a particular rate of return on an investment is in direct violation of the standard. Fleming has essentially guaranteed a minimum rate of return on the secondary offering equal to the lowest rate of return earned on the IPO shares over the last three years. Even though a specific number isn't mentioned in the question, it would be observable by the Crockett Foundation. The other statements might also be considered violations of the standards but are not specifically violations of I(C)-Misrepresentation as noted in the question. (Study Session 1, LOS 2.a,b)

Question #116 of 142

Question ID: 461319

Which of the following statements *most* accurately assesses Fleming's comment about Waverly during his conversation with the CIO of the Crockett Foundation? According to the Code and Standards, Fleming's statement is:

✗ **A)** **in violation of Standard I(C)-Misrepresentation because his statement may be misleading with regard to future performance of the offering.**

✓ **B)** in violation of Standard III(E)-Preservation of Confidentiality because his failure to keep information about a client's investment action confidential.

✗ **C)** not in violation of any standard because he only disclosed factual information, and he did not disclose the details of Waverly's purchase.

Explanation

According to Standard III(E)-Preservation of Confidentiality, members and candidates must keep information about current, former, and prospective clients confidential unless the information concerns illegal activities, disclosure is required by law, or the client permits disclosure. By telling other clients of Waverly's investment actions, whether offering specific information on the trade or not, Fleming could adversely affect Waverly's investment in the offering. (Study Session 1, LOS 2.a,b)

Question #117 of 142

Question ID: 461320

According to CFA Institute Standards of Professional Conduct, did Fleming's conversation with the CIO of the Crockett Foundation or his decision to sell GlobalBank's position in DCH stock *most likely* violate Standard II(B)-Market Manipulation?

	Conversation with CIO	Sell decision
✓ **A)**	**No**	**Yes**
✗ **B)**	Yes	Yes
✗ **C)**	Yes	No

Explanation

Standard II(B)-Market Manipulation prohibits practices that distort prices or artificially inflate trading volume with the intent to mislead market participants, including the dissemination of false or misleading information. Although Fleming's conversation included two prohibited comments (a guarantee of performance and an inappropriate disclosure of client information), he did not give the CIO of Crockett information in an attempt to manipulate prices or trading volume and thus did not violate Standard II(B). His decision to sell GlobalBank's shares of DCH, however, was intended to manipulate the price of DCH stock in order to intimidate smaller investors into withdrawing their purchase order in the secondary offering, thereby freeing up shares for his client, the Crockett Foundation. This action is clearly a violation of Standard II(B). (Study Session 1, LOS 2.a,b)

Question #118 of 142

Question ID: 461321

Is it *most likely* that Fleming violated any CFA Institute Standards of Professional Conduct related to his meeting with the CIO of the Crockett Foundation?

✗ **A)** **No-he maintained an IPS and followed established procedures in maintaining client records and data.**

✓ **B)** Yes-he failed to maintain appropriate records to support his investment recommendation.

✗ **C)** No-he does not have a duty to maintain client records, only his employer does.

Explanation

Standard V(C)-Record Retention states that members and candidate must maintain appropriate records to support their investment recommendations and actions. Fleming maintained an IPS and records of conversations, but he is also required by the standard to keep research and other documentation supporting investment recommendations and actions, which Fleming did not do. When there are no regulatory requirements related to record retention, the Standard recommends that members and candidates keep client records for a minimum of seven years. (Study Session 1, LOS 2.a,b)

Question #119 of 142

Question ID: 412659

Scott Marsh is a research analyst for a brokerage firm following the computer industry. Joe Perry is Marsh's former college roommate and is the head of technology for Mercury, a large software company. Perry informs Marsh on Tuesday that in two days the company will be making an official announcement that its release of its newest version of its software will be moved up one month, from October 1 to September 1. The announcement will be surprising to the industry and will likely be met with skepticism because the company has had trouble meeting release dates in the past. Perry assures Marsh that he is certain that they will meet the September 1 date. Marsh considers Perry to be very honest and highly competent. Marsh should:

✗ **A)** **produce his research report in two days based solely on the official announcement, not taking into consideration the information from Perry.**

✓ **B)** wait until the public announcement is made, then release a report explaining that he believes the company will make the release date, disclosing that one of the reasons for his opinion is Perry is a friend of his.

✗ **C)** immediately put out a report recommending the stock, but waiting until the official announcement to state his reasons.

Explanation

The research report cannot be released until the official announcement is made, otherwise he will be violating the Standard on prohibition against the use of material nonpublic information. Once it is made public, Marsh can disclose the nature of the conversation without violating that Standard because the information will now be public. However, he should disclose the relationship with Perry or he will be violating the Standard on communications with clients and prospective clients.

