

## Standard I A Professionalism Knowledge of the Law

### (Notification of Known Violations):

Michael Allen works for a brokerage firm and is responsible for an underwriting of securities. A company official gives Allen information indicating that the financial statements Allen filed with the regulator overstate the issuer's earnings. Allen seeks the advice of the brokerage firm's general counsel, who states that it would be difficult for the regulator to prove that Allen has been involved in any wrongdoing.

Comment: Although it is recommended that members and candidates seek the advice of legal counsel, the reliance on such advice does not absolve a member or candidate from the requirement to comply with the law or regulation. Allen should report this situation to his supervisor, seek an independent legal opinion, and determine whether the regulator should be notified of the error.

### (Dissociating from a Violation):

Lawrence Brown's employer, an investment banking firm, is the principal underwriter for an issue of convertible debentures by the Courtney Company. Brown discovers that the Courtney Company has concealed severe third-quarter losses in its foreign operations. The preliminary prospectus has already been distributed.

Comment: Knowing that the preliminary prospectus is misleading, Brown should report his findings to the appropriate supervisory persons in his firm. If the matter is not remedied and Brown's employer does not dissociate from the underwriting, Brown should sever all his connections with the underwriting. Brown should also seek legal advice to determine whether additional reporting or other action should be taken.

### (Dissociating from a Violation):

Kamisha Washington's firm advertises its past performance record by showing the 10-year return of a composite of its client accounts. Washington discovers, however, that the composite omits the performance of accounts that have left the firm during the 10-year period, whereas the description of the composite indicates the inclusion of all firm accounts. This omission has led to an inflated performance figure. Washington is asked to use promotional material that includes the erroneous performance number when soliciting business for the firm.

Comment: Misrepresenting performance is a violation of the Code and Standards. Although she did not calculate the performance herself, Washington would be assisting in violating Standard I(A) if she were to use the inflated performance number when soliciting clients. She must dissociate herself from the activity. If discussing the misleading number with the person responsible is not an option for correcting the problem, she can bring the situation to the attention of her supervisor or the compliance department at her firm. If her firm is unwilling to recalculate performance, she must refrain from using the misleading promotional material and should notify the firm of her reasons. If the firm insists that she use the material, she should consider whether her obligation to dissociate from the activity requires her to seek other employment.

### (Following the Highest Requirements):

James Collins is an investment analyst for a major Wall Street brokerage firm. He works in a developing country with a rapidly modernizing economy and a growing capital market. Local securities laws are minimal—in form and content—and include no punitive prohibitions against insider trading.

Comment: Collins must abide by the requirements of the Code and Standards, which might be more strict than the rules of the developing country. He should be aware of the risks that a small market and the absence of a fairly regulated flow of information to the market represent to his ability to obtain information and make timely judgments. He should include this factor in formulating his advice to clients. In handling material nonpublic information that accidentally comes into his possession, he must follow Standard II(A)—Material Nonpublic Information.

### (Following the Highest Requirements):

Laura Jameson works for a multinational investment adviser based in the United States. Jameson lives and works as a registered investment adviser in the tiny, but wealthy, island nation of Karramba. Karramba's securities laws state that no investment adviser registered and working in that country can participate in initial public offerings (IPOs) for the adviser's personal account. Jameson, believing that, as a US citizen working for a US-based company, she should comply only with US law, has ignored this Karrambian law. In addition, Jameson believes that as a charterholder, as long as she adheres to the Code and Standards requirement that she disclose her participation in any IPO to her employer and clients when such ownership creates a conflict of interest, she is meeting the highest ethical requirements.

Comment: Jameson is in violation of Standard I(A). As a registered investment adviser in Karramba, Jameson is prevented by Karrambian securities law from participating in IPOs regardless of the law of her home country. In addition, because the law of the country where she is working is stricter than the Code and Standards, she must follow the stricter requirements of the local law rather than the requirements of the Code and Standards.

### (Laws and Regulations Based on Religious Tenets):

Amanda Janney is employed as a fixed-income portfolio manager for a large international firm. She is on a team within her firm that is responsible for creating and managing a fixed-income hedge fund to

be sold throughout the firm's distribution centers to high-net-worth clients. Her firm receives expressions of interest from potential clients from the Middle East who are seeking investments that comply with Islamic law. The marketing and promotional materials for the fixed-income hedge fund do not specify whether or not the fund is a suitable investment for an investor seeking compliance with Islamic law. Because the fund is being distributed globally, Janney is concerned about the reputation of the fund and the firm and believes disclosure of whether or not the fund complies with Islamic law could help minimize potential mistakes with placing this investment.

Comment: As the financial market continues to become globalized, members and candidates will need to be aware of the differences between cultural and religious laws and requirements as well as the different governmental laws and regulations. Janney and the firm could be proactive in their efforts to acknowledge areas where the new fund may not be suitable for clients.

(Reporting Potential Unethical Actions):

Krista Blume is a junior portfolio manager for high-net-worth portfolios at a large global investment manager. She observes a number of new portfolios and relationships coming from a country in Europe where the firm did not have previous business and is told that a broker in that country is responsible for this new business. At a meeting on allocation of research resources to third-party research firms, Blume notes that this broker has been added to the list and is allocated payments for research. However, she knows the portfolios do not invest in securities in the broker's country, and she has not seen any research come from this broker. Blume asks her supervisor about the name being on the list and is told that someone in marketing is receiving the research and that the name being on the list is OK. She believes that what may be going on is that the broker is being paid for new business through the inappropriate research payments, and she wishes to dissociate from the misconduct.

Comment: Blume should follow the firm's policies and procedures for reporting potential unethical activity, which may include discussions with her supervisor or someone in a designated compliance department. She should communicate her concerns appropriately while advocating for disclosure between the new broker relationship and the research payments.

(Failure to Maintain Knowledge of the Law):

Colleen White is excited to use new technology to communicate with clients and potential clients. She recently began posting investment information, including performance reports and investment opinions and recommendations, to her Facebook page. In addition, she sends out brief announcements, opinions, and thoughts via her Twitter account (for example, "Prospects for future growth of XYZ company look good! #makingmoney4U"). Prior to White's use of these social media platforms, the local regulator had issued new requirements and guidance governing online electronic communication. White's communications appear to conflict with the recent regulatory announcements.

Comment: White is in violation of Standard I(A) because her communications do not comply with the existing guidance and regulation governing use of social media. White must be aware of the evolving legal requirements pertaining to new and dynamic areas of the financial services industry that are applicable to her. She should seek guidance from appropriate, knowledgeable, and reliable sources, such as her firm's compliance department, external service providers, or outside counsel, unless she diligently follows legal and regulatory trends affecting her professional responsibilities.

## I B Professionalism Independence and Objectivity

(Travel Expenses):

Steven Taylor, a mining analyst with Bronson Brokers, is invited by Precision Metals to join a group of his peers in a tour of mining facilities in several western US states. The company arranges for chartered group flights from site to site and for accommodations in Spartan Motels, the only chain with accommodations near the mines, for three nights. Taylor allows Precision Metals to pick up his tab, as do the other analysts, with one exception—John Adams, an employee of a large trust company who insists on following his company's policy and paying for his hotel room himself.

Comment: The policy of the company where Adams works complies closely with Standard I(B) by avoiding even the appearance of a conflict of interest, but Taylor and the other analysts were not necessarily violating Standard

In general, when allowing companies to pay for travel and/or accommodations in these circumstances, members and candidates must use their judgment. They must be on guard that such arrangements not impinge on a member's or candidate's independence and objectivity. In this example, the trip was strictly for business and Taylor was not accepting irrelevant or lavish hospitality. The itinerary required chartered flights, for which analysts were not expected to pay. The accommodations were modest. These arrangements are not unusual and did not violate Standard I(B) as long as Taylor's independence and objectivity were not compromised. In the final analysis, members and candidates should consider both whether they can remain objective and whether their integrity might be perceived by their clients to have been compromised.

(Research Independence):

Susan Dillon, an analyst in the corporate finance department of an investment services firm, is making a presentation to a potential new business client that includes the promise that her firm will provide full research coverage of the potential client.

Comment: Dillon may agree to provide research coverage, but she must not commit her firm's research department to providing a favorable recommendation. The firm's recommendation (favorable, neutral, or unfavorable) must be based on an independent and objective investigation and analysis of the company and its securities.

(Research Independence and Intrafirm Pressure):

Walter Fritz is an equity analyst with Hilton Brokerage who covers the mining industry. He has concluded that the stock of Metals & Mining is overpriced at its current level, but he is concerned that a negative research report will hurt the good relationship between Metals & Mining and the investment banking division of his firm. In fact, a senior manager of Hilton Brokerage has just sent him a copy of a proposal his firm has made to Metals & Mining to underwrite a debt offering. Fritz needs to produce a report right away and is concerned about issuing a less-than-favorable rating.

Comment: Fritz's analysis of Metals & Mining must be objective and based solely on consideration of company fundamentals. Any pressure from other divisions of his firm is inappropriate. This conflict could have been eliminated if, in anticipation of the offering, Hilton Brokerage had placed Metals & Mining on a restricted list for its sales force.

(Research Independence and Issuer Relationship Pressure):

As in Example 3, Walter Fritz has concluded that Metals & Mining stock is overvalued at its current level, but he is concerned that a negative research report might jeopardize a close rapport that he has nurtured over the years with Metals & Mining's CEO, chief finance officer, and investment relations officer. Fritz is concerned that a negative report might result also in management retaliation—for instance, cutting him off from participating in conference calls when a quarterly earnings release is made, denying him the ability to ask questions on such calls, and/or denying him access to top management for arranging group meetings between Hilton Brokerage clients and top Metals & Mining managers.

Comment: As in Example 3, Fritz's analysis must be objective and based solely on consideration of company fundamentals. Any pressure from Metals & Mining is inappropriate. Fritz should reinforce the integrity of his conclusions by stressing that his investment recommendation is based on relative valuation, which may include qualitative issues with respect to Metals & Mining's management.

(Research Independence and Sales Pressure):

As support for the sales effort of her corporate bond department, Lindsey Warner offers credit guidance to purchasers of fixed-income securities. Her compensation is closely linked to the performance of the corporate bond department. Near the quarter's end, Warner's firm has a large inventory position in the bonds of Milton, Ltd., and has been unable to sell the bonds because of Milton's recent announcement of an operating problem. Salespeople have asked her to contact large clients to push the bonds.

Comment: Unethical sales practices create significant potential violations of the Code and Standards. Warner's opinion of the Milton bonds must not be affected by internal pressure or compensation. In this case, Warner must refuse to push the Milton bonds unless she is able to justify that the market price has already adjusted for the operating problem.

(Research Independence and Prior Coverage):

Jill Jorund is a securities analyst following airline stocks and a rising star at her firm. Her boss has been carrying a "buy" recommendation on International Airlines and asks Jorund to take over coverage of that airline. He tells Jorund that under no circumstances should the prevailing buy recommendation be changed.

Comment: Jorund must be independent and objective in her analysis of International Airlines. If she believes that her boss's instructions have compromised her, she has two options: She can tell her boss that she cannot cover the company under these constraints, or she can take over coverage of the company, reach her own independent conclusions, and if they conflict with her boss's opinion, share the conclusions with her boss or other supervisors in the firm so that they can make appropriate recommendations. Jorund must issue only recommendations that reflect her independent and objective opinion.

(Gifts and Entertainment from Related Party):

Edward Grant directs a large amount of his commission business to a New York-based brokerage house. In appreciation for all the business, the brokerage house gives Grant two tickets to the World Cup in South Africa, two nights at a nearby resort, several meals, and transportation via limousine to the game. Grant fails to disclose receiving this package to his supervisor.

Comment: Grant has violated Standard I(B) because accepting these substantial gifts may impede his independence and objectivity. Every member and candidate should endeavor to avoid situations that might cause or be perceived to cause a loss of independence or objectivity in recommending investments or taking investment action. By accepting the trip, Grant has opened himself up to the accusation that he may give the broker favored treatment in return.

(Gifts and Entertainment from Client):

Theresa Green manages the portfolio of Ian Knowlden, a client of Tisbury Investments. Green achieves an annual return for Knowlden that is consistently better than that of the benchmark she and the client previously agreed to. As a reward, Knowlden offers Green two tickets to Wimbledon and the use of Knowlden's flat in London for a week. Green discloses this

gift to her supervisor at Tisbury.

Comment: Green is in compliance with Standard I(B) because she disclosed the gift from one of her clients in accordance with the firm's policies. Members and candidates may accept bonuses or gifts from clients as long as they disclose them to their employer because gifts in a client relationship are deemed less likely to affect a member's or candidate's objectivity and independence than gifts in other situations. Disclosure is required, however, so that supervisors can monitor such situations to guard against employees favoring a gift-giving client to the detriment of other fee-paying clients (such as by allocating a greater proportion of IPO stock to the gift-giving client's portfolio).

Best practices for monitoring include comparing the transaction costs of the Knowlden account with the costs of other accounts managed by Green and other similar accounts within Tisbury. The supervisor could also compare the performance returns with the returns of other clients with the same mandate. This comparison will assist in determining whether a pattern of favoritism by Green is disadvantaging other Tisbury clients or the possibility that this favoritism could affect her future behavior.

(Travel Expenses from External Manager):

Tom Wayne is the investment manager of the Franklin City Employees Pension Plan. He recently completed a successful search for a firm to manage the foreign equity allocation of the plan's diversified portfolio. He followed the plan's standard procedure of seeking presentations from a number of qualified firms and recommended that his board select Penguin Advisors because of its experience, well-defined investment strategy, and performance record. The firm claims compliance with the Global Investment Performance Standards (GIPS) and has been verified. Following the selection of Penguin, a reporter from the Franklin City Record calls to ask if there was any connection between this action and the fact that Penguin was one of the sponsors of an "investment fact-finding trip to Asia" that Wayne made earlier in the year. The trip was one of several conducted by the Pension Investment Academy, which had arranged the itinerary of meetings with economic, government, and corporate officials in major cities in several Asian countries. The Pension Investment Academy obtains support for the cost of these trips from a number of investment managers, including Penguin Advisors; the Academy then pays the travel expenses of the various pension plan managers on the trip and provides all meals and accommodations. The president of Penguin Advisors was also one of the travelers on the trip.

Comment: Although Wayne can probably put to good use the knowledge he gained from the trip in selecting portfolio managers and in other areas of managing the pension plan, his recommendation of Penguin Advisors may be tainted by the possible conflict incurred when he participated in a trip partly paid for by Penguin Advisors and when he was in the daily company of the president of Penguin Advisors. To avoid violating Standard I(B), Wayne's basic expenses for travel and accommodations should have been paid by his employer or the pension plan; contact with the president of Penguin Advisors should have been limited to informational or educational events only; and the trip, the organizer, and the sponsor should have been made a matter of public record. Even if his actions were not in violation of Standard I(B), Wayne should have been sensitive to the public perception of the trip when reported in the newspaper and the extent to which the subjective elements of his decision might have been affected by the familiarity that the daily contact of such a trip would encourage. This advantage would probably not be shared by firms competing with Penguin Advisors.

(Research Independence and Compensation Arrangements):

Javier Herrero recently left his job as a research analyst for a large investment adviser. While looking for a new position, he was hired by an investor-relations firm to write a research report on one of its clients, a small educational software company. The investor-relations firm hopes to generate investor interest in the technology company. The firm will pay Herrero a flat fee plus a bonus if any new investors buy stock in the company as a result of Herrero's report.

Comment: If Herrero accepts this payment arrangement, he will be in violation of Standard I(B) because the compensation arrangement can reasonably be expected to compromise his independence and objectivity. Herrero will receive a bonus for attracting investors, which provides an incentive to draft a positive report regardless of the facts and to ignore or play down any negative information about the company. Herrero should accept only a flat fee that is not tied to the conclusions or recommendations of the report. Issuer-paid research that is objective and unbiased can be done under the right circumstances as long as the analyst takes steps to maintain his or her objectivity and includes in the report proper disclosures regarding potential conflicts of interest.

(Recommendation Objectivity and Service Fees):

Two years ago, Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class of funds. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review Western's funds to determine whether they were suitable for clients of Central Midas Bank. The manager completed the normal due diligence review and determined that the new funds were fairly valued in the market with fee structures on a par with competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments.

Now, two years later, the funds managed by Western begin to underperform their peers. Wade is counting on the fees to reach his profitability targets and continues to push these funds as acceptable investments for Central's clients.

Comment: Wade is violating Standard I(B) because the fee arrangement has affected the objectivity of his recommendations. Wade is relying on the fee as a component of the department's profitability and is unwilling to offer other products that may affect the fees received.

(Recommendation Objectivity):

Bob Thompson has been doing research for the portfolio manager of the fixed-income department. His assignment is to do sensitivity analysis on securitized subprime mortgages. He has discussed with the manager possible scenarios to use to calculate expected returns. A key assumption in such calculations is housing price appreciation (HPA) because it drives "prepays" (prepayments of mortgages) and losses. Thompson is concerned with the significant appreciation experienced over the previous five years as a result of the increased availability of funds from subprime mortgages. Thompson insists that the analysis should include a scenario run with -10% for Year 1, -5% for Year 2, and then (to project a worst-case scenario) 0% for Years 3 through 5. The manager replies that these assumptions are too dire because there has never been a time in their available database when HPA was negative.

Thompson conducts his research to better understand the risks inherent in these securities and evaluates these securities in the worst-case scenario, an unlikely but possible environment. Based on the results of the enhanced scenarios, Thompson does not recommend the purchase of the securitization. Against the general market trends, the manager follows Thompson's recommendation and does not invest. The following year, the housing market collapses. In avoiding the subprime investments, the manager's portfolio outperforms its peer group that year.

Comment: Thompson's actions in running the worst-case scenario against the protests of the portfolio manager are in alignment with the principles of Standard I(B). Thompson did not allow his research to be pressured by the general trends of the market or the manager's desire to limit the research to historical norms.

(Influencing Manager Selection Decisions):

Adrian Mandel, CFA, is a senior portfolio manager for ZZZY Capital Management who oversees a team of investment professionals who manage labor union pension funds. A few years ago, ZZZY sought to win a competitive asset manager search to manage a significant allocation of the pension fund of the United Doughnut and Pretzel Bakers Union (UDPBU). UDPBU's investment board is chaired by a recognized key decision maker and long-time leader of the union, Ernesto Gomez. To improve ZZZY's chances of winning the competition, Mandel made significant monetary contributions to Gomez's union reelection campaign fund. Even after ZZZY was hired as a primary manager of the pension, Mandel believed that his firm's position was not secure. Mandel continued to contribute to Gomez's reelection campaign chest as well as to entertain lavishly the union leader and his family at top restaurants on a regular basis. All of Mandel's outlays were routinely handled as marketing expenses reimbursed by ZZZY's expense accounts and were disclosed to his senior management as being instrumental in maintaining a strong close relationship with an important client.

Comment: Mandel not only offered but actually gave monetary gifts, benefits, and other considerations that reasonably could be expected to compromise Gomez's objectivity. Therefore, Mandel was in violation of Standard I(B).

