



CredGuild

STUDY NOTES

CFA® Program Level I

Ethical and Professional Standards

2027 curriculum · 10 readings · 36 practice questions

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ABOUT THIS EDITION

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USING THIS BOOK

These notes are a study aid. Use them alongside the CFA Institute curriculum. The latest version is free at credguild.com.

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How to use this book

These are the CredGuild notes for the 2027 CFA® Program Level I curriculum, Ethical and Professional Standards: 10 readings. They are the same notes as on credguild.com, set out for reading on paper or offline.

What each reading contains

- **What you'll learn:** the learning outcome statements the reading covers.
- **The notes, module by module:** worked examples, key concepts, common exam traps, exam shortcuts and a bottom line.
- **A quick check after each module:** one question with its answer and the full explanation.
- **Practice questions at the end, with the answers.** The full explanation for each one is free on the reading's page at credguild.com; the link is under the answers.

The coloured boxes

KEY CONCEPT

Definitions and formulas to know.

Example. A worked problem, step by step. Try it before you read the working.

COMMON EXAM TRAPS

Mistakes that cost marks.

EXAM SHORTCUTS

Faster ways through a question.

BOTTOM LINE

What to remember from the module.

Using it with the website

Paper is good for reading. Practice works better on the site: it scores each answer as you go, explains every option, keeps a list of the questions you got wrong and spreads the readings across the weeks before your exam. If you are not sure where to start, the free diagnostic test (credguild.com/cfa/level-1/diagnostic/) gives you a score in each topic.

If this book helps you, pass it on to someone else who is studying.

CFA® PROGRAM LEVEL I · TOPIC

Ethical and Professional Standards

Exam weight 10–15% · 10 readings

Why trust matters in investment work, the CFA Institute Code of Ethics and the seven Standards of Professional Conduct with guidance for each Standard, and how to apply them to the kind of cases set at Level I.

Reading 93 Ethics and Trust in the Investment Profession

Reading 94 Code of Ethics

Reading 95 Knowledge of the Law

Reading 96 Material Nonpublic Information

Reading 97 Duties to Clients

Reading 98 Duties to Employers

Reading 99 Investment Analysis Recommendations and Actions

Reading 100 Conflicts of Interest

Reading 101 Responsibilities as a CFA Institute Member

Reading 102 Application of the Code and Standards: Level I

ETHICAL AND PROFESSIONAL STANDARDS · READING 93

Ethics and Trust in the Investment Profession

What you'll learn

- LOS 93.a** Explain what ethics means: shared beliefs about good (acceptable) and bad (unacceptable) behavior, balancing self-interest against effects on stakeholders.
- LOS 93.b** Describe how a code of ethics communicates a group's values and how it can help define a profession; distinguish a code of ethics from standards of conduct.
- LOS 93.c** Describe what makes an occupation a profession and the ways professions build and keep public trust.
- LOS 93.d** Explain why investment management needs especially high ethical standards and how unethical conduct harms clients, firms and the wider economy.
- LOS 93.e** Explain professionalism in investment management, including the difference between a suitability standard and a fiduciary standard.
- LOS 93.f** Identify the main challenges to ethical behavior, especially situational influences and overconfidence in one's own ethics.
- LOS 93.g** Compare ethical standards with legal standards and explain why neither is a subset of the other.
- LOS 93.h** Describe the Identify / Consider / Decide and act / Reflect framework for ethical decision making.

MODULE 93.1

Ethics and Trust

This reading defines ethics, codes of ethics and standards of conduct, explains how professions establish trust and why investment management needs high ethical standards, and contrasts the suitability and fiduciary standards. It then covers the challenges to ethical behavior, the difference between ethical and legal standards, and a four-step framework for ethical decision making that a candidate must be able to apply.

LOS 93.a — What ethics means

Ethics is the body of shared beliefs about which behavior is good (acceptable) and which is bad (unacceptable). **Ethical conduct** is behavior that conforms to moral principles and meets the ethical expectations of society.

A second, practical description: ethical conduct is behavior that improves outcomes for **stakeholders**, meaning everyone directly or indirectly affected by a decision. For an investment professional the stakeholders include clients, coworkers, the employer and the investment profession as a whole. Ethical behavior therefore balances self-interest against the impact on others. A decision can bring good results for the person who makes it and still have negative consequences for a stakeholder such as a coworker.

LOS 93.b — Codes of ethics and standards of conduct

A **code of ethics** sets down in writing the moral principles that tell members of a group what behavior is acceptable. It communicates the group's values, principles and general expectations to its own members and to the public. A code may be **principles-based** (broad statements), **rules-based** (specific requirements) or a mix of the two.

Standards of conduct go further. They set out the minimum level of acceptable behavior in particular situations. A code of ethics may include standards of conduct, but it does not have to: a code can consist of general principles alone.

KEY CONCEPT

	Code of ethics	Standards of conduct
Purpose	States values and general expectations	Sets a minimum acceptable level of behavior
Level of detail	Usually general principles	Specific guidance for situations
Relationship	The overall statement	Optional part of a code

A **profession** is made up of people who use specialized knowledge and skills in the service of others and who commit to a code of ethics. A professional code tells the public that members will apply their expertise for clients' benefit in an honest and ethical way, which can increase public trust. It cannot guarantee that every member will behave ethically. A profession may properly point to its code when it presents itself to the public.

LOS 93.c — Professions and how they establish trust

A profession is an occupational group (doctors, lawyers, engineers) whose core requirement is **specialized expert knowledge**, usually combined with a focus on ethical behavior and on **service to society**. A profession may also have:

- a code and standards of professional behavior, with a **regulatory body** that enforces them and monitors members' conduct;
- attention to clients' needs, with client interests placed first;
- a focus on, or a requirement for, continuing education.

Professions establish trust by:

1. demanding a high level of expertise, knowledge and skill;
2. setting **standards of ethical behavior**;
3. **monitoring professional conduct**;
4. encouraging **continuing education**;
5. focusing on clients' needs;
6. mentoring and inspiring others in the profession.

Example. An actuarial society admits only members who pass a series of exams, publishes a conduct code, investigates complaints and requires 30 hours of study a year. Each of these requirements is a way to establish trust.

LOS 93.d — Why investment management needs high ethical standards

Investment professionals are entrusted with client wealth and must use their specialized skills both to protect it and to grow it. Investment advice and management are **intangible products**. Their quality and value are harder for a client to judge than those of a meal or a laptop, so trust matters more than in most businesses.

Unethical behavior has consequences at three levels:

- Clients lose wealth.
- Firms and professionals find it harder to succeed, because potential investors are less likely to use their services.
- Society suffers. The financial industry links savers with businesses that need financing. Less trust means less money entrusted to the industry and a higher perceived risk of investing, so investors require higher returns and the **cost of capital** rises. Misleading or false information also misallocates capital away from the most productive firms, which slows economic growth and harms everyone in the economy.

KEY CONCEPT

Effect of unethical conduct on	Direction
Perceived investment risk	Increases
Cost of capital for businesses	Increases
Amount of capital invested	Decreases
Efficiency of capital allocation	Decreases
Rate of economic growth	Decreases
Use of investment firms' and professionals' services	Decreases

LOS 93.e — Professionalism: suitability vs fiduciary standards

Clients often know little about securities, fee structures and possible sources of bias in recommendations, so they rely on the adviser's expertise, judgment and ethics. Some financial professionals must meet a suitability standard; others must meet a fiduciary standard:

	Suitability standard	Fiduciary standard
Requirement	The characteristics of recommended securities must match the client's return requirements and risk tolerance	Professional must use knowledge and expertise to act in the best interests of the client
Strength	Weaker	Stronger

LOS 93.f — Challenges to ethical behavior

1. **Overconfidence in one's own ethics.** People tend to rate their own behavior as more ethical than other people's and to overstate how much their personal traits determine what they do.
2. **Situational influences.** External pressures are thought to shape the ethical quality of behavior more strongly than a person's internal traits do. Examples are social pressure from colleagues, loyalty to a supervisor, employer or coworkers, and the prospect of more money or prestige. These pressures push people to put self-interest and short-term results ahead of long-term consequences.
3. **Rules-focused compliance cultures.** A firm that concentrates on strict, rules-based compliance can breed a culture in which staff ask only what they can do (what is allowed). The question of what they should do, based on ethical principles and long-term effects, often goes unasked.

A lack of ethical principles is a personal trait of the decision maker, so it is not a situational influence.

LOS 93.g — Ethical standards vs legal standards

Law and ethics overlap, but neither is a subset of the other:

- Some legal acts are unethical. Recommending a relative's company without disclosing the relationship may break no law.
- Some illegal acts are considered ethical by many. Examples are **whistle-blowing** that breaks a confidentiality law to expose harm to clients, and **civil disobedience**.

Legal and ethical are separate tests (examples)

	Legal	Illegal
Ethical	Most everyday professional conduct, such as disclosing a conflict to clients	Breaking a curfew to drive an injured neighbor to hospital
Unethical	Keeping a referral fee secret from clients where no law requires it to be disclosed	Fraud, such as sending clients falsified account statements

Ethical principles often set a higher standard than law and require more judgment about the impact on many stakeholders. Laws are more specific and often respond to past misconduct: the 1929 crash led to the Glass-Steagall Act, the Securities Act of 1933 and the Securities Exchange Act of 1934; the Enron and WorldCom scandals led to Sarbanes-Oxley; and the 2008 crisis led to the Dodd-Frank Act. New laws can in turn create opportunities for new kinds of unethical behavior.