Question #120 of 142

Question ID: 412679

Steven Wade, CFA, writes an investment newsletter focusing on high-tech companies, which he distributes by e-mail to paid subscribers. Wade does not gather any information about his clients' needs and circumstances. Wade has developed several complex valuation models that serve as the basis for his recommendations. Each month, his newsletter contains a list of "buy" and "sell" recommendations. He states that his recommendations are suitable for all types of portfolios and clients. Because of their proprietary nature, Wade does not disclose, except in general terms, the nature of his valuation models. He conducted numerous statistical tests of these models and they appear to have worked well in the past. In his newsletter, Wade claims that subscribers who follow his recommendations can expect to earn superior returns because of the past success of his models.

Wade violated all of the following CFA Institute Standards of Professional Conduct EXCEPT:

✓ **A)** **Standard III(B), Fair Dealing.**

✗ **B)** Standard I(C), Misrepresentation.

✗ **C)** Standard V(B), Communication with Clients and Prospective Clients.

Explanation

Wade did not violate Standard III(B), Fair Dealing, because this situation does not indicate that he failed to deal fairly and objectively with all clients when disseminating his newsletter containing investment recommendations.

Wade violated Standard V(B), Communication with Clients and Prospective Clients, because he failed to include all relevant factors behind his recommendations. Without providing the basis for his recommendations, clients cannot evaluate the limitations or the risks inherent in his recommendations.

Wade violated Standard I(C), Misrepresentation, because his claims about gaining superior expected returns are misleading to potential investors.

Question #121 of 142

Question ID: 412651

A company has a defined benefit plan that is currently under-funded. The plan sponsor has instructed the portfolio manager of the plan to invest more aggressively to bring the funding level up to an adequate amount. Which of the following statements *best* describes the course of action the portfolio manager should take? The portfolio manager should:

- ✗ **A) invest more aggressively because his fiduciary duties lie with the plan sponsor.**
- ✗ **B)** not invest more aggressively because this is not the method used to increase the funding level of a plan.
- ✓ **C)** not invest more aggressively since this may expose the plan to too much risk and may not be in the best interest of the plan's beneficiaries.

Explanation

Standard III(A), Loyalty, Prudence, and Care, applies in this situation. According to this Standard, investment actions should be carried out for the sole benefit of the client and in a manner the manager believes to be in the best interest of the client. Here, the client is the plan beneficiaries, not the manager or the entity that hired the manager.

Question #122 of 142

Question ID: 461272

Greg Allen is a security analyst and visits David Dawson, the Chief Financial Officer of Edmonds Company. Dawson reveals a great deal of nonmaterial financial data to Allen, data that Dawson routinely reveals to all security analysts who visit him. From this data and other industry information, Allen conjectures that Edmonds is likely to make a tender offer for another company in the industry, a fact that if true would be considered material to the value of the company. Allen:

- ✓ **A) can publish his conclusion in a research report.**
- ✗ **B)** should send a copy of the report to Dawson for verification before disseminating the report to clients.
- ✗ **C)** must not disseminate the information or use it for trading purposes until the tender offer is announced.

Explanation

Releasing information to analysts does not constitute a public release of information. Dawson's information should be considered nonpublic until it is released to the public. Allen has used this information, along with other industry information, to come to his conclusion of a pending tender offer which he can use to trade upon based on the mosaic theory.

Question #123 of 142

Question ID: 412635

After a very successful quarter of high investment returns, Judy O'Berry, CFA, receives several gifts from grateful clients. O'Berry considers the gifts to be of novelty or sentimental value only, but she hears rumors that several junior employees are jealous of the attention she received for the group's efforts. She decides to consult the company's compliance rules on gifts and is surprised to learn her firm has no established rules. She consults the Standards of Practice Handbook, and then submits proposed rules on gifts to her company's compliance department. These rules should contain all of the following EXCEPT:

✓ **A)** **restrictions on all types business entertainment.**

✗ **B)** a requirement to disclose the gift.

✗ **C)** a formal value limit based on local customs.

Explanation

The rules should contain a formal value limit based on local customs. Not all types of business entertainment are forbidden. Only business entertainment which is intended to influence or reward members and candidates should be avoided.

Question #124 of 142

Question ID: 412696

Albert Long, CFA, manages portfolios of high net worth individuals for HKB Corp. Alice Thurmont, one of his close friends, heads a local charity for homeless children that depends on donations to operate. Because donations have declined during the past year, the charity is experiencing financial difficulty. Thurmont asks Long to give her a partial list of his clients so that she can contact them to make tax-deductible donations. Because Long knows that the charity provides much benefit to the community, he provides Thurmont with the requested list.