(Influencing Manager Selection Decisions):

Adrian Mandel, CFA, had heard about the manager search competition for the UDPBU Pension Fund through a broker/dealer contact. The contact told him that a well-known retired professional golfer, Bobby "The Bear" Finlay, who had become a licensed broker/dealer serving as a pension consultant, was orchestrating the UDPBU manager search. Finlay had gained celebrity status with several labor union pension fund boards by entertaining their respective board members and regaling them with colorful stories of fellow pro golfers' antics in clubhouses around the world. Mandel decided to improve ZZZY's chances of being invited to participate in the search competition by befriending Finlay to curry his favor. Knowing Finlay's love of entertainment, Mandel wined and dined Finlay at high-profile bistros where Finlay could glow in the fan recognition lavished on him by all the other patrons. Mandel's endeavors paid off handsomely when Finlay recommended to the UDPBU board that ZZZY be entered as one of three finalist asset management firms in its search.

Comment: Similar to Example 13, Mandel lavished gifts, benefits, and other considerations in the form of expensive entertainment that could reasonably be expected to influence the consultant to recommend the hiring of his firm. Therefore, Mandel was in violation of Standard I(B).

(Fund Manager Relationships):

Amie Scott is a performance analyst within her firm with responsibilities for analyzing the performance of external managers. While completing her quarterly analysis, Scott notices a change in one manager's reported composite construction. The change concealed the bad performance of a particularly large account by placing that account into a new residual composite. This change allowed the manager to remain at the top of the list of manager performance. Scott knows her firm has a large allocation to this manager, and the fund's manager is a close personal friend of the CEO. She needs to deliver her final report but is concerned with pointing out the composite change.

Comment: Scott would be in violation of Standard I(B) if she did not disclose the change in her final report. The analysis of managers' performance should not be influenced by personal relationships or the size of the allocation to the outside managers. By not including the change, Scott would not be providing an independent analysis of the performance metrics for her firm.

(Intrafirm Pressure):

Jill Stein is head of performance measurement for her firm. During the last quarter, many members of the organization's research department were removed because of the poor quality of their recommendations. The subpar research caused one larger account holder to experience significant underperformance, which resulted in the client withdrawing his money after the end of the quarter. The head of sales requests that Stein remove this account from the firm's performance composite because the performance decline can be attributed to the departed research team and not the client's adviser.

Comment: Pressure from other internal departments can create situations that cause a member or candidate to violate the Code and Standards. Stein must maintain her independence and objectivity

and refuse to exclude specific accounts from the firm's performance composites to which they belong. As long as the client invested under a strategy similar to that of the defined composite, it cannot be excluded because of the poor stock selections that led to the underperformance and asset withdrawal.

**I C Professionalism Misrepresentation  
(Disclosure of Issuer-Paid Research):**

Anthony McGuire is an issuer-paid analyst hired by publicly traded companies to electronically promote their stocks. McGuire creates a website that promotes his research efforts as a seemingly independent analyst. McGuire posts a profile and a strong buy recommendation for each company on the website indicating that the stock is expected to increase in value. He does not disclose the contractual relationships with the companies he covers on his website, in the research reports he issues, or in the statements he makes about the companies in internet chat rooms.

**Comment:** McGuire has violated Standard I(C) because the website is misleading to potential investors. Even if the recommendations are valid and supported with thorough research, his omissions regarding the true relationship between himself and the companies he covers constitute a misrepresentation. McGuire has also violated Standard VI(A)–Disclosure of Conflicts by not disclosing the existence of an arrangement with the companies through which he receives compensation in exchange for his services.

**(Correction of Unintentional Errors):**

Hijian Yao is responsible for the creation and distribution of the marketing materials for his firm, which claims compliance with the GIPS standards. Yao creates and distributes a presentation of performance by the firm's Asian equity composite that states the composite has ¥350 billion in assets. In fact, the composite has only ¥35 billion in assets, and the higher figure on the presentation is a result of a typographical error. Nevertheless, the erroneous material is distributed to a number of clients before Yao catches the mistake.

**Comment:** Once the error is discovered, Yao must take steps to cease distribution of the incorrect material and correct the error by informing those who have received the erroneous information. Because Yao did not knowingly make the misrepresentation, however, he did not violate Standard I(C). Because his firm claims compliance with the GIPS standards, it must also comply with the GIPS Guidance Statement on Error Correction in relation to the error.

**(Noncorrection of Known Errors):**

Syed Muhammad is the president of an investment management firm. The promotional material for the firm, created by the firm's marketing department, incorrectly claims that Muhammad has an advanced degree in finance from a prestigious business school in addition to the CFA designation. Although Muhammad attended the school for a short period of time, he did not receive a degree. Over the years, Muhammad and others in the firm have distributed this material to numerous prospective clients and consultants.

**Comment:** Even though Muhammad may not have been directly responsible for the misrepresentation of his credentials in the firm's promotional material, he used this material numerous times over an extended period and should have known of the misrepresentation. Thus, Muhammad has violated Standard I(C).

**(Plagiarism):**

Cindy Grant, a research analyst for a Canadian brokerage firm, has specialized in the Canadian mining industry for the past 10 years. She recently read an extensive research report on Jefferson Mining, Ltd., by Jeremy Barton, another analyst. Barton provided extensive statistics on the mineral reserves, production capacity, selling rates, and marketing factors affecting Jefferson's operations. He also noted that initial drilling results on a new ore body, which had not been made public, might show the existence of mineral zones that could increase the life of Jefferson's main mines, but Barton cited no specific data as to the initial drilling results. Grant called an officer of Jefferson, who gave her the initial drilling results over the telephone. The data indicated that the expected life of the main mines would be tripled. Grant added these statistics to Barton's report and circulated it within her firm as her own report.

**Comment:** Grant plagiarized Barton's report by reproducing large parts of it in her own report without acknowledgment.

**(Misrepresentation of Information):**

When Ricki Marks sells mortgage-backed derivatives called "interest-only strips" (IOs) to public pension plan clients, she describes them as "guaranteed by the US government." Purchasers of the IOs are entitled only to the interest stream generated by the mortgages, however, not the notional principal itself. One particular municipality's investment policies and local law require that securities purchased by its public pension plans be guaranteed by the US government. Although the underlying mortgages are guaranteed, neither the investor's investment nor the interest stream on the IOs is guaranteed. When interest rates decline, causing an increase in prepayment of mortgages, interest payments to the IOs' investors decline, and these investors lose a portion of their investment.

**Comment:** Marks violated Standard I(C) by misrepresenting the terms and character of the investment.

**(Potential Information Misrepresentation):**

Khalouck Abdrabbo manages the investments of several high-net-worth individuals in the United States

who are approaching retirement. Abdrabbo advises these individuals that a portion of their investments be moved from equity to bank-sponsored certificates of deposit and money market accounts so that the principal will be “guaranteed” up to a certain amount. The interest is not guaranteed.

Comment: Although there is risk that the institution offering the certificates of deposits and money market accounts could go bankrupt, in the United States, these accounts are insured by the US government through the Federal Deposit Insurance Corporation. Therefore, using the term “guaranteed” in this context is not inappropriate as long as the amount is within the government-insured limit. Abdrabbo should explain these facts to the clients.

(Plagiarism):

Steve Swanson is a senior analyst in the investment research department of Ballard and Company. Apex Corporation has asked Ballard to assist in acquiring the majority ownership of stock in the Campbell Company, a financial consulting firm, and to prepare a report recommending that stockholders of Campbell agree to the acquisition. Another investment firm, Davis and Company, had already prepared a report for Apex analyzing both Apex and Campbell and recommending an exchange ratio. Apex has given the Davis report to Ballard officers, who have passed it on to Swanson. Swanson reviews the Davis report and other available material on Apex and Campbell. From his analysis, he concludes that the common stocks of Campbell and Apex represent good value at their current prices; he believes, however, that the Davis report does not consider all the factors a Campbell stockholder would need to know to make a decision. Swanson reports his conclusions to the partner in charge, who tells him to “use the Davis report, change a few words, sign your name, and get it out.”

Comment: If Swanson does as requested, he will violate Standard I(C). He could refer to those portions of the Davis report that he agrees with if he identifies Davis as the source; he could then add his own analysis and conclusions to the report before signing and distributing it.

(Plagiarism):

Claude Browning, a quantitative analyst for Double Alpha, Inc., returns from a seminar in great excitement. At that seminar, Jack Jorrelly, a well-known quantitative analyst at a national brokerage firm, discussed one of his new models in great detail, and Browning is intrigued by the new concepts. He proceeds to test the model, making some minor mechanical changes but retaining the concepts, until he produces some very positive results. Browning quickly announces to his supervisors at Double Alpha that he has discovered a new model and that clients and prospective clients should be informed of this positive finding as ongoing proof of Double Alpha’s continuing innovation and ability to add value.

Comment: Although Browning tested Jorrelly’s model on his own and even slightly modified it, he must still acknowledge the original source of the idea. Browning can certainly take credit for the final, practical results; he can also support his conclusions with his own test. The credit for the innovative thinking, however, must be awarded to Jorrelly.

(Plagiarism):

Fernando Zubia would like to include in his firm’s marketing materials some “plain-language” descriptions of various concepts, such as the price-to-earnings (P/E) multiple and why standard deviation is used as a measure of risk. The descriptions come from other sources, but Zubia wishes to use them without reference to the original authors. Would this use of material be a violation of Standard I(C)?

Comment: Copying verbatim any material without acknowledgement, including plain-language descriptions of the P/E multiple and standard deviation, violates Standard I(C). Even though these concepts are general, best practice would be for Zubia to describe them in his own words or cite the sources from which the descriptions are quoted. Members and candidates would be violating Standard I(C) if they either were responsible for creating marketing materials without attribution or knowingly use plagiarized materials.

(Misrepresentation of Information):

Paul Ostrowski runs a two-person investment management firm. Ostrowski’s firm subscribes to a service from a large investment research firm that provides research reports that can be repackaged by smaller firms for those firms’ clients. Ostrowski’s firm distributes these reports to clients as its own work.

Comment: Ostrowski can rely on third-party research that has a reasonable and adequate basis, but he cannot imply that he is the author of such research. If he does, Ostrowski is misrepresenting the extent of his work in a way that misleads the firm’s clients or prospective clients.

(Misrepresentation of Information):

Tom Stafford is part of a team within Appleton Investment Management responsible for managing a pool of assets for Open Air Bank, which distributes structured securities to offshore clients. He becomes aware that Open Air is promoting the structured securities as a much less risky investment than the investment management policy followed by him and the team to manage the original pool of assets. Also, Open Air has procured an independent rating for the pool that significantly overstates the quality of the investments. Stafford communicates his concerns to his supervisor, who responds that Open Air owns the product and is responsible for all marketing and distribution. Stafford’s supervisor goes on to say that the product is outside of the US regulatory regime that Appleton follows and that all risks of the product are disclosed at the bottom of page 184 of the prospectus.

Comment: As a member of the investment team, Stafford is qualified to recognize the degree of accuracy of the materials that characterize the portfolio, and he is correct to be worried about

Appleton's responsibility for a misrepresentation of the risks. Thus, he should continue to pursue the issue of Open Air's inaccurate promotion of the portfolio according to the firm's policies and procedures.

The Code and Standards stress protecting the reputation of the firm and the sustainability and integrity of the capital markets. Misrepresenting the quality and risks associated with the investment pool may lead to negative consequences for others well beyond the direct investors.

(Avoiding a Misrepresentation):

Trina Smith is a fixed-income portfolio manager at a pension fund. She has observed that the market for highly structured mortgages is the focus of salespeople she meets and that these products represent a significant number of trading opportunities. In discussions about this topic with her team, Smith learns that calculating yields on changing cash flows within the deal structure requires very specialized vendor software. After more research, they find out that each deal is unique and that deals can have more than a dozen layers and changing cash flow priorities. Smith comes to the conclusion that, because of the complexity of these securities, the team cannot effectively distinguish between potentially good and bad investment options. To avoid misrepresenting their understanding, the team decides that the highly structured mortgage segment of the securitized market should not become part of the core of the fund's portfolio; they will allow some of the less complex securities to be part of the core.

Comment: Smith is in compliance with Standard I(C) by not investing in securities that she and her team cannot effectively understand. Because she is not able to describe the risk and return profile of the securities to the pension fund beneficiaries and trustees, she appropriately limits the fund's exposure to this sector.

(Misrepresenting Composite Construction):

Robert Palmer is head of performance for a fund manager. When asked to provide performance numbers to fund rating agencies, he avoids mentioning that the fund manager is quite liberal in composite construction. The reason accounts are included/ excluded is not fully explained. The performance values reported to the rating agencies for the composites, although accurate for the accounts shown each period, may not present a true representation of the fund manager's ability.

Comment: "Cherry picking" accounts to include in either published reports or information provided to rating agencies conflicts with Standard I(C). Moving accounts into or out of a composite to influence the overall performance results materially misrepresents the reported values over time. Palmer should work with his firm to strengthen its reporting practices concerning composite construction to avoid misrepresenting the firm's track record or the quality of the information being provided.

(Presenting Out-of-Date Information):

David Finch is a sales director at a commercial bank, where he directs the bank's client advisers in the sale of third-party mutual funds. Each quarter, he holds a division-wide training session where he provides fact sheets on investment funds the bank is allowed to offer to clients. These fact sheets, which can be redistributed to potential clients, are created by the fund firms and contain information about the funds, including investment strategy and target distribution rates.

Finch knows that some of the fact sheets are out of date; for example, one long-only fund approved the use of significant leverage last quarter as a method to enhance returns. He continues to provide the sheets to the sales team without updates because the bank has no control over the marketing material released by the mutual fund firms.

Comment: Finch is violating Standard I(C) by providing information that misrepresents aspects of the funds. By not providing the sales team and, ultimately, the clients with the updated information, he is misrepresenting the potential risks associated with the funds with outdated fact sheets. Finch can instruct the sales team to clarify the deficiencies in the fact sheets with clients and ensure they have the most recent fund prospectus document before accepting orders for investing in any fund.

I D Professionalism Misconduct

(Professionalism and Competence):

Simon Sasserman is a trust investment officer at a bank in a small affluent town. He enjoys lunching every day with friends at the country club, where his clients have observed him having numerous drinks. Back at work after lunch, he clearly is intoxicated while making investment decisions. His colleagues make a point of handling any business with Sasserman in the morning because they distrust his judgment after lunch.

Comment: Sasserman's excessive drinking at lunch and subsequent intoxication at work constitute a violation of Standard I(D) because this conduct has raised questions about his professionalism and competence. His behavior reflects poorly on him, his employer, and the investment industry.

(Fraud and Deceit):

Howard Hoffman, a security analyst at ATZ Brothers, Inc., a large brokerage house, submits reimbursement forms over a two-year period to ATZ's self-funded health insurance program for more than two dozen bills, most of which have been altered to increase the amount due. An investigation by the firm's director of employee benefits uncovers the inappropriate conduct. ATZ subsequently terminates Hoffman's employment and notifies CFA Institute.

Comment: Hoffman violated Standard I(D) because he engaged in intentional conduct involving fraud and deceit in the workplace that adversely reflected on his integrity.

(Fraud and Deceit):

Jody Brink, an analyst covering the automotive industry, volunteers much of her spare time to local charities. The board of one of the charitable institutions decides to buy five new vans to deliver hot lunches to low-income elderly people. Brink offers to donate her time to handle purchasing agreements. To pay a long-standing debt to a friend who operates an automobile dealership—and to compensate herself for her trouble—she agrees to a price 20% higher than normal and splits the surcharge with her friend. The director of the charity ultimately discovers the scheme and tells Brink that her services, donated or otherwise, are no longer required.

Comment: Brink engaged in conduct involving dishonesty, fraud, and misrepresentation and has violated Standard I(D).

(Personal Actions and Integrity):

Darmen Garcia manages a mutual fund dedicated to socially responsible investing. She is also an environmental activist. As the result of her participation in nonviolent protests, Garcia has been arrested on numerous occasions for trespassing on the property of a large petrochemical plant that is accused of damaging the environment.

Comment: Generally, Standard I(D) is not meant to cover legal transgressions resulting from acts of civil disobedience in support of personal beliefs because such conduct does not reflect poorly on the member's or candidate's professional reputation, integrity, or competence.

(Professional Misconduct):

Meredith Rasmussen works on a buy-side trading desk of an investment management firm and concentrates on in-house trades for a hedge fund subsidiary managed by a team at the investment management firm. The hedge fund has been very successful and is marketed globally by the firm. From her experience as the trader for much of the activity of the fund, Rasmussen has become quite knowledgeable about the hedge fund's strategy, tactics, and performance. When a distinct break in the market occurs and many of the securities involved in the hedge fund's strategy decline markedly in value, Rasmussen observes that the reported performance of the hedge fund does not reflect this decline. In her experience, the lack of effect is a very unlikely occurrence. She approaches the head of trading about her concern and is told that she should not ask any questions and that the fund is big and successful and is not her concern. She is fairly sure something is not right, so she contacts the compliance officer, who also tells her to stay away from the issue of the hedge fund's reporting.

Comment: Rasmussen has clearly come across an error in policies, procedures, and compliance practices within the firm's operations. According to the firm's procedures for reporting potentially unethical activity, she should pursue the issue by gathering some proof of her reason for doubt. Should all internal communications within the firm not satisfy her concerns, Rasmussen should consider reporting the potential unethical activity to the appropriate regulator.

## II A Integrity of the Capital Markets Material Nonpublic Information

(Acting on Nonpublic Information):

Frank Barnes, the president and controlling shareholder of the SmartTown clothing chain, decides to accept a tender offer and sell the family business at a price almost double the market price of its shares. He describes this decision to his sister (SmartTown's treasurer), who conveys it to her daughter (who owns no stock in the family company at present), who tells her husband, Staple. Staple, however, tells his stockbroker, Alex Halsey, who immediately buys SmartTown stock for himself.

Comment: The information regarding the pending sale is both material and nonpublic. Staple has violated Standard II(A) by communicating the inside information to his broker. Halsey also has violated the standard by buying the shares on the basis of material nonpublic information.

(Controlling Nonpublic Information):

Samuel Peter, an analyst with Scotland and Pierce Incorporated, is assisting his firm with a secondary offering for Bright Ideas Lamp Company. Peter participates, via telephone conference call, in a meeting with Scotland and Pierce investment banking employees and Bright Ideas' CEO. Peter is advised that the company's earnings projections for the next year have significantly dropped. Throughout the telephone conference call, several Scotland and Pierce salespeople and portfolio managers walk in and out of Peter's office, where the telephone call is taking place. As a result, they are aware of the drop in projected earnings for Bright Ideas. Before the conference call is concluded, the salespeople trade the stock of the company on behalf of the firm's clients and other firm personnel trade the stock in a firm proprietary account and in employees' personal accounts.

Comment: Peter has violated Standard II(A) because he failed to prevent the transfer and misuse of material nonpublic information to others in his firm. Peter's firm should have adopted information barriers to prevent the communication of nonpublic information between departments of the firm. The salespeople and portfolio managers who traded on the information have also violated Standard II(A) by trading on inside information.

(Selective Disclosure of Material Information):

Elizabeth Levenson is based in Hanoi and covers the Vietnamese market for her firm, which is based in Singapore. She is invited, together with the other 10 largest shareholders of a manufacturing company, to meet the finance director of that company. During the meeting, the finance director states that the company expects its workforce to strike next Friday, which will cripple productivity and

distribution. Can Levenson use this information as a basis to change her rating on the company from “buy” to “sell”?

Comment: Levenson must first determine whether the material information is public. According to Standard II(A), if the company has not made this information public (a small group forum does not qualify as a method of public dissemination), she cannot use the information.