LOS 93.h — A framework for ethical decision making

Building ethics into a firm's decision process is an important part of developing an ethical culture. Adopting a code of ethics is the first requirement, and backing from senior management matters a great deal. It gives the firm a routine for teaching ethical decision making and reinforcing it through practice, and it lets teams weigh **alternative actions** and their short- and long-term consequences for different stakeholders. A framework helps people identify the issues, examine them from several perspectives, develop judgment and avoid unanticipated (unintended) ethical consequences.

The **ethical decision-making framework** has four steps:

KEY CONCEPT

Step	What to do
1. Identify	Relevant facts (those known and those wanted), stakeholders and the duties owed to each, ethical principles, conflicts of interest
2. Consider	Situational influences and personal biases; additional guidance (mentor, colleagues, legal/compliance); alternative actions and their short- and long-term effects
3. Decide and act	Choose and carry out the action

Step**What to do**

4. Reflect

Was the outcome as anticipated? Why or why not? Were duties and principles properly weighed?

Example. A fund manager is offered a paid trip by a broker. Identify: the facts, her duties to clients and employer, and the conflict. Consider: pressure from the broker relationship, advice from compliance, and alternatives such as declining or paying her own way. Decide and act: she pays her own way. Reflect: did the decision work out as expected?

Common exam traps

- One person's private beliefs about right and wrong are not ethics in this sense, and a written code or firm rulebook is only one way of expressing ethics.
- Standards of conduct are not a statement of best practice.
- Fair dealing is Standard III(B), a duty under the CFA Institute Standards. It is not another name for the suitability standard or the fiduciary standard.
- Higher pay, or seeing work as a calling, does not make an occupation a profession. Putting clients first is a common characteristic of professions but is not the definition.
- The framework's steps differ from the qualitative characteristics of financial reports (relevance, faithful representation) and from the steps of a financial analysis project.

BOTTOM LINE

- Ethics is the body of shared beliefs about which behavior is good and which is bad, and ethical conduct can also be described as behavior that improves outcomes for stakeholders, balancing self-interest against the impact on others.
- A code of ethics states a group's values, principles and general expectations, while standards of conduct set the minimum acceptable behavior in particular situations and are an optional part of a code.
- Professions establish trust through demanding requirements for expertise, knowledge and skill, standards of ethical behavior, monitoring of professional conduct, continuing education, a focus on clients' needs, and mentoring others in the profession.
- Investment advice and management are intangible products whose quality clients find hard to judge, and unethical conduct raises perceived investment risk and the cost of capital while reducing capital invested, the efficiency of capital allocation and economic growth.
- The suitability standard requires recommended securities to match the client's return requirements and risk tolerance, while the stronger fiduciary standard requires acting in the client's best interests.
- The challenges to ethical behavior are overconfidence in one's own ethics, situational influences and rules-focused compliance cultures; a lack of ethical principles is a personal trait, not a situational influence.
- Law and ethics overlap but neither is a subset of the other: some legal acts are unethical, and some illegal acts, such as whistle-blowing or civil disobedience, are considered ethical by many.

- The ethical decision-making framework has four steps: identify the facts, stakeholders, duties, principles and conflicts; consider influences, guidance and alternatives; decide and act; and reflect on the outcome.

QUICK CHECK

Question 1

Ethics is *best* described as:

- A a written set of rules adopted by a firm.
- B commonly shared beliefs about good and bad behavior.
- C one individual's belief about proper conduct.

Answer: B

Ethics is a set of shared beliefs about what behavior is good or acceptable and what behavior is bad or unacceptable. It is broader than any particular written rulebook and broader than one person's view.

Why the other options are wrong

- A. A written code of standards is one way a group expresses its ethics; it is narrower than ethics itself.
- C. A single person's belief about proper conduct is a personal view. Ethics rests on beliefs that are commonly shared.

Key takeaway Ethics means commonly shared beliefs about good and bad behavior. It is broader than one person's view or a single written code.

Practice questions

Question 2

Which of the following *best* distinguishes the members of a profession from people working in an ordinary occupation? Members of a profession:

- A earn higher compensation for their services.
- B regard their work as a vocation or calling.
- C agree to comply with a common code of ethics.

Question 3

Anika Dorsey, a junior trader, goes along with her desk's habit of delaying the reporting of losing trades. She does so because her supervisor and colleagues expect it and her bonus depends on the desk's reported profits. Lapses like Dorsey's are *most likely* to be explained by:

- A** situational influences.
- B** a lack of technical training.
- C** her personal character traits.

Question 4

Which of the following lists the steps of the ethical decision-making framework presented in the Level I CFA curriculum?

- A** Relevance; faithful representation; comparability; verifiability; timeliness; understandability.
- B** Define the objective; collect and analyze data; report findings; update the analysis.
- C** Identify facts and duties; consider influences and alternatives; decide and act; reflect.

Answers: 2. C · 3. A · 4. C

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/ethics-and-trust-in-the-investment-profession/. The full bank has 24 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 94

Code of Ethics

What you'll learn

LOS 94.a Describe how the CFA Institute Professional Conduct Program is organized, how inquiries start and proceed, and which sanctions can result.

LOS 94.b Identify the six components of the Code of Ethics and the seven Standards of Professional Conduct, and tell Code components apart from Standards.

LOS 94.c Explain the ethical responsibilities set out in the Code and Standards, including every sub-section of each Standard.

MODULE 94.1

Code and Standards

This reading describes how the CFA Institute Professional Conduct Program enforces the Code and Standards, sets out the Code of Ethics with its six components, and lists the seven Standards of Professional Conduct with their sub-sections. A candidate must be able to explain how an inquiry starts and how it can end, and to match a duty to the Code or to the Standard it comes from.

LOS 94.a — The Professional Conduct Program and enforcement

The Professional Conduct Program is how CFA Institute enforces the Code and Standards: it looks into possible violations and, where needed, imposes sanctions. The **Professional Conduct Program** (PCP) is governed by the CFA Institute Bylaws and by its Rules of Procedure for Proceedings Related to Professional Conduct. Two principles run through it: **fairness** toward the members and candidates involved, and **confidentiality** of the proceedings.

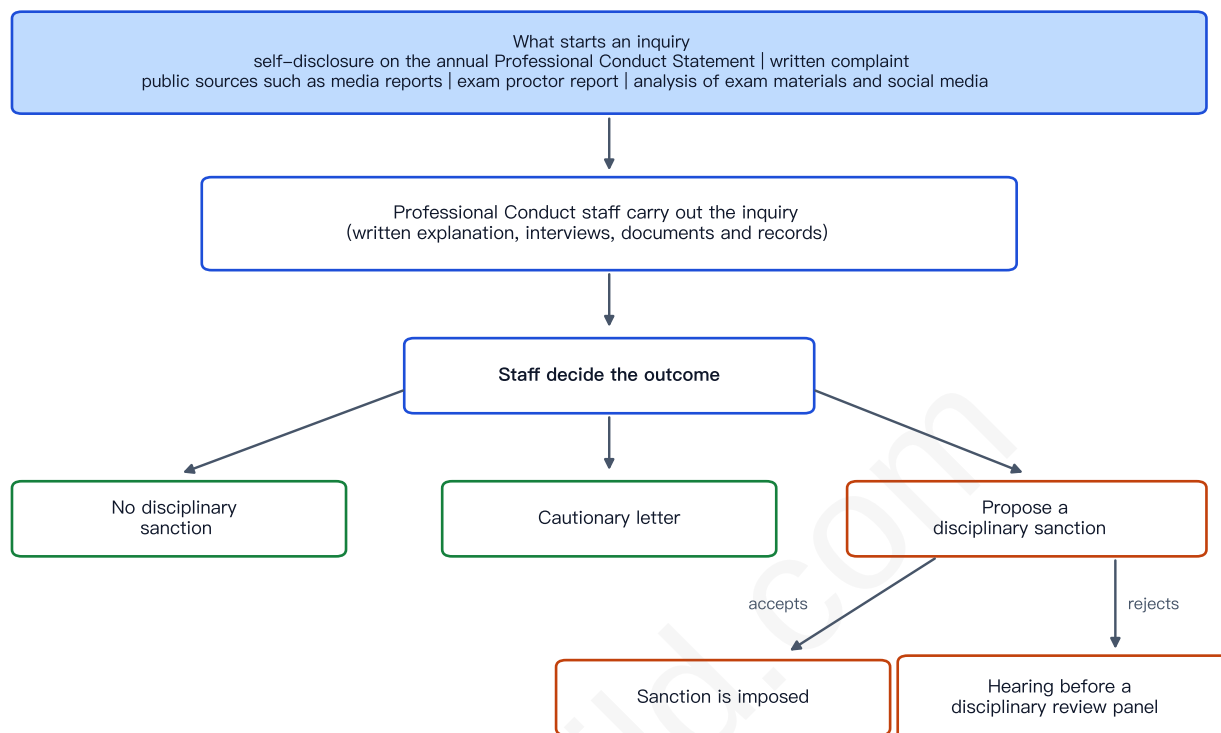
- The **CFA Institute Board of Governors** has overall responsibility for the program.
- Its **Disciplinary Review Committee** is responsible for enforcing the Code and Standards.
- The **Professional Conduct staff** carry out inquiries.