Betty Short, CFA, also works for HKB Corp. She receives a letter from CFA Institute's Professional Conduct Program (PCP) requesting that she provide information about one of HKB's clients who is being investigated. Short complies with the request despite the confidential nature of the information requested by the PCP.

Based on Standard III(E), Preservation of Confidentiality, which of the following statements about Long and Short's actions is CORRECT?

✓ **A)** **Long violated Standard III(E) but Short did not violate Standard III(E).**

✗ **B)** Both Long and Short violated Standard III(E).

✗ **C)** Short violated Standard III(E) but Long did not violate Standard III(E).

Explanation

Long violated Standard III(E) because he did not preserve the confidentiality of information communicated by clients. Short did not violate Standard III(E) because this standard does not prevent members from cooperating with an investigation by CFA Institute's Professional Conduct Program. Thus, Short can forward confidential information to the PCP.

Question #125 of 142

Question ID: 412652

If the Chief Investment Officer of an investment advisory firm also is a CFA charterholder, which of the following statements is

CORRECT?

- ✗ **A)** **The firm must present an historical composite.**
- ✓ **B)** The firm must comply with the CFA Institute Global Investment Performance Standards only if it states that it follows the Standards.
- ✗ **C)** All performance results that are presented must comply with the CFA Institute Global Investment Performance Standards.

Explanation

Global Investment Performance Standards (GIPS) are the best way to comply with the Standard on performance presentation; however, adoption of GIPS is voluntary.

Question #126 of 142

Question ID: 461247

Which of the following statements about soft dollars is *least* accurate?

- ✓ **A)** **Directed brokerage are soft dollars to be used for research that benefits the investment firm.**
- ✗ **B)** Soft dollars are third party research arrangements.
- ✗ **C)** Soft dollars are assets of the client.

Explanation

Directed brokerage are soft dollars directed by the client to the investment manager to pay for goods and services that benefits the client only and not the firm.

Questions #127-132 of 142

Lon Smith is an analyst in the Research Department of Lincoln & Co., a large investment bank. Smith has just completed a temporary assignment in Lincoln's Corporate Finance Department related to underwriting a debt offering for FinSoft, a computer software company. FinSoft's recent operating record has reflected lagging sales volume and heavy product development expenses. Smith has marked his FinSoft notes and work sheets "CONFIDENTIAL / CORPORATE FINANCE DEPARTMENT" and sent them to the company file in the Research Department. This material reveals that FinSoft is about to receive a major contract for an innovative software program that will have a very significant positive impact on earnings as well as on the company's visibility and stature in the industry.

Jay Jones, a CFA candidate and a portfolio manager for Lincoln, has come upon these notes and work sheets while reviewing the FinSoft research file. Jones had been considering sale of the stock from the accounts under his management, but realizes after reading the file material that the recent weakness in operating results is about to be reversed and that the company's prospects are actually quite favorable. Perhaps, he thinks, he should add to his clients' FinSoft positions instead of considering their sale.

Jones briefly reflects on the matter of "inside information" in relation to perhaps buying more of the stock instead of selling it, but his recollection is hazy and Lincoln has no formal guidelines on the subject to which he can refer. Based on the circumstances, Jones believes he is free to use this new knowledge for the benefit of Lincoln's clients.

Question #127 of 142

Question ID: 461302

Based on CFA Institute Standards of Professional Conduct, which of the following is *least accurate*?

✗ **A)** **The information is material because the new software is likely to significantly increase FinSoft's future earnings.**

✗ **B)** There is misappropriation of information by Jones because the file is marked "Confidential / Corporate Finance Department."

✓ **C)** There is no breach of duty if traded on Smith's report because Jones did not conduct the research that produced the information.

Explanation

Jones has a duty not to trade or cause others to trade on material nonpublic information. It does not matter that he did not conduct the research.

(LOS 2.a)

Question #128 of 142

Question ID: 461303

Based on the information presented in this situation, Jones has an obligation to do all of the following EXCEPT:

✓ **A)** **wait to trade on the information until after a reasonable period has passed.**

✗ **B)** encourage public dissemination of the information.

✗ **C)** encourage his employer to review the compliance procedures as they relate to material nonpublic information issues.

Explanation

Jones has an obligation to not trade on the information until after he is sure the information has been made public.

(LOS 2.a,b)

Question #129 of 142

Question ID: 461304

Based on the information presented, Lincoln should adopt a set of guidelines on inside information that include each of the following EXCEPT:

✗ **A)** **have in place a supervisor or compliance officer who has the authority and responsibility to decide whether information is material and nonpublic.**

✓ **B)** prohibit exchange of personnel, even temporary, between investment banking and institutional money management departments.