(Determining Materiality):

Leah Fechtman is trying to decide whether to hold or sell shares of an oil-and-gas exploration company that she owns in several of the funds she manages. Although the company has underperformed the index for some time already, the trends in the industry sector signal that companies of this type might become takeover targets. While she is considering her decision, her doctor, who casually follows the markets, mentions that she thinks that the company in question will soon be bought out by a large multinational conglomerate and that it would be a good idea to buy the stock right now. After talking to various investment professionals and checking their opinions on the company as well as checking industry trends, Fechtman decides the next day to accumulate more stock in the oil-and-gas exploration company.

Comment: Although information on an expected takeover bid may be of the type that is generally material and nonpublic, in this case, the source of information is unreliable, so the information cannot be considered material. Therefore, Fechtman is not prohibited from trading the stock on the basis of this information.

(Applying the Mosaic Theory):

Jagdish Teja is a buy-side analyst covering the furniture industry. Looking for an attractive company to recommend as a buy, he analyzes several furniture makers by studying their financial reports and visiting their operations. He also talks to some designers and retailers to find out which furniture styles are trendy and popular. Although none of the companies that he analyzes are a clear buy, he discovers that one of them, Swan Furniture Company (SFC), may be in financial trouble. SFC's extravagant new designs have been introduced at substantial cost. Even though these designs initially attracted attention, the public is now buying more conservative furniture from other makers. Based on this information and on a profit-and-loss analysis, Teja believes that SFC's next quarter earnings will drop substantially. He issues a sell recommendation for SFC. Immediately after receiving that recommendation, investment managers start reducing the SFC stock in their portfolios.

Comment: Information on quarterly earnings data is material and nonpublic. Teja arrived at his conclusion about the earnings drop on the basis of public information and on pieces of nonmaterial nonpublic information (such as opinions of designers and retailers). Therefore, trading based on Teja's correct conclusion is not prohibited by Standard II(A).

(Applying the Mosaic Theory):

Roger Clement is a senior financial analyst who specializes in the European automobile sector at Rivoli Capital. Because he has been repeatedly nominated by many leading industry magazines and newsletters as a “best analyst” for the automobile industry, he is widely regarded as an authority on the sector. After speaking with representatives of Turgot Chariots—a European auto manufacturer with sales primarily in South Korea—and after conducting interviews with salespeople, labor leaders, his firm's Korean currency analysts, and banking officials, Clement analyzed Turgot Chariots and concluded that (1) its newly introduced model will probably not meet sales expectations, (2) its corporate restructuring strategy may well face serious opposition from unions, (3) the depreciation of the Korean won should lead to pressure on margins for the industry in general and Turgot's market segment in particular, and (4) banks could take a tougher-than-expected stance in the upcoming round of credit renegotiations with the company. For these reasons, he changes his conclusion about the company from “market outperform” to “market underperform.” Clement retains the support material used to reach his conclusion in case questions later arise.

Comment: To reach a conclusion about the value of the company, Clement has pieced together a number of nonmaterial or public bits of information that affect Turgot Chariots. Therefore, under the mosaic theory, Clement has not violated Standard II(A) in drafting the report.

(Analyst Recommendations as Material Nonpublic Information):

The next day, Clement is preparing to be interviewed on a global financial news television program where he will discuss his changed recommendation on Turgot Chariots for the first time in public. While preparing for the program, he mentions to the show's producers and Mary Zito, the journalist who will be interviewing him, the information he will be discussing. Just prior to going on the air, Zito sells her holdings in Turgot Chariots. She also phones her father with the information because she knows that he and other family members have investments in Turgot Chariots.

Comment: When Zito receives advance notice of Clement's change of opinion, she knows it will have a material impact on the stock price, even if she is not totally aware of Clement's underlying reasoning. She is not a client of Clement but obtains early access to the material nonpublic information prior to publication. Her trades are thus based on material nonpublic information and violate Standard II(A).

Zito further violates the Standard by relaying the information to her father. It would not matter if he or any other family member traded; the act of providing the information violates Standard II(A). The fact that the information is provided to a family member does not absolve someone of the prohibition of using or communicating material nonpublic information.

(Acting on Nonpublic Information):

Ashton Kellogg is a retired investment professional who manages his own portfolio. He owns shares in National Savings, a large local bank. A close friend and golfing buddy, John Mayfield, is a senior

executive at National. National has seen its stock price drop considerably, and the news and outlook are not good. In a conversation about the economy and the banking industry on the golf course, Mayfield relays the information that National will surprise the investment community in a few days when it announces excellent earnings for the quarter. Kellogg is pleasantly surprised by this information, and thinking that Mayfield, as a senior executive, knows the law and would not disclose inside information, he doubles his position in the bank. Subsequently, National announces that it had good operating earnings but had to set aside reserves for anticipated significant losses on its loan portfolio. The combined news causes the stock to go down 60%.

Comment: Even though Kellogg believes that Mayfield would not break the law by disclosing inside information and money was lost on the purchase, Kellogg should not have purchased additional shares of National. It is the member's or candidate's responsibility to make sure, before executing investment actions, that comments about earnings are not material non-public information. Kellogg has violated Standard II(A).

(Mosaic Theory):

John Doll is a research analyst for a hedge fund that also sells its research to a select group of paying client investment firms. Doll's focus is medical technology companies and products, and he has been in the business long enough and has been successful enough to build up a very credible network of friends and experts in the business. Doll has been working on a major research report recommending Boyce Health, a medical device manufacturer. He recently ran into an old acquaintance at a wedding who is a senior executive at Boyce, and Doll asked about the business. Doll was drawn to a statement that the executive, who has responsibilities in the new products area, made about a product: "I would not get too excited about the medium-term prospects; we have a lot of work to do first." Doll incorporated this and other information about the new Boyce product in his long-term recommendation of Boyce.

Comment: Doll's conversation with the senior executive is part of the mosaic of information used in recommending Boyce. When holding discussions with a firm executive, Doll would need to guard against soliciting or obtaining material nonpublic information. Before issuing the report, the executive's statement about the continuing development of the product would need to be weighed against the other known public facts to determine whether it would be considered material.

(Materiality Determination):

Larry Nadler, a trader for a mutual fund, gets a text message from another firm's trader, whom he has known for years. The message indicates a software company is going to report strong earnings when the firm publicly announces in two days. Nadler has a buy order from a portfolio manager within his firm to purchase several hundred thousand shares of the stock. Nadler is aggressive in placing the portfolio manager's order and completes the purchases by the following morning, a day ahead of the firm's planned earnings announcement.

Comment: There are often rumors and whisper numbers before a release of any kind. The text message from the other trader would most likely be considered market noise. Unless Nadler knew that the trader had an ongoing business relationship with the public firm, he had no reason to suspect he was receiving material nonpublic information that would prevent him from completing the trading request of the portfolio manager.

(Using an Expert Network):

Mary McCoy is the senior drug analyst at a mutual fund. Her firm hires a service that connects her to experts in the treatment of cancer. Through various phone conversations, McCoy enhances her understanding of the latest therapies for successful treatment. This information is critical to Mary making informed recommendations of the companies producing these drugs.

Comment: McCoy is appropriately using the expert networks to enhance her evaluation process. She has neither asked for nor received information that may be considered material and nonpublic, such as preliminary trial results. McCoy is allowed to seek advice from professionals within the industry that she follows.

(Using an Expert Network):

Tom Watson is a research analyst working for a hedge fund. To stay informed, Watson relies on outside experts for information on such industries as technology and pharmaceuticals, where new advancements occur frequently. The meetings with the industry experts often are arranged through networks or placement agents that have specific policies and procedures in place to deter the exchange of material non-public information.

Watson arranges a call to discuss future prospects for one of the fund's existing technology company holdings, a company that was testing a new semiconductor product. The scientist leading the tests indicates his disappointment with the performance of the new semiconductor. Following the call, Watson relays the insights he received to others at the fund. The fund sells its current position in the company and buys many put options because the market is anticipating the success of the new semiconductor and the share price reflects the market's optimism.

Comment: Watson has violated Standard II(A) by passing along material nonpublic information concerning the ongoing product tests, which the fund used to trade in the securities and options of the related company. Watson cannot simply rely on the agreements signed by individuals who participate in expert networks that state that he has not received information that would prohibit his trading activity. He must make his own determination whether information he received through these arrangements reaches a materiality threshold that would affect his trading abilities.

The principal owner of Financial Information Services (FIS) entered into an agreement with two microcap companies to promote the companies' stock in exchange for stock and cash compensation. The principal owner caused FIS to disseminate e-mails, design and maintain several websites, and distribute an online investment newsletter—all of which recommended investment in the two companies. The systematic publication of purportedly independent analyses and recommendations containing inaccurate and highly promotional and speculative statements increased public investment in the companies and led to dramatically higher stock prices.

Comment: The principal owner of FIS violated Standard II(B) by using inaccurate reporting and misleading information under the guise of independent analysis to artificially increase the stock price of the companies. Furthermore, the principal owner violated Standard V(A)—Diligence and Reasonable Basis by not having a reasonable and adequate basis for recommending the two companies and violated Standard VI(A)—Disclosure of Conflicts by not disclosing to investors the compensation agreements (which constituted a conflict of interest).

(Personal Trading Practices and Price):

John Gray is a private investor in Belgium who bought a large position several years ago in Fame Pharmaceuticals, a German small-cap security with limited average trading volume. He has now decided to significantly reduce his holdings owing to the poor price performance. Gray is worried that the low trading volume for the stock may cause the price to decline further as he attempts to sell his large position.

Gray devises a plan to divide his holdings into multiple accounts in different brokerage firms and private banks in the names of family members, friends, and even a private religious institution. He then creates a rumor campaign on various blogs and social media outlets promoting the company.

Gray begins to buy and sell the stock using the accounts in hopes of raising the trading volume and the price. He conducts the trades through multiple brokers, selling slightly larger positions than he bought on a tactical schedule, and over time, he is able to reduce his holding as desired without negatively affecting the sale price.

Comment: John violated Standard II(B) by fraudulently creating the appearance that there was a greater investor interest in the stock through the online rumors. Additionally, through his trading strategy, he created the appearance that there was greater liquidity in the stock than actually existed. He was able to manipulate the price through both misinformation and trading practices.

(Creating Artificial Price Volatility):

Matthew Murphy is an analyst at Divisadero Securities & Co., which has a significant number of hedge funds among its most important brokerage clients. Some of the hedge funds hold short positions on Wirewolf Semiconductor. Two trading days before the publication of a quarter-end report, Murphy alerts his sales force that he is about to issue a research report on Wirewolf that will include the following opinions:

- quarterly revenues are likely to fall short of management's guidance,
- earnings will be as much as 5 cents per share (or more than 10%) below consensus, and
- Wirewolf's highly respected chief financial officer may be about to join another company.

Knowing that Wirewolf has already entered its declared quarter-end "quiet period" before reporting earnings (and thus would be reluctant to respond to rumors), Murphy times the release of his research report specifically to sensationalize the negative aspects of the message in order to create significant downward pressure on Wirewolf's stock—to the distinct advantage of Divisadero's hedge fund clients. The report's conclusions are based on speculation, not on fact. The next day, the research report is broadcast to all of Divisadero's clients and to the usual newswire services.

Before Wirewolf's investor-relations department can assess the damage on the final trading day of the quarter and refute Murphy's report, its stock opens trading sharply lower, allowing Divisadero's clients to cover their short positions at substantial gains.

Comment: Murphy violated Standard II(B) by aiming to create artificial price volatility designed to have a material impact on the price of an issuer's stock. Moreover, by lacking an adequate basis for the recommendation, Murphy also violated Standard V(A)—Diligence and Reasonable Basis.

(Personal Trading and Volume):

Rajesh Sekar manages two funds—an equity fund and a balanced fund—whose equity components are supposed to be managed in accordance with the same model. According to that model, the funds' holdings in stock of Digital Design Inc. (DD) are excessive. Reduction of the DD holdings would not be easy, however, because the stock has low liquidity in the stock market. Sekar decides to start trading larger portions of DD stock back and forth between his two funds to slowly increase the price; he believes market participants will see growing volume and increasing price and become interested in the stock. If other investors are willing to buy the DD stock because of such interest, then Sekar will be able to get rid of at least some of his overweight position without inducing price decreases. In this way, the whole transaction will be for the benefit of fund participants, even if additional brokers' commissions are incurred.

Comment: Sekar's plan would be beneficial for his funds' participants but is based on artificial distortion of both trading volume and the price of the DD stock and thus constitutes a violation of Standard II(B).

("Pump-Priming" Strategy):

ACME Futures Exchange is launching a new bond futures contract. To convince investors, traders, arbitrageurs, hedgers,

and so on, to use its contract, the exchange attempts to demonstrate that it has the best liquidity. To do so, it enters into agreements with members in which they commit to a substantial minimum trading volume on the new contract over a specific period in exchange for substantial reductions of their regular commissions.

Comment: The formal liquidity of a market is determined by the obligations set on market makers, but the actual liquidity of a market is better estimated by the actual trading volume and bid–ask spreads. Attempts to mislead participants about the actual liquidity of the market constitute a violation of Standard II(B). In this example, investors have been intentionally misled to believe they chose the most liquid instrument for some specific purpose, but they could eventually see the actual liquidity of the contract significantly reduced after the term of the agreement expires. If the ACME Futures Exchange fully discloses its agreement with members to boost transactions over some initial launch period, it will not violate Standard II(B). ACME’s intent is not to harm investors but, on the contrary, to give them a better service. For that purpose, it may engage in a liquidity-pumping strategy, but the strategy must be disclosed.

(Creating Artificial Price Volatility):

Emily Gordon, an analyst of household products companies, is employed by a research boutique, Picador & Co. Based on information that she has gathered during a trip through Latin America, she believes that Hygene, Inc., a major marketer of personal care products, has generated better-than-expected sales from its new product initiatives in South America. After modestly boosting her projections for revenue and for gross profit margin in her worksheet models for Hygene, Gordon estimates that her earnings projection of US\$2.00 per diluted share for the current year may be as much as 5% too low. She contacts the chief financial officer (CFO) of Hygene to try to gain confirmation of her findings from her trip and to get some feedback regarding her revised models. The CFO declines to comment and reiterates management’s most recent guidance of US\$1.95–US\$2.05 for the year.

Gordon decides to try to force a comment from the company by telling Picador & Co. clients who follow a momentum investment style that consensus earnings projections for Hygene are much too low; she explains that she is considering raising her published estimate by an ambitious US\$0.15 to US\$2.15 per share. She believes that when word of an unrealistically high earnings projection filters back to Hygene’s investor-relations department, the company will feel compelled to update its earnings guidance. Meanwhile, Gordon hopes that she is at least correct with respect to the earnings direction and that she will help clients who act on her insights to profit from a quick gain by trading on her advice.

Comment: By exaggerating her earnings projections in order to try to fuel a quick gain in Hygene’s stock price, Gordon is in violation of Standard II(B). Furthermore, by virtue of previewing her intentions of revising upward her earnings projections to only a select group of clients, she is in violation of Standard III(B)–Fair Dealing. However, it would have been acceptable for Gordon to write a report that

- framed her earnings projection in a range of possible outcomes,
- outlined clearly the assumptions used in her Hygene models that took into consideration the findings from her trip through Latin America, and
- was distributed to all Picador & Co. clients in an equitable manner.

(Pump and Dump Strategy):

In an effort to pump up the price of his holdings in Moosehead & Belfast Railroad Company, Steve Weinberg logs on to several investor chat rooms on the internet to start rumors that the company is about to expand its rail network in anticipation of receiving a large contract for shipping lumber.

Comment: Weinberg has violated Standard II(B) by disseminating false information about Moosehead & Belfast with the intent to mislead market participants.

(Manipulating Model Inputs):

Bill Mandeville supervises a structured financing team for Superior Investment Bank. His responsibilities include packaging new structured investment products and managing Superior’s relationship with relevant rating agencies. To achieve the best rating possible, Mandeville uses mostly positive scenarios as model inputs—scenarios that reflect minimal downside risk in the assets underlying the structured products. The resulting output statistics in the rating request and underwriting prospectus support the idea that the new structured products have minimal potential downside risk. Additionally, Mandeville’s compensation from Superior is partially based on both the level of the rating assigned and the successful sale of new structured investment products but does not have a link to the long-term performance of the instruments. Mandeville is extremely successful and leads Superior as the top originator of structured investment products for the next two years. In the third year, the economy experiences difficulties and the values of the assets underlying structured products significantly decline. The subsequent defaults lead to major turmoil in the capital markets, the demise of Superior Investment Bank, and the loss of Mandeville’s employment.

Comment: Mandeville manipulates the inputs of a model to minimize associated risk to achieve higher ratings. His understanding of structured products allows him to skillfully decide which inputs to include in support of the desired rating and price. This information manipulation for short-term gain, which is in violation of Standard II(B), ultimately causes significant damage to many parties and the capital markets as a whole. Mandeville should have realized that promoting a rating and price with inaccurate information could cause not only a loss of price confidence in the particular structured product but also a loss of investor trust in the system. Such loss of confidence affects the ability of the capital markets to operate efficiently.

(Information Manipulation):

Allen King is a performance analyst for Torrey Investment Funds. King believes that the portfolio manager for the firm's small- and microcap equity fund dislikes him because the manager never offers him tickets to the local baseball team's games but does offer tickets to other employees. To incite a potential regulatory review of the manager, King creates user profiles on several online forums under the portfolio manager's name and starts rumors about potential mergers for several of the smaller companies in the portfolio. As the prices of these companies' stocks increase, the portfolio manager sells the position, which leads to an investigation by the regulator as King desired.

Comment: King has violated Standard II(B) even though he did not personally profit from the market's reaction to the rumor. In posting the false information, King misleads others into believing the companies were likely to be acquired. Although his intent was to create trouble for the portfolio manager, his actions clearly manipulated the factual information that was available to the market.

### III A Duties to Clients Loyalty Prudence and Care (Identifying the Client—Plan Participants):

First Country Bank serves as trustee for the Miller Company's pension plan. Miller is the target of a hostile takeover attempt by Newton, Inc. In attempting to ward off Newton, Miller's managers persuade Julian Wiley, an investment manager at First Country Bank, to purchase Miller common stock in the open market for the employee pension plan. Miller's officials indicate that such action would be favorably received and would probably result in other accounts being placed with the bank. Although Wiley believes the stock is overvalued and would not ordinarily buy it, he purchases the stock to support Miller's managers, to maintain Miller's good favor toward the bank, and to realize additional new business. The heavy stock purchases cause Miller's market price to rise to such a level that Newton retracts its takeover bid.

Comment: Standard III(A) requires that a member or candidate, in evaluating a takeover bid, act prudently and solely in the interests of plan participants and beneficiaries. To meet this requirement, a member or candidate must carefully evaluate the long-term prospects of the company against the short-term prospects presented by the takeover offer and by the ability to invest elsewhere. In this instance, Wiley, acting on behalf of his employer, which was the trustee for a pension plan, clearly violated Standard III(A). He used the pension plan to perpetuate existing management, perhaps to the detriment of plan participants and the company's shareholders, and to benefit himself. Wiley's responsibilities to the plan participants and beneficiaries should have taken precedence over any ties of his bank to corporate managers and over his self-interest. Wiley had a duty to examine the takeover offer on its own merits and to make an independent decision. The guiding principle is the appropriateness of the investment decision to the pension plan, not whether the decision benefited Wiley or the company that hired him.