An inquiry can start in five ways. Complaints are only one of them.

1. **Self-disclosure** on the annual **Professional Conduct Statement** (being party to civil litigation, being under criminal investigation, or being named in a written complaint), for example a statement that reports a pending lawsuit;
2. **written complaints** that reach the Professional Conduct staff about how a member or candidate has acted professionally, such as a client's letter to CFA Institute;
3. evidence of misconduct from **public sources**, such as a newspaper article on a fraud;
4. a report by a **CFA exam proctor** of a possible violation during the exam;
5. CFA Institute's own **analysis of exam materials and monitoring of social media**, which can reveal a candidate posting exam content online.

During an inquiry the staff may ask the member or candidate (in writing) for an explanation, interview him or her, interview the complainant or third parties, and collect relevant documents and records.

The staff may conclude with (1) no disciplinary sanction, (2) a **cautionary letter**, or (3) disciplinary sanction. A member or candidate offered a proposed sanction can either accept it or reject it. If it is rejected, the matter goes to a **disciplinary review panel** of CFA Institute members for a hearing.



Oversight: CFA Institute Board of Governors. Enforcement of the Code and Standards: Disciplinary Review Committee. Sanctions can include public censure (condemnation by peers) and suspension of a candidate's participation in the CFA Program.

How a Professional Conduct inquiry proceeds

Sanctions may include **condemnation by the member's peers** (public censure) and **suspension of a candidate's continued participation in the CFA Program**.

Exam convention: the curriculum lists these two sanctions. Current practice: the preamble to the Code and Standards also names **revocation** of membership, of candidacy in the CFA Program and of the right to use the CFA designation.

Fines, repayment of profits and bans from working in the industry are not on the list. The program enforces the Code and Standards, which bind members of CFA Institute (including charterholders) and candidates for the CFA designation.

Common exam traps

- Staff do not suspend a member simply because an inquiry is in progress.
- A member who does not yet hold the charter is still bound by the Code and Standards and can be sanctioned; the Code covers all members of CFA Institute, not only charterholders.
- Misconduct under Standard I(D) concerns professional activities. Acts outside a member's professional capacity, such as a minor offense unrelated to work, are not addressed by it, while disclosing exam content violates Standard VII(A).

WORKED EXAMPLE: AN INQUIRY UNDER THE PROFESSIONAL CONDUCT PROGRAM

A Level II candidate posts a description of several questions from her exam on a social media forum the day after the exam. CFA Institute's monitoring of social media finds the post. Explain how the matter reaches the Professional Conduct staff, what the staff may do, which Standard is involved and how the matter can end.

Step 1. CFA Institute's own monitoring of social media and review of exam materials is one of the five ways an inquiry can start, so no complaint is needed.

Step 2. The staff may ask the candidate in writing for an explanation, interview her and any third parties, and collect relevant documents and records.

Step 3. Disclosing exam content violates Standard VII(A), which covers conduct as a participant in CFA Institute programs.

Step 4. The staff may conclude with no disciplinary sanction, a cautionary letter or a disciplinary sanction. If the staff propose a sanction, the candidate can accept it or reject it; if she rejects it, the matter goes to a hearing before a disciplinary review panel made up of CFA Institute members.

Result. Under the exam convention, the sanctions that apply to a candidate include suspension of her continued participation in the CFA Program; current practice also names revocation of candidacy in the CFA Program.

LOS 94.b — The Code of Ethics and the seven Standards**KEY CONCEPT**

Code of Ethics. Members of CFA Institute and candidates for the CFA designation (**Members and Candidates**) must (the Code's text is in italics):

1. Act with **integrity, competence, diligence, respect** and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession, and other participants in the **global capital markets**.
2. Place the **integrity of the investment profession** and the interests of clients above their own personal interests.
3. Use **reasonable care** and exercise **independent professional judgment** when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
4. **Practice and encourage others to practice** in a professional and ethical manner that will **reflect credit** on themselves and the profession.
5. **Promote the integrity and viability** of the global capital markets for the ultimate benefit of society.
6. **Maintain and improve their professional competence** and strive to maintain and improve the competence of other investment professionals.

Exam convention: the curriculum prints component 1 with a comma after "respect". Current practice: the official Code text has no comma there, as shown above.

The seven Standards of Professional Conduct:

I. Professionalism · II. Integrity of Capital Markets · III. Duties to Clients · IV. Duties to Employers · V. Investment Analysis, Recommendations, and Actions · VI. Conflicts of Interest · VII. Responsibilities as a CFA Institute Member or CFA Candidate.

The Code is short and general. Specific duties, such as keeping records or distinguishing fact from opinion, come from the Standards. The table maps phrases that often appear in questions to their source.

Sounds like...	Where it lives
"integrity, competence, diligence, respect"	Code, component 1
"use reasonable care and exercise independent professional judgment"	Code, component 3
"reflect credit on the profession"	Code, component 4
"professional competence" of self and others	Code, component 6
act with and maintain the competence one's own responsibilities require	Standard I(E)
comply with laws; stricter law applies	Standard I(A)
diligence, independence and thoroughness in analysis	Standard V(A)
suitability of investments	Standard III(C)
priority of client transactions	Standard VI(B)
integrity of the CFA designation and exams	Standard VII(A)

Several plausible-sounding duties are not components of the Code: complying with the **Global Investment Performance Standards (GIPS)**; advocating new laws; educating the general public; honoring contractual provisions; maximizing return per unit of risk.

Common exam traps

- Component 1 names specific groups (public, clients, prospective clients, employers, employees, colleagues, other market participants). It does not name "CFA Program candidates" as a group.
- The four qualities in component 1 are integrity, competence, diligence and respect. Honesty, candor, skill and humility are not on the list.

LOS 94.c — The Standards and their sub-sections

KEY CONCEPT

Standard	Sub-sections	Core requirement in brief
I Professionalism	I(A) Knowledge of the Law; I(B) Independence and Objectivity; I(C) Misrepresentation; I(D) Misconduct; I(E) Competence	Know and follow the stricter of applicable law and the Code and Standards and dissociate from violations; maintain independence and objectivity, with no gift or benefit that could compromise it; no knowing misstatements; no professional conduct involving dishonesty, fraud or deceit, and no act that reflects badly on professional reputation, integrity or competence; stay competent
II Integrity of Capital Markets	II(A) Material Nonpublic Information; II(B) Market Manipulation	Don't act or cause others to act on material nonpublic information; don't distort prices or inflate volume to mislead
III Duties to Clients	III(A) Loyalty, Prudence, and Care; III(B) Fair Dealing; III(C) Suitability; III(D) Performance Presentation; III(E) Preservation of Confidentiality	Duty of loyalty, reasonable care and prudent judgment, with clients' interests ahead of the employer's and one's own; treat all clients fairly; in an advisory relationship, inquire into the client's experience, objectives and constraints before acting and reassess regularly, confirm that each investment suits the client's financial situation and written objectives, mandates and constraints, and judge suitability in the total-portfolio context; when managing to a stated mandate, act only within its objectives and constraints; fair, accurate, complete performance; keep information about current, former and prospective clients confidential unless it concerns illegal activities on the part of the client, disclosure is required by law, or the client or prospective client permits it
IV Duties to Employers	IV(A) Loyalty; IV(B) Additional Compensation Arrangements; IV(C) Responsibilities of Supervisors	Act for the employer's benefit: don't withhold skills, divulge confidential information or otherwise harm the employer; get written consent from all parties before accepting compensation or benefits that compete or could conflict with the employer's interest; make reasonable efforts to make supervisees comply

Standard	Sub-sections	Core requirement in brief
V Investment Analysis, Recommendations, and Actions	V(A) Diligence and Reasonable Basis; V(B) Communication with Clients and Prospective Clients; V(C) Record Retention	Diligence, independence and thoroughness, with a reasonable and adequate basis; disclose the nature and cost of services, the investment process (and material changes to it promptly), and significant risks and limitations; include the important factors in client communications; separate fact from opinion; keep records supporting analysis, recommendations and client communications
VI Conflicts of Interest	VI(A) Avoid or Disclose Conflicts; VI(B) Priority of Transactions; VI(C) Referral Fees	Avoid, or fully and fairly disclose, matters that could impair independence and objectivity or interfere with duties, in prominent, plain-language disclosures; client and employer trades before personal trades; disclose referral compensation
VII Responsibilities as a CFA Institute Member or CFA Candidate	VII(A) Conduct as Participants in CFA Institute Programs; VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program	Don't compromise the reputation or integrity of CFA Institute or the CFA designation, or the integrity, validity or security of CFA Institute programs; don't misrepresent or exaggerate what membership, the charter or candidacy means

Exam convention: the curriculum's list of the Standards extends the first III(E) exception to illegal activities of a prospective client as well as of the client. Current practice: the official Standard III(E) names illegal activities on the part of the client only, so the exception is not extended to a prospective client.