✗ **C)** develop criteria for identifying inside information.

Explanation

There is no need to avoid transfer of personnel as long as proper safeguards and procedures are observed.

(LOS 2.b)

Question #130 of 142

Question ID: 461305

Which of the following policies would be the *most appropriate* way for Lincoln & Co. to conform to the CFA Institute Standard

II(A) concerning Material Nonpublic Information?

- ✗ **A)** **Require that the compliance department implement increased scrutiny of the interchange of information between the research department and the investment banking division.**
- ✓ **B)** Prevent the exchange of information between the investment banking and research department by creating information barriers between these groups.
- ✗ **C)** Permanently prohibiting the research department from issuing recommendations on FinSoft.

Explanation

Creating informational firewalls in a firm to prevent exchange of insider information is the best method of complying with Standard II(A) concerning Material Nonpublic Information. An information barrier between the investment banking department and research department will prevent the flow of information from the investment banking department to research analysts that are writing recommendations on securities. A permanent prohibition on issuing recommendations on FinSoft securities would not be appropriate or necessary. A temporary prohibition would be an acceptable option: after the material nonpublic information becomes public, publishing recommendations on FinSoft would not be a violation of the Code and Standards. Increased scrutiny of the exchange of information flowing between the investment banking department and the research operation would be inadequate.

(LOS 2.b)

Question #131 of 142

Question ID: 461306

At a local CFA society event, Jones mentions to Mohammed Bamyeh, a friend and financial advisor, that FinSoft is about to receive a major new contract that has yet to be announced. Later that day, Bamyeh takes a large long position in a technology ETF that has a large weight for FinSoft stock. Which of the following statements is *most accurate*?

- ✓ **A)** **Bamyeh violated the Code and Standards by investing in the ETF.**
- ✗ **B)** Jones did not violate the Code and Standards because the comments made to Bamyeh were on a personal rather than professional basis.
- ✗ **C)** Bamyeh did not violate the Code and Standards because Bamyeh did not directly invest in any FinSoft securities.

Explanation

Bamyeh's decision to invest in the ETF appears to have stemmed from Jones's tip about FinSoft's prospects, so Bamyeh's action violates Standard II(A)-Material Nonpublic Information. Jones's inside information should be considered material because if made public it would cause the price of FinSoft, as well as the associated mutual fund, to rise. Jones's decision to share material non-public information was a violation of Standard II(A), even though Jones and Bamyeh are personal rather than professional acquaintances. Under Standard II(A), prohibition to trade based on inside information extends to derivatives that derive their value based on the value of the security for which inside information was used.

(LOS 2.a)

Question #132 of 142

Question ID: 461307

When recommending the purchase of FinSoft company shares to Bamyeh, Jones least likely violated the Standard relating to:

✗ **A) integrity of capital markets.**

✓ **B)** diligence and reasonable basis.

✗ **C)** loyalty to employer.

Explanation

It is unlikely that Jones violated the Standard relating to diligence and reasonable basis, as Jones appears to have had a reasonable basis for the recommendation as Standard V(A) requires. Once Jones was in possession of material nonpublic information, he was prohibited by Standard II(A) of acting or causing others to act on this information. Jones also violated her duty of loyalty to her employer under Standard IV(A) by encouraging Bamyehs to trade in FinSoft and other securities, possibly harming Lincoln's customer's ability to acquire FinSoft at an attractive price.

(LOS 2.a)

Question #133 of 142

Question ID: 412687

Jim Kent is an individual investment advisor in San Francisco with 300 clients. Kent uses open-ended mutual funds to implement his investment policy. For most of his clients, Kent has used the Baker fund, a small company growth fund based in Boston, for a portion of their portfolio. As a result he has become very friendly with Keith Dunston, the manager of the fund, whom Kent feels is mainly responsible for Baker's performance. One day Dunston calls Kent and tells him that he will be leaving the fund in four weeks and moving to San Francisco to work for a different money management company. Dunston is seeking suggestions on housing in the area. Baker has not yet announced Dunston's departure. Kent immediately finds a fund that is a suitable replacement for the Baker fund, and over the next two days he calls his 30 clients with the largest dollar investments in the funds and tells them he feels they should switch their holdings. Baker feels the remaining clients' positions are small enough to wait for their annual review to switch funds. Kent has:

✓ **A) violated the Standards by not dealing fairly with clients but has not violated the Standards regarding material nonpublic information.**

✗ **B)** violated the Standards by not dealing fairly with clients and regarding material nonpublic information.