### (Client Commission Practices):

JNI, a successful investment counseling firm, serves as investment manager for the pension plans of several large regionally based companies. Its trading activities generate a significant amount of commission-related business. JNI uses the brokerage and research services of many firms, but most of its trading activity is handled through a large brokerage company, Thompson, Inc., because the executives of the two firms have a close friendship. Thompson's commission structure is high in comparison with charges for similar brokerage services from other firms. JNI considers Thompson's research services and execution capabilities average. In exchange for JNI directing its brokerage to Thompson, Thompson absorbs a number of JNI overhead expenses, including those for rent.

Comment: JNI executives are breaching their responsibilities by using client brokerage for services that do not benefit JNI clients and by not obtaining best price and best execution for their clients. Because JNI executives are not upholding their duty of loyalty, they are violating Standard III(A).

### (Brokerage Arrangements):

Charlotte Everett, a struggling independent investment adviser, serves as investment manager for the pension plans of several companies. One of her brokers, Scott Company, is close to consummating management agreements with prospective new clients whereby Everett would manage the new client accounts and trade the accounts exclusively through Scott. One of Everett's existing clients, Crayton Corporation, has directed Everett to place securities transactions for Crayton's account exclusively through Scott. But to induce Scott to exert efforts to send more new accounts to her, Everett also directs transactions to Scott from other clients without their knowledge.

Comment: Everett has an obligation at all times to seek best price and best execution on all trades. Everett may direct new client trades exclusively through Scott Company as long as Everett receives best price and execution on the trades or receives a written statement from new clients that she is not to seek best price and execution and that they are aware of the consequence for their accounts. Everett may trade other accounts through Scott as a reward for directing clients to Everett only if the accounts receive best price and execution and the practice is disclosed to the accounts. Because Everett does not disclose the directed trading, Everett has violated Standard III(A).

### (Brokerage Arrangements):

Emilie Rome is a trust officer for Paget Trust Company. Rome's supervisor is responsible for reviewing Rome's trust account transactions and her monthly reports of personal stock transactions. Rome has been using Nathan Gray, a broker, almost exclusively for trust account brokerage transactions. When Gray makes a market in stocks, he has been giving Rome a lower price for personal purchases and a higher price for sales than he gives to Rome's trust accounts and other investors.

Comment: Rome is violating her duty of loyalty to the bank's trust accounts by using Gray for brokerage transactions simply because Gray trades Rome's personal account on favorable terms. Rome is placing her own interests before those of her clients.

(Client Commission Practices):

Lauren Parker, an analyst with Provo Advisors, covers South American equities for her firm. She likes to travel to the markets for which she is responsible and decides to go on a trip to Chile, Argentina, and Brazil. The trip is sponsored by SouthAM, Inc., a research firm with a small broker/dealer affiliate that uses the clearing facilities of a larger New York brokerage house. SouthAM specializes in arranging South American trips for analysts during which they can meet with central bank officials, government ministers, local economists, and senior executives of corporations. SouthAM accepts commission dollars at a ratio of 2 to 1 against the hard-dollar costs of the research fee for the trip. Parker is not sure that SouthAM's execution is competitive, but without informing her supervisor, she directs the trading desk at Provo to start giving commission business to SouthAM so she can take the trip. SouthAM has conveniently timed the briefing trip to coincide with the beginning of Carnival season, so Parker also decides to spend five days of vacation in Rio de Janeiro at the end of the trip. Parker uses commission dollars to pay for the five days of hotel expenses.

Comment: Parker is violating Standard III(A) by not exercising her duty of loyalty to her clients. She should have determined whether the commissions charged by SouthAM are reasonable in relation to the benefit of the research provided by the trip. She also should have determined whether best execution and prices could be received from SouthAM. In addition, the five extra days are not part of the research effort because they do not assist in the investment decision making. Thus, the hotel expenses for the five days should not be paid for with client assets.

(Excessive Trading):

Vida Knauss manages the portfolios of a number of high-net-worth individuals. A major part of her investment management fee is based on trading commissions. Knauss engages in extensive trading for each of her clients to ensure that she attains the minimum commission level set by her firm. Although the securities purchased and sold for the clients are appropriate and fall within the acceptable asset classes for the clients, the amount of trading for each account exceeds what is necessary to accomplish the client's investment objectives.

Comment: Knauss has violated Standard III(A) because she is using the assets of her clients to benefit her firm and herself.

(Managing Family Accounts):

Adam Dill recently joined New Investments Asset Managers. To assist Dill in building a book of clients, both his father and brother opened new fee-paying accounts. Dill followed all the firm's procedures in noting his relationships with these clients and in developing their investment policy statements. After several years, the number of Dill's clients has grown, but he still manages the original accounts of his family members. An IPO is coming to market that is a suitable investment for many of his clients, including his brother. Dill does not receive the amount of stock he requested, so to avoid any appearance of a conflict of interest, he does not allocate any shares to his brother's account.

Comment: Dill has violated Standard III(A) because he is not acting for the benefit of his brother's account as well as his other accounts. The brother's account is a regular fee-paying account comparable to the accounts of his other clients. By not allocating the shares proportionately across all accounts for which he thought the IPO was suitable, Dill is disadvantaging specific clients. Dill would have been correct in not allocating shares to his brother's account if that account was being managed outside the normal fee structure of the firm.

(Identifying the Client):

Donna Hensley has been hired by a law firm to testify as an expert witness. Although the testimony is intended to represent impartial advice, she is concerned that her work may have negative consequences for the law firm. If the law firm is Hensley's client, how does she ensure that her testimony will not violate the required duty of loyalty, prudence, and care to one's client?

Comment: In this situation, the law firm represents Hensley's employer and the aspect of "who is the client" is not well defined. When acting as an expert witness, Hensley is bound by the standard of independence and objectivity in the same manner as an independent research analyst would be bound. Hensley must not let the law firm influence the testimony she provides in the legal proceedings.

(Identifying the Client):

Jon Miller is a mutual fund portfolio manager. The fund is focused on the global financial services sector. Wanda Spears is a private wealth manager in the same city as Miller and is a friend of Miller. At a local CFA Institute society meeting, Spears mentions to Miller that her new client is an investor in Miller's fund. She states that the two of them now share a responsibility to this client.

Comment: Spears' statement is not totally correct. Because she provides the advisory services to her new client, she alone is bound by the duty of loyalty to this client. Miller's responsibility is to manage the fund according to the investment policy statement of the fund. His actions should not be influenced by the needs of any particular fund investor.

(Client Loyalty):

After providing client account investment performance to the external-facing departments but prior to it being finalized for release to clients, Teresa Nguyen, an investment performance analyst, notices the reporting system missed a trade. Correcting the omission resulted in a large loss for a client that had previously placed the firm on "watch" for potential termination owing to underperformance in prior periods. Nguyen knows this news is unpleasant but informs the appropriate individuals that the report needs to be updated before releasing it to the client.

Comment: Nguyen's actions align with the requirements of Standard III(A). Even though the correction may lead to the

firm's termination by the client, withholding information on errors would not be in the best interest of the client.

(Execution-Only Responsibilities):

Baftija Sulejman recently became a candidate in the CFA Program. He is a broker who executes client-directed trades for several high-net-worth individuals. Sulejman does not provide any investment advice and only executes the trading decisions made by clients. He is concerned that the Code and Standards impose a fiduciary duty on him in his dealing with clients and sends an e-mail to the CFA Ethics Helpdesk ([ethics@cfainstitute.org](mailto:ethics@cfainstitute.org)) to seek guidance on this issue.

Comment: In this instance, Sulejman serves in an execution-only capacity and his duty of loyalty, prudence, and care is centered on the skill and diligence used when executing trades—namely, by seeking best execution and making trades within the parameters set by the clients (instructions on quantity, price, timing, etc.). Acting in the best interests of the client dictates that trades are executed on the most favorable terms that can be achieved for the client. Given this job function, the requirements of the Code and

### III B Duties to Clients Fair Dealing

(Selective Disclosure):

Bradley Ames, a well-known and respected analyst, follows the computer industry. In the course of his research, he finds that a small, relatively unknown company whose shares are traded over the counter has just signed significant contracts with some of the companies he follows. After a considerable amount of investigation, Ames decides to write a research report on the small company and recommend purchase of its shares. While the report is being reviewed by the company for factual accuracy, Ames schedules a luncheon with several of his best clients to discuss the company. At the luncheon, he mentions the purchase recommendation scheduled to be sent early the following week to all the firm's clients.

Comment: Ames has violated Standard III(B) by disseminating the purchase recommendation to the clients with whom he has lunch a week before the recommendation is sent to all clients.

(Fair Dealing between Funds):

Spencer Rivers, president of XYZ Corporation, moves his company's growth-oriented pension fund to a particular bank primarily because of the excellent investment performance achieved by the bank's commingled fund for the prior five-year period. Later, Rivers compares the results of his pension fund with those of the bank's commingled fund. He is startled to learn that, even though the two accounts have the same investment objectives and similar portfolios, his company's pension fund has significantly underperformed the bank's commingled fund. Questioning this result at his next meeting with the pension fund's manager, Rivers is told that, as a matter of policy, when a new security is placed on the recommended list, Morgan Jackson, the pension fund manager, first purchases the security for the commingled account and then purchases it on a pro rata basis for all other pension fund accounts. Similarly, when a sale is recommended, the security is sold first from the commingled account and then sold on a pro rata basis from all other accounts. Rivers also learns that if the bank cannot get enough shares (especially of hot issues) to be meaningful to all the accounts, its policy is to place the new issues only in the commingled account.

Seeing that Rivers is neither satisfied nor pleased by the explanation, Jackson quickly adds that nondiscretionary pension accounts and personal trust accounts have a lower priority on purchase and sale recommendations than discretionary pension fund accounts. Furthermore, Jackson states, the company's pension fund had the opportunity to invest up to 5% in the commingled fund.

Comment: The bank's policy does not treat all customers fairly, and Jackson has violated her duty to her clients by giving priority to the growth-oriented commingled fund over all other funds and to discretionary accounts over nondiscretionary accounts. Jackson must execute orders on a systematic basis that is fair to all clients. In addition, trade allocation procedures should be disclosed to all clients when they become clients. Of course, in this case, disclosure of the bank's policy would not change the fact that the policy is unfair.

(Fair Dealing and IPO Distribution):

Dominic Morris works for a small regional securities firm. His work consists of corporate finance activities and investing for institutional clients. Arena, Ltd., is planning to go public. The partners have secured rights to buy an arena football league franchise and are planning to use the funds from the issue to complete the purchase. Because arena football is the current rage, Morris believes he has a hot issue on his hands. He has quietly negotiated some options for himself for helping convince Arena to do the financing through his securities firm. When he seeks expressions of interest, the institutional buyers oversubscribe the issue. Morris, assuming that the institutions have the financial clout to drive the stock up, then fills all orders (including his own) and decreases the institutional blocks.

Comment: Morris has violated Standard III(B) by not treating all customers fairly. He should not have taken any shares himself and should have prorated the shares offered among all clients. In addition, he should have disclosed to his firm and to his clients that he received options as part of the deal [see Standard VI(A)—Disclosure of Conflicts].

(Fair Dealing and Transaction Allocation):

Eleanor Preston, the chief investment officer of Porter Williams Investments (PWI), a medium-size money management firm, has been trying to retain a client, Colby Company. Management at Colby, which accounts for almost half of PWI's revenues, recently told Preston that if the performance of its account did not improve, it would find a new money manager. Shortly after this threat, Preston purchases mortgage-backed securities (MBSs) for several accounts, including Colby's. Preston is busy with a number of transactions that day, so she fails to allocate the trades immediately or write up

the trade tickets. A few days later, when Preston is allocating trades, she notes that some of the MBSs have significantly increased in price and some have dropped. Preston decides to allocate the profitable trades to Colby and spread the losing trades among several other PWI accounts.

Comment: Preston has violated Standard III(B) by failing to deal fairly with her clients in taking these investment actions. Preston should have allocated the trades prior to executing the orders, or she should have had a systematic approach to allocating the trades, such as pro rata, as soon as practical after they were executed. Among other things, Preston must disclose to the client that the adviser may act as broker for, receive commissions from, and have a potential conflict of interest regarding both parties in agency cross-transactions. After the disclosure, she should obtain from the client consent authorizing such transactions in advance.

(Selective Disclosure):

Saunders Industrial Waste Management (SIWM) publicly indicates to analysts that it is comfortable with the somewhat disappointing earnings-per-share projection of US\$1.16 for the quarter. Bernard Roberts, an analyst at Coffey Investments, is confident that SIWM management has understated the forecasted earnings so that the real announcement will cause an “upside surprise” and boost the price of SIWM stock. The “whisper number” (rumored) estimate based on extensive research and discussed among knowledgeable analysts is higher than US\$1.16. Roberts repeats the US\$1.16 figure in his research report to all Coffey clients but informally tells his large clients that he expects the earnings per share to be higher, making SIWM a good buy.

Comment: By not sharing his opinion regarding the potential for a significant upside earnings surprise with all clients, Roberts is not treating all clients fairly and has violated Standard III(B).

(Additional Services for Select Clients):

Jenpin Weng uses e-mail to issue a new recommendation to all his clients. He then calls his three largest institutional clients to discuss the recommendation in detail.

Comment: Weng has not violated Standard III(B) because he widely disseminated the recommendation and provided the information to all his clients prior to discussing it with a select few. Weng’s largest clients received additional personal service because they presumably pay higher fees or because they have a large amount of assets under Weng’s management. If Weng had discussed the report with a select group of clients prior to distributing it to all his clients, he would have violated Standard III(B).

(Minimum Lot Allocations):

Lynn Hampton is a well-respected private wealth manager in her community with a diversified client base. She determines that a new 10-year bond being offered by Healthy Pharmaceuticals is appropriate for five of her clients. Three clients request to purchase US\$10,000 each, and the other two request US\$50,000 each. The minimum lot size is established at US\$5,000, and the issue is oversubscribed at the time of placement. Her firm’s policy is that odd-lot allocations, especially those below the minimum, should be avoided because they may affect the liquidity of the security at the time of sale. Hampton is informed she will receive only US\$55,000 of the offering for all accounts. Hampton distributes the bond investments as follows: The three accounts that requested US\$10,000 are allocated US\$5,000 each, and the two accounts that requested US\$50,000 are allocated US\$20,000 each.

Comment: Hampton has not violated Standard III(B), even though the distribution is not on a completely pro rata basis because of the required minimum lot size. With the total allocation being significantly below the amount requested, Hampton ensured that each client received at least the minimum lot size of the issue. This approach allowed the clients to efficiently sell the bond later if necessary.

(Excessive Trading):

Ling Chan manages the accounts for many pension plans, including the plan of his father’s employer. Chan developed similar but not identical investment policies for each client, so the investment portfolios are rarely the same. To minimize the cost to his father’s pension plan, he intentionally trades more frequently in the accounts of other clients to ensure the required brokerage is incurred to continue receiving free research for use by all the pensions.

Comment: Chan is violating Standard III(B) because his trading actions are disadvantaging his clients to enhance a relationship with a preferred client. All clients are benefiting from the research being provided and should incur their fair portion of the costs. This does not mean that additional trading should occur if a client has not paid an equal portion of the commission; trading should occur only as required by the strategy.

(Limited Social Media Disclosures):

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette’s supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM’s online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf’s encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto Ltd.’s new solar technology for compact auto-mobiles. This research report will be her first for FIM, and she believes Sun Drive’s technology could revolutionize the auto industry. In her excitement, Burdette sends a quick tweet to FIM Twitter followers summarizing her “buy” recommendation for Sun Drive Auto stock.

Comment: Burdette has violated Standard III(B) by sending an investment recommendation to a select group of contacts prior to distributing it to all clients. Burdette must make sure she has received the appropriate training about FIM's policies and procedures, including the appropriate business use of personal social media networks before engaging in such activities. See Standard IV(C) for guidance related to the duties of the supervisor.

(Fair Dealing between Clients):

Paul Rove, performance analyst for Alpha-Beta Investment Management, is describing to the firm's chief investment officer (CIO) two new reports he would like to develop to assist the firm in meeting its obligations to treat clients fairly. Because many of the firm's clients have similar investment objectives and portfolios, Rove suggests a report detailing securities owned across several clients and the percentage of the portfolio the security represents. The second report would compare the monthly performance of portfolios with similar strategies. The outliers within each report would be submitted to the CIO for review.

Comment: As a performance analyst, Rove likely has little direct contact with clients and thus has limited opportunity to treat clients differently. The recommended reports comply with Standard III(B) while helping the firm conduct after-the-fact reviews of how effectively the firm's advisers are dealing with their clients' portfolios. Reports that monitor the fair treatment of clients are an important oversight tool to ensure that clients are treated fairly.

III C Duties to Clients Suitability  
(Investment Suitability—Risk Profile):

Caleb Smith, an investment adviser, has two clients: Larry Robertson, 60 years old, and Gabriel Lanai, 40 years old. Both clients earn roughly the same salary, but Robertson has a much higher risk tolerance because he has a large asset base. Robertson is willing to invest part of his assets very aggressively; Lanai wants only to achieve a steady rate of return with low volatility to pay for his children's education. Smith recommends investing 20% of both portfolios in zero-yield, small-cap, high-technology equity issues.

Comment: In Robertson's case, the investment may be appropriate because of his financial circumstances and aggressive investment position, but this investment is not suitable for Lanai. Smith is violating Standard III(C) by applying Robertson's investment strategy to Lanai because the two clients' financial circumstances and objectives differ.

(Investment Suitability—Entire Portfolio):

Jessica McDowell, an investment adviser, suggests to Brian Crosby, a risk-averse client, that covered call options be used in his equity portfolio. The purpose would be to enhance Crosby's income and partially offset any untimely depreciation in the portfolio's value should the stock market or other circumstances affect his holdings unfavorably. McDowell educates Crosby about all possible outcomes, including the risk of incurring an added tax liability if a stock rises in price and is called away and, conversely, the risk of his holdings losing protection on the downside if prices drop sharply.

Comment: When determining suitability of an investment, the primary focus should be the characteristics of the client's entire portfolio, not the characteristics of single securities on an issue-by-issue basis. The basic characteristics of the entire portfolio will largely determine whether investment recommendations are taking client factors into account. Therefore, the most important aspects of a particular investment are those that will affect the characteristics of the total portfolio. In this case, McDowell properly considers the investment in the context of the entire portfolio and thoroughly explains the investment to the client.

(IPS Updating):

In a regular meeting with client Seth Jones, the portfolio managers at Blue Chip Investment Advisors are careful to allow some time to review his current needs and circumstances. In doing so, they learn that some significant changes have recently taken place in his life. A wealthy uncle left Jones an inheritance that increased his net worth fourfold, to US\$1 million.

Comment: The inheritance has significantly increased Jones's ability (and possibly his willingness) to assume risk and has diminished the average yield required to meet his current income needs. Jones's financial circumstances have definitely changed, so Blue Chip managers must update Jones's investment policy statement to reflect how his investment objectives have changed. Accordingly, the Blue Chip portfolio managers should consider a somewhat higher equity ratio for his portfolio than was called for by the previous circumstances, and the managers' specific common stock recommendations might be heavily tilted toward low-yield, growth-oriented issues.

(Following an Investment Mandate):

Louis Perkowski manages a high-income mutual fund. He purchases zero-dividend stock in a financial services company because he believes the stock is undervalued and is in a potential growth industry, which makes it an attractive investment.