Mini-cases

- *Standard I(C) Misrepresentation.* A salesperson tells a prospect that her firm has an emerging-markets desk, not knowing whether that is true. Presenting a claim as fact without knowing whether it is true is misleading. Once she learns it is false she must correct it, and staying silent after learning the truth is a further failure.
- *Standard V(C) Record Retention.* A manager recommends a trade to a client over dinner. Back at the office he should document the recommendation, its basis and the client's response. Suitability should already have been assessed before the recommendation was made, and nothing should be executed until the client gives instructions.
- *Standard III(B) Fair Dealing.* Before changing a research rating, the firm should limit the number of people who know the change is coming and shorten the time between the decision and its release. Its personnel guidelines for pre-dissemination should forbid anyone with prior knowledge from discussing or acting on the pending change, and the change should go to all interested clients at the same time.
- *Standard I(A) Knowledge of the Law.* Where local law is less demanding than the Code and Standards, the member follows the Code and Standards because they are more strict. Where local law is stricter, the member follows local law.
- *Standard III(E) Preservation of Confidentiality.* Information about a client's illegal activity is an exception to the duty of confidentiality, so disclosing it to the authorities is permitted without the client's consent.

Common exam traps

- A misrepresentation need not be a deliberate lie. Presenting as fact a claim one knows is unverified, or leaving a statement uncorrected after learning it is false, is enough.
- Additional compensation arrangements belong to Standard IV Duties to Employers (IV(B)), even when a client offers the compensation.

EXAM SHORTCUTS

- Specific duties such as keeping records or distinguishing fact from opinion come from the Standards, so an answer that places them in the Code of Ethics can be ruled out.

BOTTOM LINE

- The Professional Conduct Program enforces the Code and Standards on the principles of fairness and confidentiality: the Disciplinary Review Committee is responsible for enforcement and the Professional Conduct staff carry out inquiries.
- An inquiry can start from self-disclosure on the annual Professional Conduct Statement, a written complaint, evidence from public sources, a report by an exam proctor, or CFA Institute's own monitoring of social media and review of exam materials.
- The Professional Conduct staff may conclude with no disciplinary sanction, a cautionary letter or a disciplinary sanction, and a member or candidate who rejects a proposed sanction is referred to a disciplinary review panel for a hearing.
- Exam convention: the sanctions listed are condemnation by the member's peers (public censure) and suspension of a candidate's continued participation in the CFA Program. Current practice: the preamble to the Code and Standards also names revocation of membership, of candidacy and of the right to use the CFA designation.
- Component 1 of the Code names four qualities, integrity, competence, diligence and respect, while complying with GIPS, advocating new laws, educating the general public, honoring contractual provisions and maximizing return per unit of risk are not components of the Code.
- Standards I to VII cover, in order: professionalism; integrity of capital markets; duties to clients; duties to employers; investment analysis, recommendations, and actions; conflicts of interest; and responsibilities as a CFA Institute member or candidate.
- Under Standard I(A), a member follows the Code and Standards where local law is less demanding and follows local law where it is stricter.
- The Code and Standards bind members of CFA Institute, including charterholders, and candidates for the CFA designation, so a member who does not yet hold the charter can still be sanctioned.

QUICK CHECK**Question 1**

Moses Adeyemi, CFA, is told that the Professional Conduct staff have concluded that he violated the Code and Standards, and they propose a disciplinary sanction. If Adeyemi rejects the proposed sanction:

- A** he is automatically suspended from membership.

- B** the matter is referred to a disciplinary review panel for a hearing.
- C** the matter is closed unless a new inquiry is opened.

Answer: B

A member or candidate may accept or reject a sanction proposed by the Professional Conduct staff. If it is rejected, the matter is referred to a disciplinary review panel of CFA Institute members, which holds a hearing.

Why the other options are wrong

- **A.** Rejecting a proposed sanction does not trigger an automatic suspension; it leads to a hearing.
- **C.** Rejection does not end the matter; the existing case is referred to a disciplinary review panel of CFA Institute members for a hearing.

Key takeaway A rejected sanction goes to a hearing before a disciplinary review panel.

Practice questions

Question 2

Sven Adler, a CFA candidate, is making flash cards. He marks each duty "Code" if it is one of the six components of the Code of Ethics and "Standard" if it appears only in the Standards of Professional Conduct. Which of the following duties should Adler mark "Standard"? Members and candidates must:

- A** not engage in conduct that compromises the integrity or reputation of CFA Institute, the CFA designation, or its programs.
- B** place the integrity of the investment profession and the interests of clients above their own personal interests.
- C** promote the integrity and viability of the global capital markets for the ultimate benefit of society.

Question 3

Elena Varga, CFA, is a relationship manager at Northgate Wealth Partners. A prospective client asks whether Northgate can manage a portfolio of Indian equities. Varga has heard that her colleague Tomas Reyes might have managed Indian equities at a previous employer, and without checking she tells the prospect that Northgate has that expertise. Two days later she learns that Reyes has never managed Indian equities. She does not contact the prospect, who later opens an account with Northgate. Varga has:

- A** violated the Code and Standards both when she made the unverified claim and when she failed to correct it.
- B** violated the Code and Standards only by failing to correct her statement once she learned it was false.
- C** not violated the Code and Standards, because she did not intend to mislead the prospect.

Answers: 2. A · 3. A

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/code-of-ethics/. The full bank has 34 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 95

Knowledge of the Law

What you'll learn

LOS 95.a Apply the Code and Standards, in particular Standards I(A) Knowledge of the Law, I(B) Independence and Objectivity, I(C) Misrepresentation, I(D) Misconduct, and I(E) Competence, to situations involving professional integrity.

LOS 95.b Recommend practices and procedures (e.g., consulting counsel and dissociating, restricted lists, gift limits, background checks, continuing education) that prevent violations of the Code and Standards.

LOS 95.c Identify conduct that conforms to the Code and Standards and conduct that violates them.

MODULE 95.1

Guidance for Standards I(A), I(B), I(C), I(D), and I(E)

This reading covers Standard I, Professionalism: Knowledge of the Law, Independence and Objectivity, Misrepresentation, Misconduct and Competence. For each part a candidate must be able to explain what it requires, apply it to a fact pattern, and recommend practices and procedures that help prevent violations.

Standard I **Professionalism** has five parts: Standard I(A) **Knowledge of the Law**, Standard I(B) **Independence and Objectivity**, Standard I(C) **Misrepresentation**, Standard I(D) **Misconduct**, and Standard I(E) **Competence**. Questions on Standard I often bring in other Standards too, such as a trustee who trades on a tip or an adviser who never updates client data. Those related Standards are summarized in a table at the end.

LOS 95.a / 95.c — Standard I(A) Knowledge of the Law

KEY CONCEPT

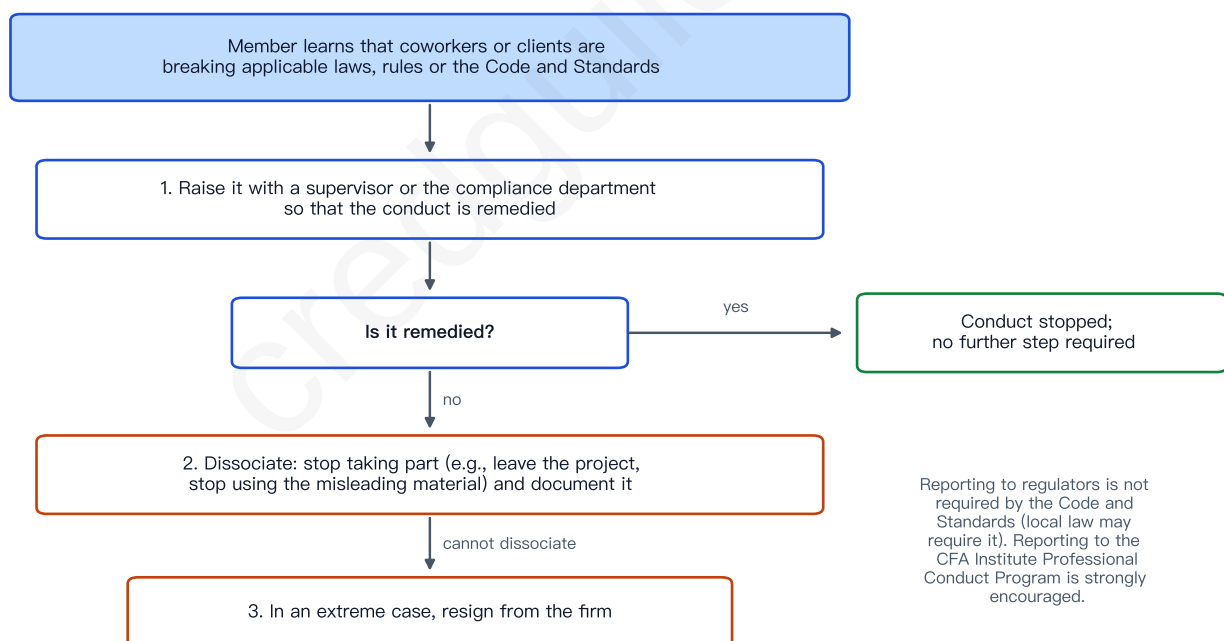
Members and candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

Guidance

- **Strictest rule wins.** The Code and Standards set a minimum level of professional conduct. A member compares the laws that apply to the activity (those of the country where he or she resides and of the country where the business is done, to the extent each governs it) with the **Code and Standards**, and follows whichever is strictest on each point. Where applicable law is weaker or silent, the Code and Standards govern, so a country with no securities law relaxes nothing.
- A member cannot use a permissive local rule to do something the Code and Standards forbid. If a market legally allows trading on **material nonpublic information**, a member still may not trade on it, either for clients or for his or her own account.
- **Knowledge of the law** means keeping current. Members need not be legal experts, but they must know the rules that govern their jobs, including new rules. Breaking an applicable rule the member did not know about is still a violation, even if a regulator's grace period allows the breach to be corrected without penalty. Relying

solely on the firm's compliance department is not enough.