✗ **C)** violated the Standards regarding nonpublic information but has not violated the Standards in failing to deal fairly with clients.

Explanation

Kent must treat all clients fairly in acting on the information, regardless of the size of the investment. The information concerning the fund manager's departure is not material nonpublic information because its release would have no effect on individual stock prices within the fund and thus should not impact the fund's net asset value.

Question #134 of 142

Question ID: 461293

Mike Lang Case Scenario

It is Jan. 29, 2009, and Mike Lang, CFA, is in trouble. Lang manages discretionary accounts for Welshire Capital, a large money management firm in New York. Lang has had some problems with the account of Carol Damon, the widow of a prominent banker who left her a sizable estate.

Damon, age 80, has little tolerance for volatility and does not like to invest in small-cap stocks. However, if her portfolio fails to advance at least 10% in a given year, she calls Lang and yells at him, then writes complaint letters to various Welshire Capital officers. Damon's complaint letters usually end up on the desk of Cynthia Silk, CFA, senior portfolio manager for Stonebridge, who oversees the work of Lang and a dozen other money managers. At a recent meeting, Silk reminded all portfolio managers that company policy is to manage against predetermined benchmarks and all exceptions should be cleared first with her.

Last year, Damon's portfolio lost 25% for the year, versus a 38% decline for the S&P 500 Index, the benchmark Welshire Capital uses for all of its portfolios. Lang tried to explain to Damon that the market had an extremely bad year, and the portfolio beat the benchmark by a wide margin in large measure because Lang primarily selected large-cap stocks for Damon's portfolio that outperformed the market. Damon said that she did not care to listen to these excuses and was not concerned about the market return, only her portfolio's return.

The most recent complaint letter was particularly ruthless, with Damon calling into question Lang's competence and threatening to move her account to another firm. Damon, long-time president of the Nassau County Council, further vowed to persuade four local businessmen to move their accounts as well. In total, Damon and the businessmen she plans to influence represent more than 20% of Welshire Capital's assets under management.

In an effort to fix his relationship with Damon, Lang decides to take four actions:

1. Set up a meeting at Damon's home, at which time he will explain how important her business is to Welshire Capital and discuss changes to her investment policy statement.
2. Prepare quarterly and annual reports that include the rationale for purchasing each stock.
3. Defend himself against her attack on his competence by discussing the grueling studies and difficult examinations required to earn the CFA charter and assure her it gives her every reason to expect the portfolio will perform better in the future.
4. Explain to her that despite the fact that two of the mutual funds in her portfolio pay referral fees to Stonebridge, he feels both funds are excellent investments.

Lang further decides to begin using a different benchmark for Damon's portfolio, one that better reflects the nature of the investments in the portfolio and creates a more accurate perception of portfolio performance.

While Lang is moving to sort out his differences with Damon, Silk, his supervisor, takes action of a different sort. Silk serves with Damon on the Nassau County Council, which takes up a considerable amount of Silk's time, and considers Damon to be a personal friend. She also knows about Damon's volatile temper and irrational expectations. She has historically tried to resolve any animosity Damon has towards Lang.

This time, Silk is concerned that Damon will make good on her threat to take business away from Stonebridge. In a phone call to Damon, Silk says she understands Damon's unhappiness with the poor performance and promises to discuss the situation with Lang and take appropriate action if necessary. She also promises Damon shares on a pro rata basis in an upcoming equity offering the company is handling assuming the stock is suitable for Damon's portfolio.

Later that day, Silk reviews transactions in Damon's portfolio and determines that Lang's poor asset allocation reduced the portfolio's returns by a considerable amount. She then calls Lang into her office. During that closed-door meeting, Silk criticizes Lang's handling of the portfolio and tells him she is giving the portfolio to another analyst with more experience. Before dismissing Lang, she calls the other analyst, John Van Zant, and tells him that he will be taking over Damon's portfolio immediately, adding the warning that if the portfolio does not perform better, Van Zant will not get his bonus this year and he must make up the past under-performance.

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In his attempt to appease Damon, Lang would *most likely* violate the Code and Standards by:

✗ **A)** **setting up a meeting at Damon's home, at which he will explain how important her business is to Welshire Capital and discuss changes to her investment policy statement.**

✗ **B)** preparing quarterly and annual reports that include the rationale for purchasing each stock.

✓ **C)** defending himself against her attack on his competence by discussing the grueling studies and difficult examinations required to earn the CFA charter and expected performance.

Explanation

It appears Lang has linked the charter to some expectation of better performance which is a violation of the Code and Standards. The other actions are acceptable.