Comment: A zero-dividend stock does not seem to fit the mandate of the fund that Perkowski is managing. Unless Perkowski's investment fits within the mandate or is within the realm of allowable investments the fund has made clear in its disclosures, Perkowski has violated Standard III(C).

(IPS Requirements and Limitations):

Max Gubler, chief investment officer of a property/casualty insurance subsidiary of a large financial conglomerate, wants to improve the diversification of the subsidiary's investment portfolio and increase its returns. The subsidiary's investment policy statement provides for highly liquid investments, such as

large-cap equities and government, supranational, and corporate bonds with a minimum credit rating of AA and maturity of no more than five years. In a recent presentation, a venture capital group offered very attractive prospective returns on some of its private equity funds that provide seed capital to ventures. An exit strategy was already contemplated, but investors would have to observe a minimum three-year lockup period and a subsequent laddered exit option for a maximum of one-third of their shares per year. Gubler does not want to miss this opportunity. After extensive analysis, with the intent to optimize the return on the equity assets within the subsidiary's current portfolio, he invests 4% in this seed fund, leaving the portfolio's total equity exposure still well below its upper limit.

Comment: Gubler is violating Standard III(A)—Loyalty, Prudence, and Care as well as Standard III(C). His new investment locks up part of the subsidiary's assets for at least three years and up to as many as five years and possibly beyond. The IPS requires investments in highly liquid investments and describes accepted asset classes; private equity investments with a lockup period certainly do not qualify. Even without a lockup period, an asset class with only an occasional, and thus implicitly illiquid, market may not be suitable for the portfolio. Although an IPS typically describes objectives and constraints in great detail, the manager must also make every effort to understand the client's business and circumstances. Doing so should enable the manager to recognize, understand, and discuss with the client other factors that may be or may become material in the investment management process.

(Submanager and IPS Reviews):

Paul Ostrowski's investment management business has grown significantly over the past couple of years, and some clients want to diversify internationally. Ostrowski decides to find a submanager to handle the expected international investments. Because this will be his first subadviser, Ostrowski uses the CFA Institute model "request for proposal" to design a questionnaire for his search. By his deadline, he receives seven completed questionnaires from a variety of domestic and international firms trying to gain his business. Ostrowski reviews all the applications in detail and decides to select the firm that charges the lowest fees because doing so will have the least impact on his firm's bottom line.

Comment: When selecting an external manager or subadviser, Ostrowski needs to ensure that the new manager's services are appropriate for his clients. This due diligence includes comparing the risk profile of the clients with the investment strategy of the manager. In basing the decision on the fee structure alone, Ostrowski may be violating Standard III(C). When clients ask to diversify into international products, it is an appropriate time to review and update the clients' IPSs. Ostrowski's review may determine that the risk of international investments modifies the risk profiles of the clients or does not represent an appropriate investment.

(Investment Suitability—Risk Profile):

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indexes. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

Comment: Snead violated Standard III(C) by investing the clients' assets in high-beta stocks. These high-risk investments are contrary to the long-term risk profile established in the clients' IPSs. Snead has changed the investment strategy of the clients in an attempt to reap short-term rewards offered by her firm's new compensation arrangement, not in response to changes in clients' investment policy statements.

(Investment Suitability):

Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

### III D Duties to Clients Performance Presentation

(Performance Calculation and Length of Time):

Kyle Taylor of Taylor Trust Company, noting the performance of Taylor's common trust fund for the past two years, states in a brochure sent to his potential clients, "You can expect steady 25% annual compound growth of the value of your investments over the year." Taylor Trust's common trust fund did increase at the rate of 25% per year for the past year, which mirrored the increase of the entire market. The fund has never averaged that growth for more than one year, however, and the average rate of growth of all of its trust accounts for five years is 5% per year.

Comment: Taylor's brochure is in violation of Standard III(D). Taylor should have disclosed that the 25% growth occurred only in one year. Additionally, Taylor did not include client accounts other than

those in the firm's common trust fund. A general claim of firm performance should take into account the performance of all categories of accounts. Finally, by stating that clients can expect a steady 25% annual compound growth rate, Taylor is also violating Standard I(C)—Misrepresentation, which prohibits assurances or guarantees regarding an investment.

(Performance Calculation and Asset Weighting):

Anna Judd, a senior partner of Alexander Capital Management, circulates a performance report for the capital appreciation accounts for the years 1988 through 2004. The firm claims compliance with the GIPS standards. Returns are not calculated in accordance with the requirements of the GIPS standards, however, because the composites are not asset weighted.

Comment: Judd is in violation of Standard III(D). When claiming compliance with the GIPS standards, firms must meet all of the requirements, make mandatory disclosures, and meet any other requirements that apply to that firm's specific situation. Judd's violation is not from any misuse of the data but from a false claim of GIPS compliance.

(Performance Presentation and Prior Fund/ Employer):

Aaron McCoy is vice president and managing partner of the equity investment group of Mastermind Financial Advisors, a new business. Mastermind recruited McCoy because he had a proven six-year track record with G&P Financial. In developing Mastermind's advertising and marketing campaign, McCoy prepares an advertisement that includes the equity investment performance he achieved at G&P Financial. The advertisement for Mastermind does not identify the equity performance as being earned while at G&P. The advertisement is distributed to existing clients and prospective clients of Mastermind.

Comment: McCoy has violated Standard III(D) by distributing an advertisement that contains material misrepresentations about the historical performance of Mastermind. Standard III(D) requires that members and candidates make every reasonable effort to ensure that performance information is a fair, accurate, and complete representation of an individual's or firm's performance. As a general matter, this standard does not prohibit showing past performance of funds managed at a prior firm as part of a performance track record as long as showing that record is accompanied by appropriate disclosures about where the performance took place and the person's specific role in achieving that performance. If McCoy chooses to use his past performance from G&P in Mastermind's advertising, he should make full disclosure of the source of the historical performance.

(Performance Presentation and Simulated Results):

Jed Davis has developed a mutual fund selection product based on historical information from the 1990–95 period. Davis tested his methodology by applying it retroactively to data from the 1996–2003 period, thus producing simulated performance results for those years. In January 2004, Davis's employer decided to offer the product and Davis began promoting it through trade journal advertisements and direct dissemination to clients. The advertisements included the performance results for the 1996–2003 period but did not indicate that the results were simulated.

Comment: Davis violated Standard III(D) by failing to clearly identify simulated performance results. Standard III(D) prohibits members and candidates from making any statements that misrepresent the performance achieved by them or their firms and requires members and candidates to make every reasonable effort to ensure that performance information presented to clients is fair, accurate, and complete. Use of simulated results should be accompanied by full disclosure as to the source of the performance data, including the fact that the results from 1995 through 2003 were the result of applying the model retroactively to that time period.

(Performance Calculation and Selected Accounts Only):

In a presentation prepared for prospective clients, William Kilmer shows the rates of return realized over a five-year period by a "composite" of his firm's discretionary accounts that have a "balanced" objective. This composite, however, consisted of only a few of the accounts that met the balanced criterion set by the firm, excluded accounts under a certain asset level without disclosing the fact of their exclusion, and included accounts that did not have the balanced mandate because those accounts would boost the investment results. In addition, to achieve better results, Kilmer manipulated the narrow range of accounts included in the composite by changing the accounts that made up the composite over time.

Comment: Kilmer violated Standard III(D) by misrepresenting the facts in the promotional material sent to prospective clients, distorting his firm's performance record, and failing to include disclosures that would have clarified the presentation.

(Performance Attribution Changes):

Art Purell is reviewing the quarterly performance attribution reports for distribution to clients. Purell works for an investment management firm with a bottom-up, fundamentals-driven investment process that seeks to add value through stock selection. The attribution methodology currently compares each stock with its sector. The attribution report indicates that the value added this quarter came from asset allocation and that stock selection contributed negatively to the calculated return.

Through running several different scenarios, Purell discovers that calculating attribution by comparing each stock with its industry and then rolling the effect to the sector level improves the appearance of the manager's stock selection activities. Because the firm defines the attribution terms and the results better reflect the stated strategy, Purell recommends that the client reports should use the revised methodology.

Comment: Modifying the attribution methodology without proper notifications to clients would fail

to meet the requirements of Standard III(D). Purrell's recommendation is being done solely for the interest of the firm to improve its perceived ability to meet the stated investment strategy. Such changes are unfair to clients and obscure the facts regarding the firm's abilities.

Had Purrell believed the new methodology offered improvements to the original model, then he would have needed to report the results of both calculations to the client. The report should also include the reasons why the new methodology is preferred, which would allow the client to make a meaningful comparison to prior results and provide a basis for comparing future attributions.

(Performance Calculation Methodology Disclosure):

While developing a new reporting package for existing clients, Alisha Singh, a performance analyst, discovers that her company's new system automatically calculates both time-weighted and money-weighted returns. She asks the head of client services and retention which value would be preferred given that the firm has various investment strategies that include bonds, equities, securities without leverage, and alternatives. Singh is told not to label the return value so that the firm may show whichever value is greatest for the period.

Comment: Following these instructions would lead to Singh violating Standard III(D). In reporting inconsistent return values, Singh would not be providing complete information to the firm's clients. Full information is provided when clients have sufficient information to judge the performance generated by the firm.

(Performance Calculation Methodology Disclosure):

Richmond Equity Investors manages a long-short equity fund in which clients can trade once a week (on Fridays). For transparency reasons, a daily net asset value of the fund is calculated by Richmond. The monthly fact sheets of the fund report month-to-date and year-to-date performance. Richmond publishes the performance based on the higher of the last trading day of the month (typically, not the last business day) or the last business day of the month as determined by Richmond. The fact sheet mentions only that the data are as of the end of the month, without giving the exact date. Maggie Clark, the investment performance analyst in charge of the calculations, is concerned about the frequent changes and asks her supervisor whether they are appropriate.

Comment: Clark's actions in questioning the changing performance metric comply with Standard III(D). She has shown concern that these changes are not presenting an accurate and complete picture of the performance generated.

III E Preservation of Confidentiality  
(Disclosing Possible Illegal Activity):

Government officials approach Casey Samuel, the portfolio manager for Garcia Company's pension plan, to examine pension fund records. They tell her that Garcia's corporate tax returns are being audited and the pension fund is being reviewed. Two days earlier, Samuel had learned in a regular investment review with Garcia officers that potentially excessive and improper charges were being made to the pension plan by Garcia. Samuel consults her employer's general counsel and is advised that Garcia has probably violated tax and fiduciary regulations and laws.

Comment: Samuel should inform her supervisor of these activities, and her employer should take steps, with Garcia, to remedy the violations. If that approach is not successful, Samuel and her employer should seek advice of legal counsel to determine the appropriate steps to be taken. Samuel may well have a duty to disclose the evidence she has of the continuing legal violations and to resign as asset manager for Garcia.

(Disclosing Possible Illegal Activity):

David Bradford manages money for a family-owned real estate development corporation. He also manages the individual portfolios of several of the family members and officers of the corporation, including the chief financial officer (CFO). Based on the financial records of the corporation and some questionable practices of the CFO that Bradford has observed, Bradford believes that the CFO is embezzling money from the corporation and putting it into his personal investment account.

Comment: Bradford should check with his firm's compliance department or appropriate legal counsel to determine whether applicable securities regulations require reporting the CFO's financial records.

(Accidental Disclosure of Confidential Information):

Lynn Moody is an investment officer at the Lester Trust Company (LTC). She has stewardship of a significant number of individually managed taxable accounts. In addition to receiving quarterly written reports, about a dozen high-net-worth individuals have indicated to Moody a willingness to receive communications about overall economic and financial market outlooks directly from her by way of a social media platform. Under the direction of her firm's technology and compliance departments, she established a new group page on an existing social media platform specifically for her clients. In the instructions provided to clients, Moody asked them to "join" the group so they may be granted access to the posted content. The instructions also advised clients that all comments posted would be available to the public and thus the platform was not an appropriate method for communicating personal or confidential information.

Six months later, in early January, Moody posted LTC's year-end "Market Outlook." The report outlined a new asset allocation strategy that the firm is adding to its recommendations in the new year. Moody introduced the publication with a note informing her clients that she would be discussing the changes with them individually in their upcoming meetings. One of Moody's clients responded directly on the group page that his family recently experienced a major change in their financial profile. The client described highly personal and confidential details of the event. Unfortunately, all clients that were part of the group were also able to read the detailed posting until Moody was able to have the comment removed.

Comment: Moody has taken reasonable steps for protecting the confidentiality of client information while using the social media platform. She provided instructions clarifying that all information posted to the site would be publicly viewable to all group members and warned against using this method for communicating confidential information. The accidental disclosure of confidential information by a client is not under Moody's control. Her actions to remove the information promptly once she became aware further align with Standard III(E).

In understanding the potential sensitivity clients express surrounding the confidentiality of personal information, this event highlights a need for further training. Moody might advocate for additional warnings or controls for clients when they consider using social media platforms for two-way communications.

#### IV A Duties to Employers Loyalty (Soliciting Former Clients):

Samuel Magee manages pension accounts for Trust Assets, Inc., but has become frustrated with the working environment and has been offered a position with Fiduciary Management. Before resigning from Trust Assets, Magee asks four big accounts to leave that firm and open accounts with Fiduciary. Magee also persuades several prospective clients to sign agreements with Fiduciary Management. Magee had previously made presentations to these prospects on behalf of Trust Assets.

Comment: Magee violated the employee-employer principle requiring him to act solely for his employer's benefit. Magee's duty is to Trust Assets as long as he is employed there. The solicitation of Trust Assets' current clients and prospective clients is unethical and violates Standard IV(A).

#### (Addressing Rumors):

Reuben Winston manages all-equity portfolios at Target Asset Management (TAM), a large, established investment counselor. Ten years previously, Philpott & Company, which manages a family of global bond mutual funds, acquired TAM in a diversification move. After the merger, the combined operations prospered in the fixed-income business but the equity management business at TAM languished. Lately, a few of the equity pension accounts that had been with TAM before the merger have terminated their relationships with TAM. One day, Winston finds on his voice mail the following message from a concerned client: "Hey! I just heard that Philpott is close to announcing the sale of your firm's equity management business to Rugged Life. What is going on?" Not being aware of any such deal, Winston and his associates are stunned. Their internal inquiries are met with denials from Philpott management, but the rumors persist. Feeling left in the dark, Winston contemplates leading an employee buyout of TAM's equity management business.

Comment: An employee-led buyout of TAM's equity asset management business would be consistent with Standard IV(A) because it would rest on the permission of the employer and, ultimately, the clients. In this case, however, in which employees suspect the senior managers or principals are not truthful or forthcoming, Winston should consult legal counsel to determine appropriate action.

#### (Ownership of Completed Prior Work):

Laura Clay, who is unemployed, wants part-time consulting work while seeking a full-time analyst position. During an interview at Bradley Associates, a large institutional asset manager, Clay is told that the firm has no immediate research openings but would be willing to pay her a flat fee to complete a study of the wireless communications industry within a given period of time. Clay would be allowed unlimited access to Bradley's research files and would be welcome to come to the offices and use whatever support facilities are available during normal working hours. Bradley's research director does not seek any exclusivity for Clay's output, and the two agree to the arrangement on a handshake. As Clay nears completion of the study, she is offered an analyst job in the research department of Winston & Company, a brokerage firm, and she is pondering submitting the draft of her wireless study for publication by Winston.

Comment: Although she is under no written contractual obligation to Bradley, Clay has an obligation to let Bradley act on the output of her study before Winston & Company or Clay uses the information to their advantage. That is, unless Bradley gives permission to Clay and waives its rights to her wireless report, Clay would be in violation of Standard IV(A) if she were to immediately recommend to Winston the same transactions recommended in the report to Bradley. Furthermore, Clay must not take from Bradley any research file material or other property that she may have used.

#### (Ownership of Completed Prior Work):

Emma Madeline, a recent college graduate and a candidate in the CFA Program, spends her summer as an unpaid intern at Murdoch and Lowell. The senior managers at Murdoch are attempting to bring the firm into compliance with the GIPS standards, and Madeline is assigned to assist in its efforts. Two months into her internship, Madeline applies for a job at McMillan & Company, which has plans to become GIPS compliant. Madeline accepts the job with McMillan. Before leaving Murdoch, she copies the firm's software that she helped develop because she believes this software will assist her in her new position.

Comment: Even though Madeline does not receive monetary compensation for her services at Murdoch, she has used firm resources in creating the software and is considered an employee because she receives compensation and benefits in the form of work experience and knowledge. By

copying the software, Madeline violated Standard IV(A) because she misappropriated Murdoch's property without permission.

(Confidential Firm Information):

Sanjay Gupta is a research analyst at Naram Investment Management (NIM). NIM uses a team-based research process to develop recommendations on investment opportunities covered by the team members. Gupta, like others, provides commentary for NIM's clients through the company blog, which is posted weekly on the NIM password-protected website. According to NIM's policy, every contribution to the website must be approved by the company's compliance department before posting. Any opinions expressed on the website are disclosed as representing the perspective of NIM. Gupta also writes a personal blog to share his experiences with friends and family. As with most blogs, Gupta's personal blog is widely available to interested readers through various internet search engines. Occasionally, when he disagrees with the team-based research opinions of NIM, Gupta uses his personal blog to express his own opinions as a counterpoint to the commentary posted on the NIM website. Gupta believes this provides his readers with a more complete perspective on these investment opportunities.

Comment: Gupta is in violation of Standard IV(A) for disclosing confidential firm information through his personal blog. The recommendations on the firm's blog to clients are not freely available across the internet, but his personal blog post indirectly provides the firm's recommendations. Additionally, by posting research commentary on his personal blog, Gupta is using firm resources for his personal advantage. To comply with Standard IV(A), members and candidates must receive consent from their employer prior to using company resources.

IV B Additional Compensation Arrangements

(Notification of Client Bonus Compensation):

Geoff Whitman, a portfolio analyst for Adams Trust Company, manages the account of Carol Cochran, a client. Whitman is paid a salary by his employer, and Cochran pays the trust company a standard fee based on the market value of assets in her portfolio. Cochran proposes to Whitman that "any year that my portfolio achieves at least a 15% return before taxes, you and your wife can fly to Monaco at my expense and use my condominium during the third week of January." Whitman does not inform his employer of the arrangement and vacations in Monaco the following January as Cochran's guest.

Comment: Whitman violated Standard IV(B) by failing to inform his employer in writing of this supplemental, contingent compensation arrangement. The nature of the arrangement could have resulted in partiality to Cochran's account, which could have detracted from Whitman's performance with respect to other accounts he handles for Adams Trust. Whitman must obtain the consent of his employer to accept such a supplemental benefit.

(Notification of Outside Compensation):

Terry Jones sits on the board of directors of Exercise Unlimited, Inc. In return for his services on the board, Jones receives unlimited membership privileges for his family at all Exercise Unlimited facilities. Jones purchases Exercise Unlimited stock for the client accounts for which it is appropriate. Jones does not disclose this arrangement to his employer because he does not receive monetary compensation for his services to the board.

Comment: Jones has violated Standard IV(B) by failing to disclose to his employer benefits received in exchange for his services on the board of directors. The nonmonetary compensation may create a conflict of interest in the same manner as being paid to serve as a director.