- **Knowingly participating or assisting** includes looking the other way: a member who knows (or who is dealing with conduct whose illegality would be evident to anyone knowing the law) and takes no action to stop it or to dissociate can be treated as a participant. Senior management approval does not excuse a member. Passing the task to someone else, such as asking a supervisor to sign a document the member has refused to sign, is still assisting.
- **Reporting.** The Code and Standards do not require members to report wrongdoers to governmental or regulatory authorities, although local law may require it and reporting may be prudent. CFA Institute strongly encourages members to report potential violations of the Code and Standards by other members and candidates to the CFA Institute **Professional Conduct Program**.
- **Escalation path.** A member who learns that coworkers or clients are breaking applicable rules first goes to a supervisor or the compliance department to have the conduct remedied. If they will not or cannot fix it, the member must **dissociate** (e.g., stop working with a trading desk that allocates client trades unfairly, stop using marketing material the member knows or should know is misleading). In an extreme case, dissociation may mean resigning from the firm.
- Because the Code and Standards are themselves among the rules a member must obey, any violation of the Code and Standards is also a violation of Standard I(A).
- Standard I(A) covers the rules that govern **professional activities**. A scuffle at a recreational sports match or a traffic offense is personal conduct. It falls outside Standard I(A) and, for the same reason, outside Standard I(D) Misconduct (see below).



Staying silent while continuing to work with the people involved can itself be treated as participating or assisting.

What a member does on learning of a violation (Standard I(A))

Example: which rule applies?

Situation	Law where member resides	Law where business is done	Member must follow
Home law weaker than the Code; client country has no securities law	Weaker than Code	None	Code and Standards in both countries
Client country's disclosure rule is stricter than the Code	Weaker than Code	Stricter than Code	Client country's law for that business
Home country forbids gifts from issuers, and the ban covers its residents' business abroad; business country allows them	Stricter than Code	Weaker than Code	Home law (no gifts)
Home law is stricter than the Code but tells residents to follow local law for business done abroad; client country's law is weaker than the Code	Stricter than Code, but defers to local law abroad	Weaker than Code	Code and Standards

Recommended procedures (LOS 95.b)

- *When in doubt about legality:* consult a supervisor, compliance personnel or a lawyer (legal counsel).
- *When dissociating:* keep **records documenting the violation**, encourage the employer to bring it to an end, and remove one's name from documents one cannot stand behind.
- *Members (or their employers) should:* set up procedures that keep employees **informed of changes** in relevant laws, rules, and regulations; **review the written compliance procedures** regularly; and **maintain copies of current laws**, rules, and regulations.
- *Firms should:* have a **code of ethics**, give employees information on the laws, rules, and regulations that govern their professional activities, and have **procedures for reporting suspected violations**.

WORKED EXAMPLE: DISSOCIATING FROM A VIOLATION

A portfolio manager learns that her firm's trading desk regularly gives its best fills on block trades to a few large accounts, which breaks the firm's allocation rules and applicable regulation. She is not involved in the allocations, but her own clients' orders go through the desk. Explain what Standard I(A) requires of her and what she should do.

Step 1. Standard I(A) forbids knowingly participating or assisting in a violation of applicable laws, rules or regulations and requires dissociation from it. Looking the other way after learning of the practice could make her a participant.

Step 2. She takes the matter to her supervisor or the compliance department to have the conduct remedied.

Step 3. If they will not or cannot fix it, she must dissociate, for example by not working with the desk for her clients' trades. In an extreme case, dissociation may mean resigning from the firm.

Step 4. While dissociating, she keeps records documenting the violation and encourages the firm to bring it to an end.

Result. The Code and Standards do not require her to report the desk to a regulator, although local law may require it and reporting may be prudent; CFA Institute strongly encourages members to report potential violations by other members and candidates to the Professional Conduct Program.

LOS 95.a / 95.c — Standard I(B) Independence and Objectivity

KEY CONCEPT

Members and candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

Guidance

- *Gifts and entertainment.* Modest gifts and ordinary business entertainment are acceptable. The test is objective: whether the item could reasonably be expected to compromise judgment, whatever the member believes about her own resolve. The Standard does not require token items from non-clients to be reported to the employer, although firm policy may. Distinguish the source:
 - a gift from a client usually rewards past service and is considered less likely to impair objectivity. It may be accepted, but it must be disclosed to the employer, before acceptance if possible and otherwise afterward. Standard IV(B) Additional Compensation Arrangements requires written consent when the benefit is compensation tied to future performance;
 - a gift from a party seeking to influence the member (an issuer, a broker, a fund sponsor) calls for more caution.
- *Offering benefits.* The Standard covers giving as well as receiving. A manager competing for a university endowment's mandate who treats the chair of its investment committee to a weekend at a luxury resort violates Standard I(B), even if his own firm approved the cost as a marketing expense.
- **Pressure and inducements** to give a security a particular rating, to **select certain outside managers or vendors**, or to produce favorable (or unfavorable) research all threaten objectivity. A member who lets them shape the analysis violates the Standard. Allocating shares of an **oversubscribed IPO** to one's personal account violates this Standard and Standard III(B) Fair Dealing.
- *Sell-side and investment banking pressure.* Research must reflect the analyst's own view even when the firm's investment banking department has a relationship with the issuer. Firms separate research from banking with **firewalls**. When a firm does not want to issue a negative opinion on a banking client, it places the company on a **restricted list** and publishes only factual information, instead of issuing favorable opinions it does not hold. A banker may tell a prospective corporate finance client that the firm will cover the company, but may not promise favorable research: the analysts must stay free to reach their own conclusion.
- *Buy-side and issuer pressure.* Portfolio managers who hold a stock may lean on analysts not to downgrade; companies may threaten to cut off access. Neither is a reason to change a rating.
- **Issuer-paid research** is permitted if compensation is a **flat fee** (best practice: agreed before the report is written) that is not tied to the report's conclusions, recommendations, or market impact, and if the fact that the research is issuer-paid is disclosed.

- **Credit ratings.** Ratings from recognized agencies are not automatically objective; members should consider the conflicts of interest in the rating process and may need independent research to judge a rating's soundness.
- **Using outside research.** A member may rely on third-party research (another firm's reports, a data vendor, a model licensed from outside) after a **reasonable and diligent review** of its assumptions and soundness. Nothing requires a member to use only his own or his firm's research.
- **Other pressures** include fund manager and custodial relationships, credit rating agency work, performance measurement, and the member's own holdings in a covered stock (disclose them).

Recommended procedures (LOS 95.b)

- **Members:** pay (or have the firm pay) for travel to company events when practicable; limit use of corporate aircraft to trips where commercial travel is not an alternative.
- **Firms:** **restrict employee participation in IPOs and private placements** and require **pre-approval** for participation; appoint a **compliance officer**, have **written policies on independence and objectivity**, and establish clear procedures for reporting violations; allow only **token items** as gifts from anyone other than clients.

LOS 95.a / 95.c — Standard I(C) Misrepresentation

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

Guidance

- **Misrepresentation** includes knowingly misleading investors, **omitting relevant information**, **presenting selective data** to mislead, and **plagiarism**.
- Typical violations: presenting third-party research as one's own; guaranteeing a specific return on securities not explicitly guaranteed by a government body or financial institution; picking the **valuation service** that assigns the highest values to untraded holdings; choosing a **benchmark** that is not comparable to the strategy; performance or attribution data that **omit accounts** or relevant variables; false or misleading claims about the experience, expertise or capabilities of the analyst or the firm; and using misleading **third-party marketing materials**.
- **Services and qualifications.** Members must not overstate their own experience, credentials, or their firm's capabilities. Telling a client "our firm can handle all your needs" is acceptable if it is true, based on the firm's actual capabilities and the client's facts. A trainee claiming years of experience in areas she does not cover is a violation. Claiming a degree before it has been awarded (for example, by handing out business cards that show it) is a violation. Ordering cards to use once the degree is awarded is not.
- **Guarantees.** Accurately describing an instrument that really is guaranteed by a government body or financial institution (e.g., a government-backed bond) is not a misrepresentation. An opinion ("I think this stock looks attractive") is not a guarantee.
- **Keeping information current.** If a member is responsible for a firm website or marketing material, outdated or inaccurate content that clients rely on is a misrepresentation. An honest slip, such as a misplaced decimal point in a published report, is not a knowing misstatement when it is made. Once the member discovers it, she must stop its circulation and correct it promptly, because continuing to circulate it after that point would be a knowing misrepresentation.