(Study Session 2, LOS 3.b)

Question #135 of 142

Question ID: 412681

Which of the following would be the *least* important proxy issue?

✗ **A)** **Compensation plans for officers.**

✓ **B)** Election of internal auditors.

✗ **C)** Takeover defense and related actions.

Explanation

Election of internal auditors is not a major proxy issue.

Questions #136-141 of 142

Christopher Lance, CFA, Chuck Cunningham, and Lucy Hunt, CFA, went to graduate school together and have remained close friends ever since. Lance and Hunt earned their CFA charters this past June and Cunningham is a Level III candidate. Lance, Cunningham, and Hunt have dinner every month at Cunningham's country club, one of the most prestigious in the metropolitan area where they live.

Lance was a well-respected research analyst covering the pharmaceutical industry at an international broker-dealer before accepting a job as Vice President, Investor Relations, at IMed, a large multinational pharmaceutical company that he covered as an analyst. Since he started coverage of IMed, Lance had consistently been named "top analyst" of the pharmaceutical industry by *Investment Professional*, the leading journal of the investment industry.
In his new position at IMed, Lance is the principal spokesperson on the company's financial performance and is responsible for developing and maintaining good relationships with the company's shareholders, especially large institutional investors, and with approximately 30 research analysts who issue research reports and make recommendations about publicly-traded equity and debt securities. It is April 12th and Lance is preparing to conduct the next conference call following the release on April 15th of IMed's quarterly earnings. Participating in the call will be Lance's former colleague and good friend, Cunningham, and the other analysts who cover IMed. In addition, Hunt, a portfolio manager at Primary Pensions, a major institutional investor, has told Lance she will also be on the call. Primary Pensions has accumulated the largest single holding in IMed equity.

Lance is concerned about this call because IMed's president, Bill Norton, has just told the management team that sales of Mediplex, its new cancer drug, have begun to sag after rumors of serious side effects, including death, have hit the press. Norton told Lance that if sales continue to fall that this year's earnings would be considerably less than the current consensus forecast. Norton is also concerned that the regulatory agency that approves the sale of drugs will repeal IMed's license to market Mediplex.

Cunningham is a research analyst at Lance's former employer and has taken over coverage of IMed following Lance's resignation. Until his promotion to Lance's former position, Cunningham was a junior analyst covering the oil and gas industry. Although knowledgeable about fundamental financial analysis and equity valuation, he is unfamiliar with IMed and the pharmaceutical industry. Cunningham has been reviewing the past 5 years of IMed's financial statements and Lance's research reports in preparation for participating in IMed's quarterly conference call to discuss its quarterly earnings release. Cunningham is under considerable pressure from his employer to meet or exceed Lance's reputation and be rated "top analyst" by *Investment Professional*. His firm's currently rates IMed as a "strong buy" based on Lance's last research report. Based on his own preliminary analysis, Cunningham has a hard time justifying a "hold" recommendation. He is puzzled by several of the earnings adjustments that Lance made to achieve his target share price for IMed. He plans to ask Lance about these adjustments at their dinner on April 14th.

Hunt has been managing a large cap equity portfolio at Primary Pensions for 5 years. Based almost exclusively on Lance's buy recommendations in his research report, she began purchasing IMed several years ago just before it made several major acquisitions that contributed to its phenomenal growth and to her portfolio's performance over the last 5 years. Since Lance moved to IMed, Hunt has been doing some due diligence and has become concerned that the growth of IMed's earnings is overly dependent on sales of Mediplex. Based on her enthusiasm for IMed and her portfolio's performance, other managers at Primary Pensions have also taken considerable positions in IMed to the extent that Primary Pensions is IMed's largest single stockholder. If she is right, Hunt knows that she will need to reduce her portfolio's holdings. Since Primary Pensions prohibits its employees from owning individual equity securities, Hunt has no personal investment in IMed. However, she had boasted about IMed's performance to her mother and is aware that her mother's investment club invested 10 percent of the club's assets in IMed. Hunt is preparing her questions for the upcoming conference call and her exit strategy if the answers confirm her fears.

Lance, Cunningham, and Hunt met for their regular monthly dinner on April 14th. Cunningham opens the after dinner discussion by questioning Lance about his new job and asks him if he and Hunt should anticipate any surprises at tomorrow's conference call. Cunningham specifically asks Lance if IMed will meet or beat analyst expectations and the consensus earnings forecast. Lance responds that, under current securities laws, he is unable to discuss details of IMed's performance with Cunningham and Hunt and that they'll both be briefed with the other analysts and shareholders on tomorrow's call. Shortly thereafter, the three friends say their good-byes. Hunt and Cunningham wish Lance well on the next day's conference call.