(Prior Approval for Outside Compensation):

Jonathan Hollis is an analyst of oil-and-gas companies for Specialty Investment Management. He is currently recommending the purchase of ABC Oil Company shares and has published a long, well-thought-out research report to substantiate his recommendation. Several weeks after publishing the report, Hollis receives a call from the investor-relations office of ABC Oil saying that Thomas Andrews, CEO of the company, saw the report and really liked the analyst's grasp of the business and his company. The investor-relations officer invites Hollis to visit ABC Oil to discuss the industry further. ABC Oil offers to send a company plane to pick Hollis up and arrange for his accommodations while visiting. Hollis, after gaining the appropriate approvals, accepts the meeting with the CEO but declines the offered travel arrangements.

Several weeks later, Andrews and Hollis meet to discuss the oil business and Hollis's report. Following the meeting, Hollis joins Andrews and the investment relations officer for dinner at an upscale restaurant near ABC Oil's headquarters.

Upon returning to Specialty Investment Management, Hollis provides a full review of the meeting to the director of research, including a disclosure of the dinner attended.

Comment: Hollis's actions did not violate Standard IV(B). Through gaining approval before accepting the meeting and declining the offered travel arrangements, Hollis sought to avoid any potential conflicts of interest between his company and ABC Oil. Because the location of the dinner was not available prior to arrival and Hollis notified his company of the dinner upon his return, accepting the dinner should not impair his objectivity. By disclosing the dinner, Hollis has enabled Specialty Investment Management to assess whether it has any impact on future reports and recommendations by Hollis related to ABC Oil.

IV C Duties to Employers Responsibilities of Supervisors

(Supervising Research Activities):

Jane Mattock, senior vice president and head of the research department of H&V, Inc., a regional brokerage firm, has decided to change her recommendation for Timber Products from buy to sell. In line with H&V's procedures, she orally advises certain other H&V executives of her proposed actions before the report is prepared for publication. As a result of Mattock's conversation with Dieter Frampton, one of the H&V executives accountable to Mattock, Frampton immediately sells Timber's stock from his own account and from certain discretionary client accounts. In addition, other personnel inform certain institutional customers of the changed recommendation before it is printed and disseminated to all H&V customers who have received previous Timber reports.

Comment: Mattock has violated Standard IV(C) by failing to reasonably and adequately supervise the actions of those accountable to her. She did not prevent or establish reasonable procedures designed to prevent dissemination of or trading on the information by those who knew of her changed recommendation. She must ensure that her firm has procedures for reviewing or recording any trading in the stock of a corporation that has been the subject of an unpublished change in recommendation. Adequate procedures would have informed the subordinates of their duties and detected sales by Frampton and selected customers.

(Supervising Research Activities):

Deion Miller is the research director for Jamestown Investment Programs. The portfolio managers have become critical of Miller and his staff because the Jamestown portfolios do not include any stock that has been the subject of a merger or tender offer. Georgia Ginn, a member of Miller's staff, tells Miller that she has been studying a local company, Excelsior, Inc., and recommends its purchase. Ginn adds that the company has been widely rumored to be the subject of a merger study by a well-known conglomerate and discussions between them are under way. At Miller's request, Ginn prepares a memo recommending the stock. Miller passes along Ginn's memo to the portfolio managers prior to leaving for vacation, and he notes that he has not reviewed the memo. As a result of the memo, the portfolio managers buy Excelsior stock immediately. The day Miller returns to the office, he learns that Ginn's only sources for the report were her brother, who is an acquisitions analyst with Acme Industries, the "well-known conglomerate," and that the merger discussions were planned but not held.

Comment: Miller violated Standard IV(C) by not exercising reasonable supervision when he disseminated the memo without checking to ensure that Ginn had a reasonable and adequate basis for her recommendations and that Ginn was not relying on material nonpublic information.

(Supervising Trading Activities):

David Edwards, a trainee trader at Wheeler & Company, a major national brokerage firm, assists a customer in paying for the securities of Highland, Inc., by using anticipated profits from the immediate sale of the same securities. Despite the fact that Highland is not on Wheeler's recommended list, a large volume of its stock is traded through Wheeler in this manner. Roberta Ann Mason is a Wheeler vice president responsible for supervising compliance with the securities laws in the trading department. Part of her compensation from Wheeler is based on commission revenues from the trading department. Although she notices the increased trading activity, she does nothing to investigate or halt it.

Comment: Mason's failure to adequately review and investigate purchase orders in Highland stock executed by Edwards and her failure to supervise the trainee's activities violate Standard IV(C). Supervisors should be especially sensitive to actual or potential conflicts between their own self-interests and their supervisory responsibilities.

(Supervising Trading Activities and Record Keeping):

Samantha Tabbings is senior vice president and portfolio manager for Crozet, Inc., a registered investment advisory and registered broker/dealer firm. She reports to Charles Henry, the president of Crozet. Crozet serves as the investment adviser and principal underwriter for ABC and XYZ public mutual funds. The two funds' prospectuses allow Crozet to trade financial futures for the funds for the limited purpose of hedging against market risks. Henry, extremely impressed by Tabbings' performance in the past two years, directs Tabbings to act as portfolio manager for the funds. For the benefit of its employees, Crozet has also organized the Crozet Employee Profit-Sharing Plan (CEPSP), a defined contribution retirement plan. Henry assigns Tabbings to manage 20% of the assets of CEPSP. Tabbings' investment objective for her portion of CEPSP's assets is aggressive growth. Unbeknownst to Henry, Tabbings frequently places S&P 500 Index purchase and sale orders for the funds and the CEPSP without providing the futures commission merchants (FCMs) who take the orders with any prior or simultaneous designation of the account for which the trade has been placed. Frequently, neither Tabbings nor anyone else at Crozet completes an internal trade ticket to record the time an order was placed or the specific account for which the order was intended. FCMs often designate a specific account only after the trade, when Tabbings provides such designation. Crozet has no written operating procedures or compliance manual concerning its futures trading, and its compliance department does not review such trading. After observing the market's movement, Tabbings assigns to CEPSP the S&P 500 positions with more favorable execution prices and assigns positions with less favorable execution prices to the funds.

Comment: Henry violated Standard IV(C) by failing to adequately supervise Tabbings with respect to her S&P 500 trading. Henry further violated Standard IV(C) by failing to establish record-keeping and reporting procedures to prevent or detect Tabbings' violations. Henry must make a reasonable effort to determine that adequate compliance procedures covering all employee trading activity are established, documented, communicated, and followed.

(Inadequate Procedures):

Brendan Witt, a former junior sell-side technology analyst, decided to return to school to earn an MBA.

To keep his research skills and industry knowledge sharp, Witt accepted a position with On-line and Informed, an independent internet-based research company. The position requires the publication of a recommendation and report on a different company every month. Initially, Witt is a regular contributor of new research and a participant in the associated discussion boards that generally have positive comments on the technology sector. Over time, his ability to manage his educational requirements and his work requirements begin to conflict with one another. Knowing a recommendation is due the next day for On-line, Witt creates a report based on a few news articles and what the conventional wisdom of the markets has deemed the “hot” security of the day.

Comment: Allowing the report submitted by Witt to be posted highlights a lack of compliance procedures by the research firm. Witt's supervisor needs to work with the management of On-line to develop an appropriate review process to ensure that all contracted analysts comply with the requirements.

(Supervising Research Activities):

Mary Burdette was recently hired by Fundamental Investment Management (FIM) as a junior auto industry analyst. Burdette is expected to expand the social media presence of the firm because she is active with various networks, including Facebook, LinkedIn, and Twitter. Although Burdette's supervisor, Joe Graf, has never used social media, he encourages Burdette to explore opportunities to increase FIM's online presence and ability to share content, communicate, and broadcast information to clients. In response to Graf's encouragement, Burdette is working on a proposal detailing the advantages of getting FIM onto Twitter in addition to launching a company Facebook page.

As part of her auto industry research for FIM, Burdette is completing a report on the financial impact of Sun Drive Auto Ltd.'s new solar technology for compact auto- mobiles. This research report will be her first for FIM, and she believes Sun Drive's technology could revolutionize the auto industry. In her excitement, Burdette sends a quick tweet to FIM Twitter followers summarizing her “buy” recommendation for Sun Drive Auto stock.

Comment: Graf has violated Standard IV(C) by failing to reasonably supervise Burdette with respect to the contents of her tweet. He did not establish reasonable procedures to prevent the unauthorized dissemination of company research through social media networks. Graf must make sure all employees receive regular training about FIM's policies and procedures, including the appropriate business use of personal social media networks.

V A Investment Analysis, Recommendations, and Actions

(Sufficient Due Diligence):

Helen Hawke manages the corporate finance department of Sarkozi Securities, Ltd. The firm is anticipating that the government will soon close a tax loophole that currently allows oil-and-gas exploration companies to pass on drilling expenses to holders of a certain class of shares. Because market demand for this tax-advantaged class of stock is currently high, Sarkozi convinces several companies to undertake new equity financings at once, before the loophole closes. Time is of the essence, but Sarkozi lacks sufficient resources to conduct adequate research on all the prospective issuing companies. Hawke decides to estimate the IPO prices on the basis of the relative size of each company and to justify the pricing later when her staff has time.

Comment: Sarkozi should have taken on only the work that it could adequately handle. By categorizing the issuers by general size, Hawke has bypassed researching all the other relevant aspects that should be considered when pricing new issues and thus has not performed sufficient due diligence. Such an omission can result in investors purchasing shares at prices that have no actual basis. Hawke has violated Standard V(A).

(Sufficient Scenario Testing):

Babu Dhaliwal works for Heinrich Brokerage in the corporate finance group. He has just persuaded Feggans Resources, Ltd., to allow his firm to do a secondary equity financing at Feggans Resources' current stock price. Because the stock has been trading at higher multiples than similar companies with equivalent production, Dhaliwal presses the Feggans Resources managers to project what would be the maximum production they could achieve in an optimal scenario. Based on these numbers, he is able to justify the price his firm will be asking for the secondary issue. During a sales pitch to the brokers, Dhaliwal then uses these numbers as the base-case production levels that Feggans Resources will achieve.

Comment: When presenting information to the brokers, Dhaliwal should have given a range of production scenarios and the probability of Feggans Resources achieving each level. By giving the maximum production level as the likely level of production, he has misrepresented the chances of achieving that production level and seriously misled the brokers. Dhaliwal has violated Standard V(A).

(Sufficient Due Diligence):

Andre Shrub owns and operates Conduit, an investment advisory firm. Prior to opening Conduit, Shrub was an account manager with Elite Investment, a hedge fund managed by his good friend Adam Reed. To attract clients to a new Conduit fund, Shrub offers lower-than-normal management fees. He can do so because the fund consists of two top-performing funds managed by Reed. Given his personal friendship with Reed and the prior performance record of these two funds, Shrub believes this new fund is a winning combination for all parties. Clients quickly invest with Conduit to gain access to the Elite funds. No one is turned away because Conduit is seeking to expand its assets under management.

Comment: Shrub violated Standard V(A) by not conducting a thorough analysis of the funds managed by Reed before developing the new Conduit fund. Shrub's reliance on his personal relationship with Reed and his prior knowledge of Elite are insufficient justification for the investments. The funds may be appropriately considered, but a full review of their operating procedures, reporting practices, and transparency are some elements of the necessary due diligence.

(Use of Quantitatively Oriented Models):

Espacia Liakos works in sales for Hellenica Securities, a firm specializing in developing intricate derivative strategies to profit from particular views on market expectations. One of her clients is Eugenie Carapalis, who has become convinced that commodity prices will become more volatile over the coming months. Carapalis asks Liakos to quickly engineer a strategy that will benefit from this expectation. Liakos turns to Hellenica's modeling group to fulfill this request. Because of the tight deadline, the modeling group outsources parts of the work to several trusted third parties. Liakos implements the disparate components of the strategy as the firms complete them.

Within a month, Carapalis is proven correct: Volatility across a range of commodities increases sharply. But her derivatives position with Hellenica returns huge losses, and the losses increase daily. Liakos investigates and realizes that although each of the various components of the strategy had been validated, they had never been evaluated as an integrated whole. In extreme conditions, portions of the model worked at cross-purposes with other portions, causing the overall strategy to fail dramatically.

Comment: Liakos violated Standard V(A). Members and candidates must understand the statistical significance of the results of the models they recommend and must be able to explain them to clients. Liakos did not take adequate care to ensure a thorough review of the whole model; its components were evaluated only individually. Because Carapalis clearly intended to implement the strategy as a whole rather than as separate parts, Liakos should have tested how the components of the strategy interacted as well as how they performed individually.

(Selecting a Service Provider):

Ellen Smith is a performance analyst at Artic Global Advisors, a firm that manages global equity mandates for institutional clients. She was asked by her supervisor to review five new performance attribution systems and recommend one that would more appropriately explain the firm's investment strategy to clients. On the list was a system she recalled learning about when visiting an exhibitor booth at a recent conference. The system is highly quantitative and something of a "black box" in how it calculates the attribution values. Smith recommended this option without researching the others because the sheer complexity of the process was sure to impress the clients.

Comment: Smith's actions do not demonstrate a sufficient level of diligence in reviewing this product to make a recommendation for selecting the service. Besides not reviewing or considering the other four potential systems, she did not determine whether the "black box" attribution process aligns with the investment practices of the firm, including its investments in different countries and currencies. Smith must review and understand the process of any software or system before recommending its use as the firm's attribution system.

(Subadviser Selection):

Craig Jackson is working for Adams Partners, Inc., and has been assigned to select a hedge fund subadviser to improve the diversification of the firm's large fund-of-funds product. The allocation must be in place before the start of the next quarter. Jackson uses a consultant database to find a list of suitable firms that claim compliance with the GIPS standards. He calls more than 20 firms on the list to confirm their potential interest and to determine their most recent quarterly and annual total return values. Because of the short turnaround, Jackson recommends the firm with the greatest total return values for selection.

Comment: By considering only performance and GIPS compliance, Jackson has not conducted sufficient review of potential firms to satisfy the requirements of Standard V(A). A thorough investigation of the firms and their operations should be conducted to ensure that their addition would increase the diversity of clients' portfolios and that they are suitable for the fund-of-funds product.

(Manager Selection):

Timothy Green works for Peach Asset Management, where he creates proprietary models that analyze data from the firm request for proposal questionnaires to identify managers for possible inclusion in the firm's fund-of-funds investment platform. Various criteria must be met to be accepted to the platform. Because of the number of respondents to the questionnaires, Green uses only the data submitted to make a recommendation for adding a new manager.

Comment: By failing to conduct any additional outside review of the information to verify what was submitted through the request for proposal, Green has likely not satisfied the requirements of Standard V(A). The amount of information requested from outside managers varies among firms. Although the requested information may be comprehensive, Green should ensure sufficient effort is undertaken to verify the submitted information before recommending a firm for inclusion. This requires that he goes beyond the information provided by the manager on the request for proposal questionnaire and may include interviews with interested managers, reviews of regulatory filings, and discussions with the managers' custodian or auditor.

V B Communication with Clients and Prospective Clients

(Sufficient Disclosure of Investment System):

Sarah Williamson, director of marketing for Country Technicians, Inc., is convinced that she has found the perfect formula for increasing Country Technicians' income and diversifying its product base. Williamson plans to build on Country Technicians' reputation as a leading money manager by marketing an exclusive and expensive investment advice letter to high-net-worth individuals. One hitch in the plan is the complexity of Country Technicians' investment system—a combination of technical trading rules (based on historical price and volume fluctuations) and portfolio construction

rules designed to minimize risk. To simplify the newsletter, she decides to include only each week's top five "buy" and "sell" recommendations and to leave out details of the valuation models and the portfolio structuring scheme.

Comment: Williamson's plans for the newsletter violate Standard V(B). Williamson need not describe the investment system in detail in order to implement the advice effectively, but she must inform clients of Country Technicians' basic process and logic. Without understanding the basis for a recommendation, clients cannot possibly understand its limitations or its inherent risks.

(Providing Opinions as Facts):

Richard Dox is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Dox completed this calculation on the basis of the core samples from the company's latest drilling. According to Dox's calculations, the company has more than 500,000 ounces of gold on the property. Dox concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong BUY."

Comment: If Dox issues the report as written, he will violate Standard V(B). His calculation of the total gold reserves for the property based on the company's recent sample drilling is a quantitative opinion, not a fact. Opinion must be distinguished from fact in research reports.

(Proper Description of a Security):

Olivia Thomas, an analyst at Government Brokers, Inc., which is a brokerage firm specializing in government bond trading, has produced a report that describes an investment strategy designed to benefit from an expected decline in US interest rates. The firm's derivative products group has designed a structured product that will allow the firm's clients to benefit from this strategy. Thomas's report describing the strategy indicates that high returns are possible if various scenarios for declining interest rates are assumed. Citing the proprietary nature of the structured product underlying the strategy, the report does not describe in detail how the firm is able to offer such returns or the related risks in the scenarios, nor does the report address the likely returns of the strategy if, contrary to expectations, interest rates rise.

Comment: Thomas has violated Standard V(B) because her report fails to describe properly the basic characteristics of the actual and implied risks of the investment strategy, including how the structure was created and the degree to which leverage was embedded in the structure. The report should include a balanced discussion of how the strategy would perform in the case of rising as well as falling interest rates, preferably illustrating how the strategies might be expected to perform in the event of a reasonable variety of interest rate and credit risk—spread scenarios. If liquidity issues are relevant with regard to the valuation of either the derivatives or the underlying securities, provisions the firm has made to address those risks should also be disclosed.

(Notification of Fund Mandate Change):

May & Associates is an aggressive growth manager that has represented itself since its inception as a specialist at investing in small-cap US stocks. One of May's selection criteria is a maximum capitalization of US\$250 million for any given company. After a string of successful years of superior performance relative to its peers, May has expanded its client base significantly, to the point at which assets under management now exceed US\$3 billion. For liquidity purposes, May's chief investment officer (CIO) decides to lift the maximum permissible market-cap ceiling to US\$500 million and change the firm's sales and marketing literature accordingly to inform prospective clients and third-party consultants.

Comment: Although May's CIO is correct about informing potentially interested parties as to the change in investment process, he must also notify May's existing clients. Among the latter group might be a number of clients who not only retained May as a small-cap manager but also retained mid-cap and large-cap specialists in a multiple-manager approach. Such clients could regard May's change of criteria as a style change that distorts their overall asset allocations.

(Notification of Fund Mandate Change):

Rather than lifting the ceiling for its universe from US\$250 million to US\$500 million, May & Associates extends its small-cap universe to include a number of non-US companies.

Comment: Standard V(B) requires that May's CIO advise May's clients of this change because the firm may have been retained by some clients specifically for its prowess at investing in US small-cap stocks. Other changes that require client notification are introducing derivatives to emulate a certain market sector or relaxing various other constraints, such as portfolio beta. In all such cases, members and candidates must disclose changes to all interested parties.

(Notification of Changes to the Investment Process):

RJZ Capital Management is an active value-style equity manager that selects stocks by using a combination of four multifactor models. The firm has found favorable results when back testing the most recent 10 years of available market data in a new dividend discount model (DDM) designed by the firm. This model is based on projected inflation rates, earnings growth rates, and interest rates. The president of RJZ decides to replace its simple model that uses price to trailing 12-month earnings with the new DDM.

Comment: Because the introduction of a new and different valuation model represents a material change in the investment process, RJZ's president must communicate the change to the firm's clients. RJZ is moving away from a model based on hard data toward a new model that is at least partly dependent on the firm's forecasting skills. Clients would likely view such a model as a significant change rather than a mere refinement of RJZ's process.