- **Plagiarism** means taking charts, graphs, spreadsheets, models, forecasts, reports, ideas or quotations that others created and using them without **crediting the source**. Quotations attributed to "leading analysts" without naming them, and slightly reworded excerpts from another analyst's report used without credit, are plagiarism. Exception: projections, statistics, and tables from **recognized financial and statistical reporting services** (factual data such as government bond yields or published index levels, as distinct from someone's analysis or opinion) may be used without citation. Models or research developed by colleagues at the member's own firm may be used, and the names of colleagues who have left may be omitted, as long as the member does not present that earlier work as solely his own.
- Forecasts or statistics by others used with the source named but with their original qualifications stripped out still mislead.

Recommended procedures (LOS 95.b)

- *Members*: prepare a summary of their own experience, qualifications, and the services they can perform; cite the source of any summaries of others' material; **keep copies of all reports, articles, and other materials** used in preparing research; encourage employers to **verify marketing materials provided by third parties**.
- *Firms*: provide a written list of the firm's available services and qualifications, and **periodically review** employees' documents and communications (including websites) to catch any misstatement of the qualifications and capabilities of employees or the firm.

LOS 95.a / 95.c — Standard I(D) Misconduct

Members and candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

Guidance

- Any professional conduct involving **dishonesty, fraud, or deceit** is a violation: lying under oath (perjury) in a case involving the firm, padding expense reports, falsifying a résumé, making promises the member knows cannot be kept.
- The Standard applies only to conduct in **professional activities**; acts outside a member's professional capacity are not addressed by it. Professional activities include dealings with clients, employees, and coworkers; activities as a member, charterholder, or candidate; volunteer work for a CFA society or CFA Institute; attending industry events, meetings, or courses; writing about investments (articles, reports, message boards) even outside the workplace; and communications with regulators and professional organizations.
- Misconduct can involve legal as well as illegal acts. Behavior that impairs the ability to perform professional duties, such as **excessive drinking during business hours** or coming to work intoxicated, violates the Standard. So does failing to act when professional obligations require it, such as **neglecting due diligence** on a recommendation.
- Not every illegal act is misconduct: **civil disobedience** (such as being arrested at a peaceful protest) is generally not a violation because it does not reflect on honesty, integrity, or competence. **Personal bankruptcy** is not a violation unless fraudulent or deceitful professional conduct was part of the circumstances.
- Members must not use enforcement of this Standard to settle personal, political, or other disputes unrelated to professional ethics or competence.

Recommended procedures (LOS 95.b)

Firms should adopt a **code of ethics** that states plainly that unethical behavior will not be tolerated, provide employees with a **list of potential violations and sanctions** (up to dismissal), and **check references** of potential employees (background checks on character and eligibility to work in the industry). Such checks are a recommended practice and do not breach any privacy obligation under the Code.

LOS 95.a / 95.c — Standard I(E) Competence

Members and candidates must act with and maintain the competence necessary to fulfill their professional responsibilities.

Guidance

- **Competence** means having, and keeping up, the knowledge, skills and abilities that the member's professional responsibilities require.
- What counts as competent depends on the role the member takes on.
- When a member accepts a new or unfamiliar role, it is the member's own responsibility, not the employer's, to develop the abilities, skills, and knowledge the role calls for.
- **Continuing education** is recommended. The Standard does not require it.
- A poor outcome does not by itself show a lack of competence. A recommendation that turns out badly, made with reasonable analysis, violates neither I(E) nor V(A) Diligence and Reasonable Basis.

Recommended procedures (LOS 95.b)

Ways to maintain competence include continuing education, professional development and employer-provided training; earning professional designations; going to relevant seminars and conferences; joining professional organizations; and informal self-study.

Related Standards that appear in the same fact patterns

Each of these Standards has its own module with the full guidance. The table gives only the points that the questions in this module rely on.

Standard	Key point when it appears alongside Standard I
II(A) Material Nonpublic Information	Do not act or cause others to act until the information is public (a magazine article out "tomorrow" is still nonpublic; news given on a conference call to analysts is not public until the announced press release). The recommended response is to make reasonable efforts to achieve public dissemination of the information by the company. The mosaic theory permits conclusions built from public information plus nonmaterial nonpublic information (e.g., executives' travel). The Standard applies to anyone who possesses such information, however it was obtained (overheard, read in a spouse's papers). Firms prevent misuse with firewalls (control of interdepartmental information), watch or restricted lists and review of trading.

Standard	Key point when it appears alongside Standard I
III(A) Loyalty, Prudence, and Care	Duty is to the ultimate beneficiaries: for a pension plan, the plan participants and beneficiaries, not the sponsor or the company paying the adviser. Proxy voting must be informed and in clients' interests (not rubber-stamped with management, and not passed to a sponsor when the manager has been given voting authority). Soft dollars: client brokerage must be used to benefit the client, so it may pay for research that benefits the client but never for the manager's own operating expenses. Governance and soft-dollar issues fall under this Standard. Because of cost-benefit considerations, it may not be necessary to vote every proxy.
III(B) Fair Dealing	Do not use hot-issue allocations to reward, placate or retain a client; offer a new issue to every client for whom it is suitable and prorate it if it is oversubscribed. Disseminate recommendation changes through a system designed to treat all clients fairly (fair, not necessarily simultaneous); never tip selected colleagues, analysts or journalists first. An issuer should release material news by press release, not to favored analysts. A client's order that goes against the current recommendation may be executed after the client is told of the recommendation. A family member's fee-paying account in which the member has no beneficial interest is treated like any other client account, neither favored nor excluded, including in the order of trades under VI(B).
III(C) Suitability	Reasonable inquiry into the client's investment experience, objectives (risk <i>and</i> return) and constraints before acting, reassessed and updated regularly (not only when something changes). A process that looks only at the probability of reaching a return target ignores risk tolerance. Suitability is judged for the portfolio as a whole, not security by security; update the policy statement when circumstances change (e.g., the client sells the concentrated holding that a hedge was built around).
III(D) Performance Presentation	Performance must be fair, accurate and complete: presenting one account's results as representative of all accounts is a violation. Recommended practice: present a weighted composite of similar portfolios, include terminated accounts and state when they were terminated, and disclose whether results are gross or net of fees.
III(E) Preservation of Confidentiality	Keep information about current, former and prospective clients confidential; for example, never pass client names to a charity, however worthy. Cooperating with an investigation by the CFA Institute Professional Conduct Program is permitted.
IV(A) Loyalty	Employer's models and records are employer property; copying them without permission is a violation, even if the employer no longer uses them. Honor legal and confidentiality agreements with former employers. While still employed, a member may prepare to compete (register a firm, sign a lease) but must not solicit clients or take records; after leaving, and absent a non-compete agreement, former clients may be contacted using memory and public sources. Giving the employer a copy of the Code and Standards is recommended, not required.
IV(B) Additional Compensation Arrangements	Written consent from all parties involved before accepting compensation, such as board fees and options, that competes with or could create a conflict with the employer's interest.

Standard	Key point when it appears alongside Standard I
IV(C) Responsibilities of Supervisors	A supervisor needs adequate compliance procedures; if the firm will not adopt them, the member should decline in writing to accept supervisory responsibility until it does. Missing procedures (e.g., none for allocating block trades) are a supervisory failure.
V(A) Diligence and Reasonable Basis	Recommendations need a reasonable and adequate basis; extrapolating a manager's offhand conjecture into a published claim fails this test, and so does changing a rating on a colleague's unfinished notes. A thoroughly researched quantitative model that the manager understands is a reasonable basis; applying a model one does not understand is a diligence failure. A poor outcome, or a later restatement by the issuer, does not by itself show a lack of diligence.
V(B) Communication with Clients and Prospective Clients	Disclose the basic format and general principles of the investment process and promptly disclose changes that could materially affect it (e.g., a new valuation method, or managers overriding a quantitative model with their own research). Routine refinements of a model need not be disclosed one by one. Distinguish fact from opinion.
VI(A) Avoid or Disclose Conflicts	Disclose board seats, stock options and similar interests to the employer and clients. The firm's market-making activity in a security and board seats held by the firm's principals must be disclosed in research and to clients. Personal matters such as a bankruptcy need disclosure only if they create a conflict.
VI(B) Priority of Transactions	Client and employer trades come before trades in which the member has beneficial ownership. Firms may require duplicate confirmations and pre-clearance; they need not collect the holdings of employees' friends. Order: clients first, then the employer's own account, then the member's personal account. A family member's fee-paying client account ranks with other clients (see III(B)). The member may own the same securities as clients, as long as client trades come first.
VI(C) Referral Fees	Disclose referral fees to the employer, clients and prospects; where local law bans them outright, the stricter rule (the ban) governs.
VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program	Members must sign the Professional Conduct Statement and pay dues each year; a member who does not is no longer an active member, so presenting the CFA designation as current would misrepresent membership. A true statement, such as having completed the CFA Program in three years, is acceptable; claiming superior ability because of it is not. No form of the designation (e.g., "CFA in waiting") before the charter is awarded — state facts such as the levels passed. Refer to someone as a CFA candidate only while he or she is registered for a CFA exam or awaiting its results. Statements that the charter reflects commitment to ethics are fine; implying superior performance is not.

Common exam traps across the reading

- "The Code and Standards apply only where the law is silent" is wrong.

- Most items turn on a single fact in the stem, such as commercial travel being unavailable, information already being public, or a statement being based on fact.