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Question ID: 461323

What Standard governs Lance's response to Cunningham's question and is he in compliance?

	Standard	Compliance
✗ A)	**III: Duties to Clients**	**No**
✓ B)	I: Professionalism	Yes
✗ C)	VII: Responsibilities as a CFA Institute Member or CFA Candidate	Yes

Explanation

Lance's response to Cunningham's question is covered under Standard I(A) which requires members to maintain knowledge of and comply with applicable laws and regulations (including the CFA Institute's Code of Ethics and Standards of Professional Conduct). In this case, Lance specifically references the requirements of securities laws not to discuss IMed's performance in advance of the quarterly conference call. If he had done so, he would have disclosed material nonpublic information, since he knows that information about the decline in sales of Mediplex will have an adverse affect on IMed's share price. In addition, Standard I(A) prohibits Lance from knowingly participating or assisting in any violation of such laws. If Lance had responded in any other way to Cunningham's question he would potentially have assisted Cunningham and Hunt in violating Standard II(A), Material Nonpublic Information. (Study Session 1, LOS 2.a,b)

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Question ID: 461324

Hunt's concerns about IMed increased after her dinner with Cunningham and Lance. She believes that Lance would have told them if IMed's earnings would meet analysts' expectations. She is convinced that Lance's failure to "look her in the eye" when he answered Cunningham's question confirms her suspicions that IMed is in trouble and is determined to start selling Primary Pensions' shares of IMed first thing in the morning.
Based on her conclusions from the dinner with Lance and Cunningham, which of the following *best* describes the actions Hunt should take regarding IMed?

✗ **A) Hunt can sell the IMed shares in the Primary Pensions' portfolio but cannot encourage her mother to sell the investment club's shares.**

✓ **B)** Hunt cannot sell IMed and cannot encourage others to sell IMed.

✗ **C)** Hunt can both tell her mother to sell the investment club's shares of IMed and sell the shares in the Primary Pensions' portfolio.

Explanation

According to Standard V(A), Diligence and Reasonable Basis, Hunt is required to exercise diligence and thoroughness in taking investment actions and she is required to have a reasonable and adequate basis, supported by appropriate research and investigation, for such actions. Her conclusions about Lance's response and actions during the dinner do not constitute a reasonable and adequate basis for selling IMed shares from Primary Pensions' portfolio.

In addition, even if Hunt were to reach the same conclusion after developing a reasonable basis for selling IMed shares, she would be able to sell Primary Pensions' share of IMed but would be prohibited under Standard VI(B), Priority of Transactions, from telling her mother and encouraging her to sell the investment club's shares until after she sells the shares in the Primary Pensions portfolio. Members must ensure that transactions for clients and employers have priority over transactions in securities or other investments of which a member is a beneficial owner so that such personal transactions do not operate adversely to their clients' or employer's interests. Hunt's relationship to her mother could reasonably be assumed to constitute an "indirect" interest in the investment club's securities. (Study Session 1, LOS 2.a,b)

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Question ID: 461325

If Lance had disclosed material that was nonpublic information about the decline of sales of Mediplex and its effect on IMed's earnings, Cunningham would have been *least likely* to be obligated to do which of the following?

✗ **A) Make reasonable efforts to achieve public dissemination of material nonpublic information disclosed in a breach of duty.**

✓ **B)** Inform the appropriate regulatory authority that Lance had violated securities laws.

✗ **C)** Not trade in shares of IMed.

Explanation

Unless required by law, the Code of Ethics and Standards of Professional Conduct do not require members to report legal violations to the appropriate governmental or regulatory authority. Such disclosure may be prudent in certain circumstances. Cunningham would be prohibited under Standard II(A), Material Nonpublic Information, from trading in the securities of IMed or causing others to trade by issuing a research report incorporating the material nonpublic information before that information is made public by IMed. Cunningham would also be required to make reasonable efforts to have Lance and IMed make public disclosure of the information. (Study Session 1, LOS 2.a,b)

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Question ID: 461326

Dinners with Lance, Cunningham and Hunt at Cunningham's exclusive country club usually cost more than $200 per person. When he and Lance worked for the same broker-dealer and Hunt was a client, Cunningham has always paid the bill.
Which Standard will Lance violate if he continues to allow Cunningham to pay for dinner?

- ✗ **A)** **Standard III(B), Fair Dealing.**
- ✓ **B)** Standard I(B), Independence and Objectivity.
- ✗ **C)** Standard IV(B), Additional Compensation Arrangements.