(Notification of Changes to the Investment Process):

RJZ Capital Management loses the chief architect of its multifactor valuation system. Without informing its clients, the president of RJZ decides to redirect the firm's talents and resources toward developing a product for passive equity management—a product that will emulate the performance of a major market index.

Comment: By failing to disclose to clients a substantial change to its investment process, the president of RJZ has violated Standard V(B).

(Notification of Changes to the Investment Process):

At Fundamental Asset Management, Inc., the responsibility for selecting stocks for addition to the firm's "approved" list has just shifted from individual security analysts to a committee consisting of the research director and three senior portfolio managers. Eleanor Morales, a portfolio manager with Fundamental Asset Management, thinks this change is not important enough to communicate to her clients.

Comment: Morales must disclose the process change to all her clients. Some of Fundamental's clients might be concerned about the morale and motivation among the firm's best research analysts after such a change. Moreover, clients might challenge the stock-picking track record of the portfolio managers and might even want to monitor the situation closely.

(Sufficient Disclosure of Investment System):

Amanda Chinn is the investment director for Diversified Asset Management, which manages the endowment of a charitable organization. Because of recent staff departures, Diversified has decided to limit its direct investment focus to large-cap securities and supplement the needs for small-cap and mid-cap management by hiring outside fund managers. In describing the planned strategy change to the charity, Chinn's update letter states, "As investment director, I will directly oversee the investment team managing the endowment's large-capitalization allocation. I will coordinate the selection and ongoing review of external managers responsible for allocations to other classes." The letter also describes the reasons for the change and the characteristics external managers must have to be considered.

Comment: Standard V(B) requires the disclosure of the investment process used to construct the portfolio of the fund. Changing the investment process from managing all classes of investments within the firm to the use of external managers is one example of information that needs to be communicated to clients. Chinn and her firm have embraced the principles of Standard V(B) by providing their client with relevant information. The charity can now make a reasonable decision about whether Diversified Asset Management remains the appropriate manager for its fund.

(Notification of Changes to the Investment Process):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

Comment: Papis has violated Standard V(B). He attempted to hide the nature of his decision to change external managers by making only a limited disclosure. The plan recipients and the fund's trustees need to be aware when changes are made to ensure that operational procedures are being followed.

(Notification of Risks and Limitations):

Quantitative analyst Yuri Yakovlev has developed an investment strategy that selects small-cap stocks on the basis of quantitative signals. Yakovlev's strategy typically identifies only a small number of stocks (10–20) that tend to be illiquid, but according to his backtests, the strategy generates significant risk-adjusted returns. The partners at Yakovlev's firm, QSC Capital, are impressed by these results. After a thorough examination of the strategy's risks, stress testing, historical back testing, and scenario analysis, QSC decides to seed the strategy with US\$10 million of internal capital in order for Yakovlev to create a track record for the strategy.

After two years, the strategy has generated performance returns greater than the appropriate benchmark and the Sharpe ratio of the fund is close to 1.0. On the basis of these results, QSC decides to actively market the fund to large institutional investors. While creating the offering materials, Yakovlev informs the marketing team that the capacity of the strategy is limited. The extent of the limitation is difficult to ascertain with precision; it depends on market liquidity and other factors in his model that can evolve over time. Yakovlev indicates that given the current market conditions, investments in the fund beyond US\$100 million of capital could become more difficult and negatively affect expected fund returns.

Alan Wellard, the manager of the marketing team, is a partner with 30 years of marketing experience and explains to Yakovlev that these are complex technical issues that will muddy the marketing message. According to Wellard, the offering material should focus solely on the great track record of the fund. Yakovlev does not object because the fund has only US\$12 million of capital, very far from

the US\$100 million threshold.

Comment: Yakovlev and Wellard have not appropriately disclosed a significant limitation associated with the investment product. Yakovlev believes this limitation, once reached, will materially affect the returns of the fund. Although the fund is currently far from the US\$100 million mark, current and prospective investors must be made aware of this capacity issue. If significant limitations are complicated to grasp and clients do not have the technical background required to understand them, Yakovlev and Wellard should either educate the clients or ascertain whether the fund is suitable for each client.

(Notification of Risks and Limitations):

Brickell Advisers offers investment advisory services mainly to South American clients. Julietta Ramon, a risk analyst at Brickell, describes to clients how the firm uses value at risk (VaR) analysis to track the risk of its strategies. Ramon assures clients that calculating a VaR at a 99% confidence level, using a 20-day holding period, and applying a methodology based on an ex ante Monte Carlo simulation is extremely effective. The firm has never had losses greater than those predicted by this VaR analysis.

Comment: Ramon has not sufficiently communicated the risks associated with the investment process to satisfy the requirements of Standard V(B). The losses predicted by a VaR analysis depend greatly on the inputs used in the model. The size and probability of losses can differ significantly from what an individual model predicts. Ramon must disclose how the inputs were selected and the potential limitations and risks associated with the investment strategy.

(Notification of Risks and Limitations):

Lily Smith attended an industry conference and noticed that John Baker, an investment manager with Baker Associates, attracted a great deal of attention from the conference participants. On the basis of her knowledge of Baker's reputation and the interest he received at the conference, Smith recommends adding Baker Associates to the approved manager platform. Her recommendation to the approval committee included the statement "John Baker is well respected in the industry, and his insights are consistently sought after by investors. Our clients are sure to benefit from investing with Baker Associates."

Comment: Smith is not appropriately separating facts from opinions in her recommendation to include the manager within the platform. Her actions conflict with the requirements of Standard V(B). Smith is relying on her opinions about Baker's reputation and the fact that many attendees were talking with him at the conference. Smith should also review the requirements of Standard V(A) regarding reasonable basis to determine the level of review necessary to recommend Baker Associates.

#### V C Record Retention

(Record Retention and IPS Objectives and Recommendations):

One of Nikolas Lindstrom's clients is upset by the negative investment returns of his equity portfolio. The investment policy statement for the client requires that the portfolio manager follow a benchmark-oriented approach. The benchmark for the client includes a 35% investment allocation in the technology sector. The client acknowledges that this allocation was appropriate, but over the past three years, technology stocks have suffered severe losses. The client complains to the investment manager for allocating so much money to this sector.

Comment: For Lindstrom, having appropriate records is important to show that over the past three years, the portion of technology stocks in the benchmark index was 35%, as called for in the IPS. Lindstrom should also have the client's IPS stating that the benchmark was appropriate for the client's investment objectives. He should also have records indicating that the investment has been explained appropriately to the client and that the IPS was updated on a regular basis. Taking these actions, Lindstrom would be in compliance with Standard V(C).

(Record Retention and Research Process):

Malcolm Young is a research analyst who writes numerous reports rating companies in the luxury retail industry. His reports are based on a variety of sources, including interviews with company managers, manufacturers, and economists; on-site company visits; customer surveys; and secondary research from analysts covering related industries.

Comment: Young must carefully document and keep copies of all the information that goes into his reports, including the secondary or third-party research of other analysts. Failure to maintain such files would violate Standard V(C).

(Records as Firm, Not Employee, Property):

Martin Blank develops an analytical model while he is employed by Green Partners Investment Management, LLP (GPIM). While at the firm, he systematically documents the assumptions that make up the model as well as his reasoning behind the assumptions. As a result of the success of his model, Blank is hired to be the head of the research department of one of GPIM's competitors. Blank takes copies of the records supporting his model to his new firm.

Comment: The records created by Blank supporting the research model he developed at GPIM are the records of GPIM. Taking the documents with him to his new employer without GPIM's permission violates Standard V(C). To use the model in the future, Blank must re-create the records supporting his model at the new firm.

#### VI A Conflicts of Interest Avoid or Disclose Conflicts

(Conflict of Interest and Business Relationships):

Hunter Weiss is a research analyst with Farmington Company, a broker and investment banking firm. Farmington's merger and acquisition department has represented Vimco, a conglomerate, in all of Vimco's acquisitions for 20 years. From time to time, Farmington officers sit on the boards of directors of various Vimco subsidiaries. Weiss is writing a research report on Vimco.

Comment: Weiss must disclose in his research report Farmington's special relationship with Vimco. Broker/dealer management of and participation in public offerings must be disclosed in research reports. Because the position of underwriter to a company entails a special past and potential future relationship with a company that is the subject of investment advice, it threatens the independence and objectivity of the report writer and must be disclosed.

(Conflict of Interest and Business Stock Ownership):

The investment management firm of Dover & Roe sells a 25% interest in its partnership to a multinational bank holding company, First of New York. Immediately after the sale, Margaret Hobbs, president of Dover & Roe, changes her recommendation for First of New York's common stock from "sell" to "buy" and adds First of New York's commercial paper to Dover & Roe's approved list for purchase.

Comment: Hobbs must disclose the new relationship with First of New York to all Dover & Roe clients. This relationship must also be disclosed to clients by the firm's portfolio managers when they make specific investment recommendations or take investment actions with respect to First of New York's securities.

(Conflict of Interest and Personal Stock Ownership):

Carl Fargmon, a research analyst who follows firms producing office equipment, has been recommending purchase of Kincaid Printing because of its innovative new line of copiers. After his initial report on the company, Fargmon's wife inherits from a distant relative US\$3 million of Kincaid stock. He has been asked to write a follow-up report on Kincaid.

Comment: Fargmon must disclose his wife's ownership of the Kincaid stock to his employer and in his follow-up report. Best practice would be to avoid the conflict by asking his employer to assign another analyst to draft the follow-up report.

(Conflict of Interest and Personal Stock Ownership):

Betty Roberts is speculating in penny stocks for her own account and purchases 100,000 shares of Drew Mining, Inc., for US\$0.30 a share. She intends to sell these shares at the sign of any substantial upward price movement of the stock. A week later, her employer asks her to write a report on penny stocks in the mining industry to be published in two weeks. Even without owning the Drew stock, Roberts would recommend it in her report as a "buy." A surge in the price of the stock to the US\$2 range is likely to result once the report is issued.

Comment: Although this holding may not be material, Roberts must disclose it in the report and to her employer before writing the report because the gain for her will be substantial if the market responds strongly to her recommendation. The fact that she has only recently purchased the stock adds to the appearance that she is not entirely objective.

(Conflict of Interest and Compensation Arrangements):

Samantha Snead, a portfolio manager for Thomas Investment Counsel, Inc., specializes in managing public retirement funds and defined benefit pension plan accounts, all of which have long-term investment objectives. A year ago, Snead's employer, in an attempt to motivate and retain key investment professionals, introduced a bonus compensation system that rewards portfolio managers on the basis of quarterly performance relative to their peers and to certain benchmark indexes. In an attempt to improve the short-term performance of her accounts, Snead changes her investment strategy and purchases several high-beta stocks for client portfolios. These purchases are seemingly contrary to the clients' investment policy statements. Following their purchase, an officer of Griffin Corporation, one of Snead's pension fund clients, asks why Griffin Corporation's portfolio seems to be dominated by high-beta stocks of companies that often appear among the most actively traded issues. No change in objective or strategy has been recommended by Snead during the year.

Comment: Snead has violated Standard VI(A) by failing to inform her clients of the changes in her compensation arrangement with her employer, which created a conflict of interest between her compensation and her clients' IPSs. Firms may pay employees on the basis of performance, but pressure by Thomas Investment Counsel to achieve short-term performance goals is in basic conflict with the objectives of Snead's accounts.

(Conflict of Interest, Options, and Compensation Arrangements):

Wayland Securities works with small companies doing IPOs or secondary offerings. Typically, these deals are in the US\$10 million to US\$50 million range, and as a result, the corporate finance fees are quite small. To compensate for the small fees, Wayland Securities usually takes "agent options"—that is, rights (exercisable within a two-year time frame) to acquire up to an additional 10% of the current offering. Following an IPO performed by Wayland for Falk Resources, Ltd., Darcy Hunter, the head of corporate finance at Wayland, is concerned about receiving value for her Falk Resources options. The options are due to expire in one month, and the stock is not doing well. She contacts John Fitzpatrick in the research department of Wayland Securities, reminds him that he is eligible for 30% of these options, and indicates that now would be a good time to give some additional coverage to Falk Resources. Fitzpatrick agrees and immediately issues a favorable report.

Comment: For Fitzpatrick to avoid being in violation of Standard VI(A), he must indicate in the report the volume and expiration date of agent options outstanding. Furthermore, because he is personally eligible for some of the options, Fitzpatrick must disclose the extent of this compensation. He also must be careful to not violate his duty of independence and objectivity under

Standard I(B).

(Conflict of Interest and Compensation Arrangements):

Gary Carter is a representative with Bengal International, a registered broker/dealer. Carter is approached by a stock promoter for Badger Company, who offers to pay Carter additional compensation for sales of Badger Company's stock to Carter's clients. Carter accepts the stock promoter's offer but does not disclose the arrangements to his clients or to his employer. Carter sells shares of the stock to his clients.

Comment: Carter has violated Standard VI(A) by failing to disclose to clients that he is receiving additional compensation for recommending and selling Badger stock. Because he did not disclose the arrangement with Badger to his clients, the clients were unable to evaluate whether Carter's recommendations to buy Badger were affected by this arrangement. Carter's conduct also violated Standard VI(A) by failing to disclose to his employer monetary compensation received in addition to the compensation and benefits conferred by his employer. Carter was required by Standard VI(A) to disclose the arrangement with Badger to his employer so that his employer could evaluate whether the arrangement affected Carter's objectivity and loyalty.

(Conflict of Interest and Directorship):

Carol Corky, a senior portfolio manager for Universal Management, recently became involved as a trustee with the Chelsea Foundation, a large not-for-profit foundation in her hometown. Universal is a small money manager (with assets under management of approximately US\$100 million) that caters to individual investors. Chelsea has assets in excess of US\$2 billion. Corky does not believe informing Universal of her involvement with Chelsea is necessary.

Comment: By failing to inform Universal of her involvement with Chelsea, Corky violated Standard VI(A). Given the large size of the endowment at Chelsea, Corky's new role as a trustee can reasonably be expected to be time consuming, to the possible detriment of Corky's portfolio responsibilities with Universal. Also, as a trustee, Corky may become involved in the investment decisions at Chelsea. Therefore, Standard VI(A) obligates Corky to discuss becoming a trustee at Chelsea with her compliance officer or supervisor at Universal before accepting the position, and she should have disclosed the degree to which she would be involved in investment decisions at Chelsea.

(Conflict of Interest and Personal Trading):

Bruce Smith covers eastern European equities for Marlborough Investments, an investment management firm with a strong presence in emerging markets. While on a business trip to Russia, Smith learns that investing in Russian equities directly is difficult but that equity-linked notes that replicate the performance of underlying Russian equities can be purchased from a New York-based investment bank. Believing that his firm would not be interested in such a security, Smith purchases a note linked to a Russian telecommunications company for his own account without informing Marlborough. A month later, Smith decides that the firm should consider investing in Russian equities by way of the equity-linked notes. He prepares a write-up on the market that concludes with a recommendation to purchase several of the notes. One note he recommends is linked to the same Russian telecom company that Smith holds in his personal account.

Comment: Smith has violated Standard VI(A) by failing to disclose his purchase and ownership of the note linked to the Russian telecom company. Smith is required by the standard to disclose the investment opportunity to his employer and look to his company's policies on personal trading to determine whether it was proper for him to purchase the note for his own account. By purchasing the note, Smith may or may not have impaired his ability to make an unbiased and objective assessment of the appropriateness of the derivative instrument for his firm, but Smith's failure to disclose the purchase to his employer impaired his employer's ability to decide whether his ownership of the security is a conflict of interest that might affect Smith's future recommendations. Then, when he recommended the particular telecom notes to his firm, Smith compounded his problems by not disclosing that he owned the notes in his personal account—a clear conflict of interest.

(Conflict of Interest and Requested Favors):

Michael Papis is the chief investment officer of his state's retirement fund. The fund has always used outside advisers for the real estate allocation, and this information is clearly presented in all fund communications. Thomas Nagle, a recognized sell-side research analyst and Papis's business school classmate, recently left the investment bank he worked for to start his own asset management firm, Accessible Real Estate. Nagle is trying to build his assets under management and contacts Papis about gaining some of the retirement fund's allocation. In the previous few years, the performance of the retirement fund's real estate investments was in line with the fund's benchmark but was not extraordinary. Papis decides to help out his old friend and also to seek better returns by moving the real estate allocation to Accessible. The only notice of the change in adviser appears in the next annual report in the listing of associated advisers.

Comment: Papis has violated Standard VI(A) by not disclosing to his employer his personal relationship with Nagle. Disclosure of his past history with Nagle would allow his firm to determine whether the conflict may have impaired Papis's independence in deciding to change managers. See also Standard IV(C)—Responsibilities of Supervisors, Standard V(A)—Diligence and Reasonable Basis, and Standard V(B)—Communication with Clients and Prospective Clients.

(Conflict of Interest and Business Relationships):

Bob Wade, trust manager for Central Midas Bank, was approached by Western Funds about promoting its family of funds, with special interest in the service-fee class. To entice Central to promote this class, Western Funds offered to pay the bank a service fee of 0.25%. Without disclosing the fee being offered to the bank, Wade asked one of the investment managers to review the Western Funds family of funds

to determine whether they were suitable for clients of Central. The manager completed the normal due diligence review and determined that the funds were fairly valued in the market with fee structures on a par with their competitors. Wade decided to accept Western's offer and instructed the team of portfolio managers to exclusively promote these funds and the service-fee class to clients seeking to invest new funds or transfer from their current investments. So as to not influence the investment managers, Wade did not disclose the fee offer and allowed that income to flow directly to the bank.

Comment: Wade is violating Standard VI(A) by not disclosing the portion of the service fee being paid to Central. Although the investment managers may not be influenced by the fee, neither they nor the client have the proper information about Wade's decision to exclusively market this fund family and class of investments. Central may come to rely on the new fee as a component of the firm's profitability and may be unwilling to offer other products in the future that could affect the fees received.

See also Standard I(B)—Independence and Objectivity.

(Disclosure of Conflicts to Employers):

Yehudit Dagan is a portfolio manager for Risk Management Bank (RMB), whose clients include retirement plans and corporations. RMB provides a defined contribution retirement plan for its employees that offers 20 large diversified mutual fund investment options, including a mutual fund managed by Dagan's RMB colleagues. After being employed for six months, Dagan became eligible to participate in the retirement plan, and she intends to allocate her retirement plan assets in six of the investment options, including the fund managed by her RMB colleagues. Dagan is concerned that joining the plan will lead to a potentially significant amount of paperwork for her (e.g., disclosure of her retirement account holdings and needing preclearance for her transactions), especially with her investing in the in-house fund.

Comment: Standard VI(A) would not require Dagan to disclose her personal or retirement investments in large diversified mutual funds, unless specifically required by her employer. For practical reasons, the standard does not require Dagan to gain preclearance for ongoing payroll deduction contributions to retirement plan account investment options.

Dagan should ensure that her firm does not have a specific policy regarding investment—whether personal or in the retirement account—for funds managed by the company's employees. These mutual funds may be subject to the company's disclosure, preclearance, and trading restriction procedures to identify possible conflicts prior to the execution of trades.

VI B Conflicts of Interest Priority of Transactions  
(Personal Trading):

Research analyst Marlon Long does not recommend purchase of a common stock for his employer's account because he wants to purchase the stock personally and does not want to wait until the recommendation is approved and the stock is purchased by his employer.