BOTTOM LINE

- Under Standard I(A), a member compares the applicable laws with the Code and Standards and follows whichever is strictest on each point, so where applicable law is weaker or silent the Code and Standards govern.
- A member who learns that coworkers or clients are breaking applicable rules goes to a supervisor or the compliance department to have the conduct remedied and, if it is not remedied, must dissociate, which in an extreme case may mean resigning.
- The Code and Standards do not require a member to report wrongdoers to governmental or regulatory authorities, although local law may require it.
- Under Standard I(B), modest gifts and ordinary business entertainment are acceptable, the test being whether an item could reasonably be expected to compromise independence and objectivity, and a gift from a client may be accepted but must be disclosed to the employer.
- Issuer-paid research is permitted if the compensation is a flat fee not tied to the report's conclusions, recommendations or market impact and the issuer payment is disclosed.
- Under Standard I(C), misrepresentation covers plagiarism, selective data presented in order to mislead, the omission of relevant information and any knowing attempt to mislead investors, but factual data from recognized financial and statistical reporting services may be used without citation.
- Standard I(D) covers only professional conduct: dishonesty, fraud or deceit violates it, while civil disobedience is generally not a violation and personal bankruptcy is not one unless fraudulent or deceitful professional conduct was involved.
- Under Standard I(E), the member, not the employer, is responsible for developing the competence a new role requires, and continuing education is recommended but not required.

QUICK CHECK

Question 1

After 18 years with a large Toronto asset manager, Lionel Batiste, CFA, sets up his own advisory firm in Port Aurelia, a jurisdiction whose securities rules are far weaker than both Canadian law and the CFA Institute Standards of Professional Conduct. Most of his clients are Canadian residents who moved their accounts to the new firm, and Canadian law continues to apply to his dealings with them. Batiste finds that Port Aurelia rules would let him skip several client disclosures that he always had to make in Canada. According to the Code and Standards, Batiste must follow:

- A** Port Aurelia rules, provided he tells his Canadian clients where they differ from Canadian law.
- B** the Code and Standards in every case, because as a charterholder he answers only to them.
- C** whichever is stricter of the Code and Standards and Canadian law.

Answer: C

Under Standard I(A) Knowledge of the Law, when applicable laws and the Code and Standards differ, members must follow the strictest requirement: the law where they live, the law where they do business (including the law governing their clients' accounts), or the Code and Standards. Because Canadian law still governs his dealings with Canadian clients, Batiste must meet the stricter of Canadian law and the Code and Standards.

Why the other options are wrong

- **A.** Moving to a less strict jurisdiction does not lower the standard. Disclosing the differences to clients does not allow a member to follow a weaker rule.
- **B.** The Code and Standards are a minimum, not the only rule. If applicable law (here, Canadian law) is stricter on a point, the member must comply with that law as well.

Key takeaway When several rule sets apply, follow the strictest one. Moving offshore never lowers the bar.

Practice questions

Question 2

Irene Vautrin, CFA, has managed domestic large-cap equity portfolios for ten years. Her firm asks her to take over its frontier-market bond fund next month, an asset class she has never analyzed. Which response is *most consistent* with Standard I(E) Competence?

- A** Take responsibility for building the knowledge and skills the new role requires.
- B** Accept the role and rely on the firm to provide any training it considers necessary.
- C** Decline the role, because the Standard does not allow members to change asset classes.

Question 3

Hana Petrov runs an independent advisory practice with 140 individual clients. When she takes on a new client, she collects the information she needs to make recommendations, such as the client's tax situation, income, spending needs, and willingness to take risk. With respect to this client information, the Standards require Petrov to:

- A** update it only when she makes a material change to the client's portfolio.
- B** reassess and update it on a regular basis.
- C** update it only after learning of a material change in the client's circumstances.

Question 4

While looking for a file on her firm's shared drive, Nadia Petrova, an equity analyst, opens a colleague's half-finished draft notes on a retailer that Petrova covers. After reading them, and without doing any further work, Petrova immediately changes her own recommendation on the retailer from sell to buy. Which Standard has Petrova violated?

- A** Standard V(A) Diligence and Reasonable Basis.
- B** Standard I(B) Independence and Objectivity.
- C** Standard III(A) Loyalty, Prudence, and Care.

Question 5

Marguerite Olsen has worked as an independent financial adviser for 20 years. She was awarded the CFA charter in 2011 but has not paid this year's CFA Institute dues because she feels the designation brings her little business, so her membership has lapsed. She still has several boxes of business cards printed with "CFA" after her name, and her brochures state that she completed the CFA Program in three years, which is true. Olsen:

- A** must stop handing out the cards that show the CFA designation, but may keep using the existing brochures.
- B** must stop handing out both the cards that show the CFA designation and the existing brochures.
- C** may keep using the existing brochures, and may hand out the cards until they run out, provided new cards omit the designation.

Answers: 2. A · 3. B · 4. A · 5. A

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/knowledge-of-the-law/. The full bank has 141 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 96

Material Nonpublic Information

What you'll learn

LOS 96.a Apply Standard II(A) Material Nonpublic Information and Standard II(B) Market Manipulation to situations involving professional integrity.

LOS 96.b Recommend practices and procedures (public dissemination, firewalls, restricted and watch lists, trading review) that prevent violations of Standard II.

LOS 96.c Identify conduct that conforms to, and conduct that violates, Standards II(A) and II(B).

MODULE 96.1

Guidance for Standards II(A) and II(B)

This reading covers Standard II, Integrity of Capital Markets, with its two parts, Material Nonpublic Information and Market Manipulation. A candidate must be able to apply both to a fact pattern, including the tests of materiality and of public dissemination and the mosaic theory, recommend procedures such as firewalls that prevent violations, and tell conduct that conforms from conduct that violates.

Standard II protects the **integrity of capital markets**: prices should reflect information that all investors can obtain, and trading activity should be genuine. It has two parts, **Standard II(A) Material Nonpublic Information** and **Standard II(B) Market Manipulation**. The three LOS cover applying the two Standards to a fact pattern (96.a), the procedures that prevent violations (96.b), and sorting conduct into "conforms" and "violates" (96.c).

LOS 96.a — Applying Standards II(A) and II(B) to fact patterns

Standard II(A) Material Nonpublic Information

Members and candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

The rule exists because investors take part in markets only if they believe everyone trades on the same public information. If insiders could profit from what others cannot know, markets would look rigged, investors would commit less capital and prices would reflect information less well.

The prohibition applies only when the information passes both tests:

KEY CONCEPT

Test	Question to ask	Passes when...	Fails when...
Material	Would disclosure move the price, or would a reasonable investor want to know it before investing?	Earnings results or guidance, mergers and tender offers , big contracts won or lost, significant litigation, regulatory decisions, dividend changes, a sudden change in a widely followed analyst's recommendation	The information is vague or ambiguous as to its price effect (e.g., only that two people met), so it may not be material; the less reliable the source, the less likely the information is material

Test	Question to ask	Passes when...	Fails when...
Nonpublic	Has it been disseminated to the marketplace in general ?	Only insiders, a few analysts, or a closed group know it	It has been released broadly (press release, regulatory filing, general newswire)

Points to apply:

- **Selective disclosure** is not public disclosure. When a company releases information to a chosen few, it creates the risk that those who receive it will trade on it. Telling a group of analysts on a conference call, a roadshow audience or a small investor group leaves the information nonpublic for everyone who heard it.
- *The source does not matter.* Information overheard at a restaurant, passed on by a relative or a housekeeper, or supplied by an outside party such as a supplier or plaintiff is still covered. The Standard applies whether or not the insider breached a duty and whether or not the information was **misappropriated**. Once a member knows the information is material and nonpublic, the member may not act on it.
- **"Act or cause others to act"** covers trading for oneself, for clients, for the employer and for family members. It also covers accepting and executing an order from someone the member knows is trading on the information, and recommending or tipping.
- *Indirect trades are still trades.* The prohibition covers the security itself, **mutual funds** and exchange-traded funds that hold it, and related **swaps** and **options** contracts. Buying funds that hold the affected stock (and shorting similar funds that do not) is still acting on the information.
- *Check before acting.* The member is responsible for finding out whether information has been publicly disseminated before acting on it or causing others to act on it.
- *Information received for a deal.* Members involved in transactions such as investment banking assignments may receive material nonpublic information from the firms involved. They may use it for the purpose for which it was provided (working on the deal) and for no other purpose until it becomes public.
- *Wait for public dissemination.* The prohibition lasts until the information has been made public. Until then, trading on it, publishing a report on it and telling clients are all prohibited.
- *Possession alone is not a violation.* Analysts often receive nonpublic information by accident or in the course of their work. The violation is acting on it or causing others to act.
- *Knowing that an item is false can itself be material nonpublic information.* If only one person knows that a market-moving statement is fake, that knowledge is material and nonpublic.

The mosaic theory

Under the **mosaic theory**, an analyst may reach a conclusion by combining **public information** with **nonmaterial nonpublic information** and may act on that conclusion even if the conclusion itself would be material had the company disclosed it. Channel checks with suppliers and customers, counting inventory in a parking lot, reading trade publications and noticing where executives travel are all legitimate research. The mosaic theory never permits using an item that is itself material and nonpublic.