Explanation

Over the course of a year, Lance will have received gifts of more $2400 from Cunningham. Standard I(B), Independence and Objectivity, covers receipt of gifts from external parties that may try to influence members' professional actions to the possible detriment of Lance's employer, IMed, and the investing public. Even though Lance and Cunningham are long-time friends and former colleagues at Cunningham's employer, the potential for undue influence exists. Lance should be particularly concerned given Cunningham's inappropriate question regarding IMed's earnings. In determining how best to comply with Standard I(B), Lance should no longer permit Cunningham to pay for his dinner and, given the prestigious nature of the country club, should also consider moving the monthly dinner to a different venue to avoid the appearance of impropriety. (Study Session 1, LOS 2.a,b)

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Question ID: 461327

Cunningham arrives in his office early on the day of the conference call. He has conducted an extensive analysis of IMed's financial statements and has reviewed his assessment of Lance's conclusions in the report that Lance issued before his departure. He regrets having asked Lance about IMed's earnings at the previous night's dinner and decides to ask Lance some very pointed questions in public during the conference call, especially regarding Lance's inclusion of some significant non-recurring gains in operating income. Based on his own knowledge and experience, Cunningham doesn't believe that Lance's target price for IMed would be sustained. He decides that, if he doesn't get clear answers to his questions on the call, he will recommend to client's in his research report that IMed's rating drop to "hold". Cunningham's research report and recommendation is sent to all of his firm's clients and is not directed to a specific client.
In conducting his analysis and developing his recommendation, which of the following requirements of Standard V, Investment Analysis, Recommendations and Actions, would Cunningham *least likely* be concerned with?

- ✗ **A)** **Clearly differentiate fact from opinion in making recommendations.**
- ✗ **B)** Exercise diligence and thoroughness in making investment recommendations.
- ✓ **C)** Consider the appropriateness and suitability of investment recommendations for each client.

Explanation

The research report and recommendation prepared by Cunningham is sent to all relevant clients of the broker-dealer and is not directed toward a particular client or portfolio. In simple terms, Cunningham's responsibility is to develop a forecast of IMed's share price and to make a general recommendation to buy, sell, or hold shares of IMed based on the difference between the current market price and his forecast. Cunningham does not interact with individual clients and is not making a specific recommendation to a client to take an investment action. He is not expected to have knowledge of the risk and return objectives, portfolio holdings or unique circumstances and constraints of individual clients. Therefore, he does not have a responsibility to consider the suitability of his recommendation for each client of the firm. Cunningham's research report should contain sufficient information so that individual clients and their investment advisors can judge the appropriateness and suitability to the client's particular situation. (Study Session 1, LOS 2.a,b)

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Question ID: 461328

Lance is very nervous before the conference call. Norton, IMed's president, has told him that he must not disclose the decline in sales of Mediplex.
During the call, Hunt asks Lance whether the rumors of the side effects of Mediplex are true and whether these rumors have negatively impacted sales. Lance assures Hunt that Mediplex sales are strong and that IMed is confident that sales will continue to rise for the remainder of the year.

Which of the following *best* describes Lance's actions when he stated that sales of Mediplex were strong?

- ✗ **A)** **Lance violated Standard III(B), Fair Dealing.**
- ✓ **B)** Lance violated Standard I(D), Misconduct.
- ✗ **C)** Lance complied with Standard IV(A), Loyalty to Employer.

Explanation

Lance violated Standards I(D), Misconduct, when he lied about the sales of Mediplex. Under Standard I(D), members are prohibited from engaging in any professional conduct involving dishonesty, fraud, deceit, or misrepresentation or commit any act that reflects adversely on their dishonesty, trustworthiness, or professional misconduct. Neither Standard IV(A), Loyalty to Employer, which relates to independent practice that could result in compensation or other benefit in competition with their employer and does not relate in this situation nor Standard III(B), Fair Dealing, which relates to dealing fairly and objectively when making recommendations to clients, are relevant or apply to this situation. Lance is also **NOT** in compliance with Standard I, Professionalism, because he violated Standard I(D), Misconduct. (Study Session 1, LOS 2.a,b)

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Question ID: 412706

Sharon Pope has been asked by the Chief Investment Officer to develop a firm-wide policy for proxy voting. Which of the following would NOT be acceptable to include in the policy statement?

- ✗ **A)** **Voting proxies may not be necessary in all instances.**
- ✗ **B)** The value of proxy voting must be maximized.
- ✓ **C)** Portfolio managers of active funds must vote in all proxies; portfolio managers of index funds should vote only when they have a definitive opinion.

Explanation

Proxies for stocks in passively managed funds must also be voted. A cost-benefit analysis may show that voting all proxies may not benefit all clients.