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Comment: Long has violated Standard VI(B) by taking advantage of his knowledge of the stock's value before allowing his employer to benefit from that information.

(Trading for Family Member Account):

Carol Baker, the portfolio manager of an aggressive growth mutual fund, maintains an account in her husband's name at several brokerage firms with which the fund and a number of Baker's other individual clients do a substantial amount of business. Whenever a hot issue becomes available, she instructs the brokers to buy it for her husband's account. Because such issues normally are scarce, Baker often acquires shares in hot issues but her clients are not able to participate in them.

Comment: To avoid violating Standard VI(B), Baker must acquire shares for her mutual fund first and acquire them for her husband's account only after doing so, even though she might miss out on participating in new issues via her husband's account. She also must disclose the trading for her husband's account to her employer because this activity creates a conflict between her personal interests and her employer's interests.

(Family Accounts as Equals):

Erin Toffler, a portfolio manager at Esposito Investments, manages the retirement account established with the firm by her parents. Whenever IPOs become available, she first allocates shares to all her other clients for whom the investment is appropriate; only then does she place any remaining portion in her parents' account, if the issue is appropriate for them. She has adopted this procedure so that no one can accuse her of favoring her parents.

Comment: Toffler has violated Standard VI(B) by breaching her duty to her parents by treating them differently from her other accounts simply because of the family relationship. As fee-paying clients of Esposito Investments, Toffler's parents are entitled to the same treatment as any other client of the firm. If Toffler has beneficial ownership in the account, however, and Esposito Investments has preclearance and reporting requirements for personal transactions, she may have to preclear the trades and report the transactions to Esposito.

(Personal Trading and Disclosure):

Gary Michaels is an entry-level employee who holds a low-paying job serving both the research department and the investment management department of an active investment management firm.

He purchases a sports car and begins to wear expensive clothes after only a year of employment with the firm. The director of the investment management department, who has responsibility for monitoring the personal stock transactions of all employees, investigates and discovers that Michaels has made substantial investment gains by purchasing stocks just before they were put on the firm's recommended "buy" list. Michaels was regularly given the firm's quarterly personal transaction form but declined to complete it.

Comment: Michaels violated Standard VI(B) by placing personal transactions ahead of client transactions. In addition, his supervisor violated Standard IV(C)–Responsibilities of Supervisors by permitting Michaels to continue to perform his assigned tasks without having signed the quarterly personal transaction form. Note also that if Michaels had communicated information about the firm's recommendations to a person who traded the security, that action would be a misappropriation of the information and a violation of Standard II(A)–Material Nonpublic Information.

(Trading Prior to Report Dissemination):

A brokerage's insurance analyst, Denise Wilson, makes a closed-circuit TV report to her firm's branches around the country. During the broadcast, she includes negative comments about a major company in the insurance industry. The following day, Wilson's report is printed and distributed to the sales force and public customers. The report recommends that both short-term traders and intermediate investors take profits by selling that insurance company's stock. Seven minutes after the broadcast, however, Ellen Riley, head of the firm's trading department, had closed out a long "call" position in the stock. Shortly thereafter, Riley established a sizable "put" position in the stock. When asked about her activities, Riley claimed she took the actions to facilitate anticipated sales by institutional clients.

Comment: Riley did not give customers an opportunity to buy or sell in the options market before the firm itself did. By taking action before the report was disseminated, Riley's firm may have depressed the price of the calls and increased the price of the puts. The firm could have avoided a conflict of interest if it had waited to trade for its own account until its clients had an opportunity to receive and assimilate Wilson's recommendations. As it is, Riley's actions violated Standard VI(B).

#### VI C Conflicts of Interest Referral Fees

(Disclosure of Referral Arrangements and Outside Parties):

Brady Securities, Inc., a broker/dealer, has established a referral arrangement with Lewis Brothers, Ltd., an investment counseling firm. In this arrangement, Brady Securities refers all prospective tax-exempt accounts, including pension, profit-sharing, and endowment accounts, to Lewis Brothers. In return, Lewis Brothers makes available to Brady Securities on a regular basis the security recommendations and reports of its research staff, which registered representatives of Brady Securities use in serving customers. In addition, Lewis Brothers conducts monthly economic and market reviews for Brady Securities personnel and directs all stock commission business generated by referral accounts to Brady Securities.

Willard White, a partner in Lewis Brothers, calculates that the incremental costs involved in functioning as the research department of Brady Securities are US\$20,000 annually.

Referrals from Brady Securities last year resulted in fee income of US\$200,000 for Lewis Brothers, and directing all stock trades through Brady Securities resulted in additional costs to Lewis Brothers' clients of US\$10,000.

Diane Branch, the chief financial officer of Maxwell Inc., contacts White and says that she is seeking an investment manager for Maxwell's profit-sharing plan. She adds, "My friend Harold Hill at Brady Securities recommended your firm without qualification, and that's good enough for me. Do we have a deal?" White accepts the new account but does not disclose his firm's referral arrangement with Brady Securities.

Comment: White has violated Standard VI(C) by failing to inform the prospective customer of the referral fee payable in services and commissions for an indefinite period to Brady Securities. Such disclosure could have caused Branch to reassess Hill's recommendation and make a more critical evaluation of Lewis Brothers' services.

(Disclosure of Interdepartmental Referral Arrangements):

James Handley works for the trust department of Central Trust Bank. He receives compensation for each referral he makes to Central Trust's brokerage department and personal financial management department that results in a sale. He refers several of his clients to the personal financial management department but does not disclose the arrangement within Central Trust to his clients.

Comment: Handley has violated Standard VI(C) by not disclosing the referral arrangement at Central Trust Bank to his clients. Standard VI(C) does not distinguish between referral payments paid by a third party for referring clients to the third party and internal payments paid within the firm to attract new business to a subsidiary. Members and candidates must disclose all such referral fees. Therefore, Handley is required to disclose, at the time of referral, any referral fee agreement in place among Central Trust Bank's departments. The disclosure should include the nature and the value of the benefit and should be made in writing.

(Disclosure of Referral Arrangements and Informing Firm):

Katherine Roberts is a portfolio manager at Katama Investments, an advisory firm specializing in managing assets for high-net-worth individuals. Katama's trading desk uses a variety of brokerage houses to execute trades on behalf of its clients. Roberts asks the trading desk to direct a large portion of its commissions to Naushon, Inc., a small broker/dealer run by one

of Roberts' business school classmates. Katama's traders have found that Naushon is not very competitive on pricing, and although Naushon generates some research for its trading clients, Katama's other analysts have found most of Naushon's research to be not especially useful. Nevertheless, the traders do as Roberts asks, and in return for receiving a large portion of Katama's business, Naushon recommends the investment services of Roberts and Katama to its wealthiest clients. This arrangement is not disclosed to either Katama or the clients referred by Naushon.

Comment: Roberts is violating Standard VI(C) by failing to inform her employer of the referral arrangement.

(Disclosure of Referral Arrangements and Outside Organizations):

Alex Burl is a portfolio manager at Helpful Investments, a local investment advisory firm. Burl is on the advisory board of his child's school, which is looking for ways to raise money to purchase new playground equipment for the school. Burl discusses a plan with his supervisor in which he will donate to the school a portion of his service fee from new clients referred by the parents of students at the school. Upon getting the approval from Helpful, Burl presents the idea to the school's advisory board and directors. The school agrees to announce the program at the next parent event and asks Burl to provide the appropriate written materials to be distributed. A week following the distribution of the flyers, Burl receives the first school-related referral. In establishing the client's investment policy statement, Burl clearly discusses the school's referral and outlines the plans for distributing the donation back to the school.

Comment: Burl has not violated Standard VI(C) because he secured the permission of his employer, Helpful Investments, and the school prior to beginning the program and because he discussed the arrangement with the client at the time the investment policy statement was designed.

(Disclosure of Referral Arrangements and Outside Parties):

The sponsor of a state employee pension is seeking to hire a firm to manage the pension plan's emerging market allocation. To assist in the review process, the sponsor has hired Thomas Arrow as a consultant to solicit proposals from various advisers. Arrow is contracted by the sponsor to represent its best interest in selecting the most appropriate new manager. The process runs smoothly, and Overseas Investments is selected as the new manager.

The following year, news breaks that Arrow is under investigation by the local regulator for accepting kickbacks from investment managers after they are awarded new pension allocations. Overseas Investments is included in the list of firms allegedly making these payments. Although the sponsor is happy with the performance of Overseas since it has been managing the pension plan's emerging market funds, the sponsor still decides to have an independent review of the proposals and the selection process to ensure that Overseas was the appropriate firm for its needs. This review confirms that, even though Arrow was being paid by both parties, the recommendation of Overseas appeared to be objective and appropriate.

Comment: Arrow has violated Standard VI(C) because he did not disclose the fee being paid by Overseas. Withholding this information raises the question of a potential lack of objectivity in the recommendation of Overseas by Arrow; this aspect is in addition to questions about the legality of having firms pay to be considered for an allocation.

Regulators and governmental agencies may adopt requirements concerning allowable consultant activities. Local regulations sometimes include having a consultant register with the regulatory agency's ethics board. Regulator policies may include a prohibition on acceptance of payments from investment managers receiving allocations and require regular reporting of contributions made to political organizations and candidates. Arrow would have to adhere to these requirements as well as the Code and Standards.

VII A Responsibilities as a CFA Institute Member or CFA Candidate  
(Sharing Exam Questions):

Travis Nero serves as a proctor for the administration of the CFA examination in his city. In the course of his service, he reviews a copy of the Level II exam on the evening prior to the exam's administration and provides information concerning the exam questions to two candidates who use it to prepare for the exam.

Comment: Nero and the two candidates have violated Standard VII(A). By giving information about the exam questions to two candidates, Nero provided an unfair advantage to the two candidates and undermined the integrity and validity of the Level II exam as an accurate measure of the knowledge, skills, and abilities necessary to earn the right to use the CFA designation. By accepting the information, the candidates also compromised the integrity and validity of the Level II exam and undermined the ethical framework that is a key part of the designation.

(Bringing Written Material into Exam Room):

Loren Sullivan is enrolled to take the Level II CFA examination. He has been having difficulty remembering a particular formula, so prior to entering the exam room, he writes the formula on the palm of his hand. During the afternoon section of the exam, a proctor notices Sullivan looking at the palm of his hand. She asks to see his hand and finds the formula.

Comment: Because Sullivan wrote down information from the Candidate Body of Knowledge (CBOK) and took that written information into the exam room, his conduct compromised the validity of his exam performance and violated Standard VII(A). Sullivan's conduct was also in direct contradiction with the rules and regulations of the CFA Program, the Candidate Pledge, and the CFA Institute Code and Standards.

(Writing after Exam Period End):

At the conclusion of the morning section of the Level I CFA examination, the proctors announce, "Stop writing now." John Davis has not completed the exam, so he continues to randomly fill in ovals on his answer sheet. A proctor approaches Davis's desk and reminds him that he should stop writing immediately. Davis, however, continues to complete the answer sheet. After the proctor asks him to stop writing two additional times, Davis finally puts down his pencil.

Comment: By continuing to complete his exam after time was called, Davis has violated Standard VII(A). By continuing to write, Davis took an unfair advantage over other candidates, and his conduct compromised the validity of his exam performance. Additionally, by not heeding the proctor's repeated instructions, Davis violated the rules and regulations of the CFA Program.

(Sharing Exam Content):

After completing Level II of the CFA exam, Annabelle Rossi posts on her blog about her experience. She posts the following: "Level II is complete! I think I did fairly well on the exam. It was really difficult, but fair. I think I did especially well on the derivatives questions. And there were tons of them! I think I counted 18! The ethics questions were really hard. I'm glad I spent so much time on the Code and Standards. I was surprised to see there were no questions at all about IPO allocations. I expected there to be a couple. Well, off to celebrate getting through it. See you tonight?"

Comment: Rossi did not violate Standard VII(A) when she wrote about how difficult she found the exam or how well she thinks she may have done. By revealing portions of the CBOK covered on the exam and areas not covered, however, she did violate Standard VII(A) and the Candidate Pledge. Depending on the time frame in which the comments were posted, Rossi not only may have assisted future candidates but also may have provided an unfair advantage to candidates yet to sit for the same exam, thereby undermining the integrity and validity of the Level II exam.

(Sharing Exam Content):

Level I candidate Etienne Gagne has been a frequent visitor to an internet forum designed specifically for CFA Program candidates. The week after completing the Level I examination, Gagne and several others begin a discussion thread on the forum about the most challenging questions and attempt to determine the correct answers.

Comment: Gagne has violated Standard VII(A) by providing and soliciting confidential exam information, which compromises the integrity of the exam process and violates the Candidate Pledge. In trying to determine correct answers to specific questions, the group's discussion included question-specific details considered to be confidential to the CFA Program.

(Sharing Exam Content):

CFA4Sure is a company that produces test-preparation materials for CFA Program candidates. Many candidates register for and use the company's products. The day after the CFA examination, CFA4Sure sends an e-mail to all its customers asking them to share with the company the hardest questions from the exam so that CFA4Sure can better prepare its customers for the next exam administration. Marisol Pena e-mails a summary of the questions she found most difficult on the exam.

Comment: Pena has violated Standard VII(A) by disclosing a portion of the exam questions. The information provided is considered confidential until publicly released by CFA Institute. CFA4Sure is likely to use such feedback to refine its review materials for future candidates. Pena's sharing of the specific questions undermines the integrity of the exam while potentially making the exam easier for future candidates.

If the CFA4Sure employees who participated in the solicitation of confidential CFA Program information are CFA Institute members or candidates, they also have violated Standard VII(A).

(Discussion of Exam Grading Guidelines and Results):

Prior to participating in grading CFA examinations, Wesley Whitcomb is required to sign a CFA Institute Grader Agreement. As part of the Grader Agreement, Whitcomb agrees not to reveal or discuss the exam materials with anyone except CFA Institute staff or other graders. Several weeks after the conclusion of the CFA exam grading, Whitcomb tells several colleagues who are candidates in the CFA Program which question he graded. He also discusses the guideline answer and adds that few candidates scored well on the question.

Comment: Whitcomb violated Standard VII(A) by breaking the Grader Agreement and disclosing information related to a specific question on the exam, which compromised the integrity of the exam process.

(Compromising CFA Institute Integrity as a Volunteer):

Jose Ramirez is an investor-relations consultant for several small companies that are seeking greater exposure to investors. He is also the program chair for the CFA Institute society in the city where he works. Ramirez schedules only companies that are his clients to make presentations to the society and excludes other companies.

Comment: Ramirez, by using his volunteer position at CFA Institute to benefit himself and his clients, compromises the reputation and integrity of CFA Institute and thus violates Standard VII(A).

(Compromising CFA Institute Integrity as a Volunteer):

Marguerite Warrenski is a member of the CFA Institute GIPS Executive Committee, which oversees the creation, implementation, and revision of the GIPS standards. As a member of the Executive Committee, she has advance knowledge of confidential information regarding the GIPS standards,

including any new or revised standards the committee is considering. She tells her clients that her Executive Committee membership will allow her to better assist her clients in keeping up with changes to the Standards and facilitating their compliance with the changes.

Comment: Warrenski is using her association with the GIPS Executive Committee to promote her firm's services to clients and potential clients. In defining her volunteer position at CFA Institute as a strategic business advantage over competing firms and implying to clients that she would use confidential information to further their interests, Warrenski is compromising the reputation and integrity of CFA Institute and thus violating Standard VII(A). She may factually state her involvement with the Executive Committee but cannot infer any special advantage to her clients from such participation.

#### VII B Responsibilities as a CFA Institute Member or CFA Candidate

(Passing Exams in Consecutive Years):

An advertisement for AZ Investment Advisors states that all the firm's principals are CFA charterholders and all passed the three examinations on their first attempt. The advertisement prominently links this fact to the notion that AZ's mutual funds have achieved superior performance.

Comment: AZ may state that all principals passed the three examinations on the first try as long as this statement is true, but it must not be linked to performance or imply superior ability. Implying that (1) CFA charterholders achieve better investment results and (2) those who pass the exams on the first try may be more successful than those who do not violates Standard VII(B).

(Right to Use CFA Designation):

Five years after receiving his CFA charter, Louis Vasseur resigns his position as an investment analyst and spends the next two years traveling abroad. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. At the conclusion of his travels, Vasseur becomes a self-employed analyst accepting assignments as an independent contractor. Without reinstating his CFA Institute membership by filing his Professional Conduct Statement and paying his dues, he prints business cards that display "CFA" after his name.

Comment: Vasseur has violated Standard VII(B) because his right to use the CFA designation was suspended when he failed to file his Professional Conduct Statement and stopped paying dues. Therefore, he no longer is able to state or imply that he is an active CFA charterholder. When Vasseur files his Professional Conduct Statement, resumes paying CFA Institute dues to activate his membership, and completes the CFA Institute reinstatement procedures, he will be eligible to use the CFA designation.

("Retired" CFA Institute Membership Status):

After a 25-year career, James Simpson retires from his firm. Because he is not actively engaged in the investment profession, he does not file a completed Professional Conduct Statement with CFA Institute and does not pay his CFA Institute membership dues. Simpson designs a plain business card (without a corporate logo) to hand out to friends with his new contact details, and he continues to put "CFA" after his name.

Comment: Simpson has violated Standard VII(B). Because he failed to file his Professional Conduct Statement and ceased paying dues, his membership has been suspended and he has given up the right to use the CFA designation. CFA Institute has procedures, however, for reclassifying a member and charterholder as "retired" and reducing the annual dues. If he wants to obtain retired status, he needs to file the appropriate paperwork with CFA Institute. When Simpson receives his notification from CFA Institute that his membership has been reclassified as retired and he resumes paying reduced dues, his membership will be reactivated and his right to use the CFA designation will be reinstated.

(Stating Facts about CFA Designation and Program):

Rhonda Reese has been a CFA charterholder since 2000. In a conversation with a friend who is considering enrolling in the CFA Program, she states that she has learned a great deal from the CFA Program and that many firms require their employees to be CFA charterholders. She would recommend the CFA Program to anyone pursuing a career in investment management.

Comment: Reese's comments comply with Standard VII(B). Her statements refer to facts: The CFA Program enhanced her knowledge, and many firms require the CFA designation for their investment professionals.

(Order of Professional and Academic Designations):

Tatiana Prittima has earned both her CFA designation and a PhD in finance. She would like to cite both her accomplishments on her business card but is unsure of the proper method for doing so.

Comment: The order of designations cited on such items as resumes and business cards is a matter of personal preference. Prittima is free to cite the CFA designation either before or after citing her PhD. Multiple designations must be separated by a comma.

(Use of Fictitious Name):

Barry Glass is the lead quantitative analyst at CityCenter Hedge Fund. Glass is responsible for the development,

maintenance, and enhancement of the proprietary models the fund uses to manage its investors' assets. Glass reads several high-level mathematical publications and blogs to stay informed on current developments. One blog, run by Expert CFA, presents some intriguing research that may benefit one of CityCenter's current models. Glass is under pressure from firm executives to improve the model's predictive abilities, and he incorporates the factors discussed in the online research. The updated output recommends several new investments to the fund's portfolio managers.

Comment: "Expert CFA" has violated Standard VII(B) by using the CFA designation inappropriately. As with any research report, authorship of online comments must include the charterholder's full name along with any reference to the CFA designation.