Which information may a member act on?

	Public	Nonpublic
Material	May act (e.g., earnings in a press release)	May not act or cause others to act until it is public
Nonmaterial	May act	May act; a usable input to a mosaic conclusion (e.g., a count of trucks at a plant)

Analysts should keep records of the research behind a mosaic conclusion.

Standard II(B) Market Manipulation

Members and candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

The Standard is broken in two ways: by spreading false information to affect prices or volume, and by making trades intended to mislead market participants.

KEY CONCEPT

Conduct

Spreading false or misleading information to affect prices or volume

Trades intended to mislead market participants

Examples

False rumors or fabricated posts on social media; overstating an earnings projection to lift a price; promoting a stock one holds with false claims; misrepresenting a product or technology

Matched buy and sell orders between related accounts to inflate volume; buying a dominant position in an asset to move the price of a related **derivative** (or the reverse)

The deciding element is the **intent to mislead**; whether the member profits does not matter. A member's trades can legitimately move prices and volume, and that alone is not a violation. The Standard is violated when the trading or the information is intended to mislead. Conduct with no such intent includes trading strategies that exploit differences in market power, information or other **market inefficiencies**, transactions made for tax purposes (e.g., selling for a tax loss while holding a synthetic long position), and **block trades** used to limit the price impact of a large order in a thinly traded security.

Example. A trader holds a large short position in a small biotech stock and then posts invented reports of a failed clinical trial. The short position alone is legitimate. The false posts violate Standard II(B), because they spread false information to move the price. The trade itself was not intended to mislead anyone, so it is not a violation.

LOS 96.b — Procedures that prevent violations

Recommendations for members and candidates who hold material nonpublic information:

- Make reasonable efforts to achieve **public dissemination** of the information by the company (for example, encourage the issuer to announce it).

- Encourage their firms to adopt procedures that prevent the misuse of material nonpublic information.

Recommendations for firms. The core control is a **firewall** (information barrier) between departments that receive inside information (investment banking, corporate finance) and sales, trading and research. Its elements:

KEY CONCEPT

Firewall element	What it does
Clearance area (compliance or legal department)	Exercises substantial control over communications between departments; any necessary contact across the wall is cleared and documented there
Review of employee trades	Pre-clearance and reporting of personal trades, so trading on inside information is detected
Watch, restricted and rumor lists	A watch list lets compliance quietly monitor trading in securities the firm has sensitive information about; a restricted list prohibits or limits trading in them; a rumor list tracks securities that are the subject of market rumors
Monitoring and restricting proprietary trading	Limits the firm's own trading while it holds material nonpublic information

A blanket ban on all proprietary trading in a security whenever the firm holds inside information may itself be inappropriate, because the sudden absence of the firm's usual trading can signal the information to the market. In such cases the firm should only take the opposite side of **unsolicited customer trades**.

Other good practice includes written procedures and training on what counts as material and nonpublic information.

LOS 96.c — Conduct that conforms vs. conduct that violates

The points under LOS 96.a already sort most conduct into the two groups. Two further contrasts:

Conforms	Violates
Declining an order from an insider who reveals an unannounced takeover	Executing that order because it is "for the insider's children"
Exploiting genuine pricing inefficiencies	Inventing a warning to move futures prices and then trading against it

COMMON EXAM TRAPS

- Standard IV(A) Loyalty concerns duties to the employer (independent practice, leaving an employer, whistleblowing). Trading on an inside tip because a supervisor ordered it violates II(A); it is not a loyalty violation.

EXAM SHORTCUTS

- Under Standard II(B), whether the member profited does not matter; the deciding element is the intent to mislead, so a trade that merely moves the price is not a violation without it.

BOTTOM LINE

- Standard II(A) applies only when information is both material, meaning disclosure would move the price or a reasonable investor would want to know it, and nonpublic, meaning it has not been disseminated to the marketplace in general.
- Selective disclosure, such as telling a group of analysts on a conference call or a roadshow audience, leaves the information nonpublic for everyone who heard it.
- Acting or causing others to act on material nonpublic information includes trading for oneself, clients, the employer or family members, executing an order from someone known to be trading on it, recommending or tipping, and trading related funds, swaps or options, while possession alone is not a violation.
- Under the mosaic theory, an analyst may act on a conclusion drawn from public information and nonmaterial nonpublic information even if the conclusion would be material had the company disclosed it, but never on an item that is itself material and nonpublic.
- Standard II(B) is violated by spreading false or misleading information to affect prices or volume, or by trades intended to mislead market participants.
- Strategies that exploit market inefficiencies, transactions made for tax purposes and block trades used to limit price impact are not manipulation when they carry no intent to mislead.
- A member who holds material nonpublic information should make reasonable efforts to achieve public dissemination of it by the company.
- The firm's core control is a firewall, with a clearance area, review of employee trades, watch, restricted and rumor lists, and monitoring and restriction of proprietary trading.

QUICK CHECK**Question 1**

Adaeze Okafor, CFA, is a broker. The chief executive of Stellan Pharmaceuticals, a listed company, telephones her and asks her to buy Stellan shares for trust accounts he set up for his grandchildren, remarking that the purchase will look very smart "once the merger we're negotiating is announced." Okafor searches news services and finds no public mention of a merger. Okafor should:

- A** execute the order, because Standard III(B) Fair Dealing requires her to treat all client orders alike.
- B** execute the order, because the shares are for the grandchildren's accounts rather than the executive's own.
- C** decline the order, because executing it would mean acting on material nonpublic information.

Answer: C

A pending merger is material, and Okafor has confirmed it has not been made public. Executing the trade would mean acting (and helping the insider act) on material nonpublic information, which Standard II(A) prohibits: Members and Candidates must not act or cause others to act on such information.

Why the other options are wrong

- **A.** Fair Dealing is about treating clients fairly when disseminating recommendations and executing trades; it never requires a member to execute a trade that violates Standard II(A).
- **B.** Whose account benefits is irrelevant: buying for trusts set up for family members on the strength of inside information is still acting on material nonpublic information, and no duty to a client overrides Standard II(A).

Key takeaway Once a client reveals material nonpublic information behind an order, the member may not execute it. The identity of the account holder does not change that.

Practice questions

Question 2

Colette Brenner is convinced that Lunaris Robotics is overvalued, and three weeks ago she sold short 60,000 Lunaris shares. This week she has been posting false, damaging claims about Lunaris's management on several investment message boards. Under Standard II(B) Market Manipulation, Brenner's conduct is:

- A** a violation through the false claims, but not through her trade.
- B** a violation through both her trade and the false claims.
- C** a violation through her trade, but not through the false claims.

Question 3

Tobias Engel, an investment analyst, has gathered several items of nonpublic information through his contacts at medical device makers. None of the items is material on its own, but by putting them together he correctly concludes that one of the companies will report much higher earnings than expected next year. According to the CFA Institute Standards of Professional Conduct, Engel:

- A** cannot legally trade or make recommendations based on this conclusion.
- B** may use the conclusion in his investment recommendations and decisions.
- C** may use the conclusion only after a compliance officer has approved it.

Answers: 2. A · 3. B

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/material-nonpublic-information/. The full bank has 32 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 97

Duties to Clients

What you'll learn

LOS 97.a Apply Standard III (loyalty, prudence and care; fair dealing; suitability; performance presentation; confidentiality) to situations involving professional integrity.

LOS 97.b Recommend practices and procedures that prevent violations of Standard III.

LOS 97.c Identify conduct that conforms to Standard III and conduct that violates it.

MODULE 97.1

Guidance for Standards III(A), III(B), III(C), III(D), and III(E)

This reading covers Standard III, Duties to Clients: Loyalty, Prudence, and Care; Fair Dealing; Suitability; Performance Presentation; and Preservation of Confidentiality. A candidate must be able to apply each duty to a fact pattern, recommend procedures for compliance, and tell conduct that conforms from conduct that violates.

Standard III sets out what members and candidates owe the people whose money or information they handle. Five Standards sit under it: Standard III(A) **Loyalty, Prudence, and Care**, Standard III(B) **Fair Dealing**, Standard III(C) **Suitability**, Standard III(D) **Performance Presentation**, and Standard III(E) **Preservation of Confidentiality**. The three LOS cover applying them to fact patterns (97.a), recommending compliance procedures (97.b) and separating conduct that conforms from conduct that violates (97.c).

LOS 97.a — Applying the five duties to clients

III(A) Loyalty, Prudence, and Care

Members and candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

The Standard does not create a **fiduciary duty** where none already exists. It does require acting in the client's best interest and recommending products that suit the client's investment objectives and risk tolerance, with the prudence, care, skill and diligence that a person acting in a similar role and familiar with such matters would use under the circumstances.

- **Governing documents and total portfolio.** Manage pooled client assets according to the governing documents (trust documents, investment management agreements), and make decisions in the context of the **total portfolio**.
- **Disclose limitations.** Tell clients about any limits on the advisory relationship (e.g., an adviser who may recommend only her own firm's products).
- **Identify the client.** For a pension plan, the duty runs to the **plan participants and beneficiaries**. The sponsoring company, its management and its shareholders are not the client. In some roles the "client" is the **investing public as a whole** rather than a specific person. For a pooled fund, decisions serve the fund's investors as a whole, in line with the fund's mandate, rather than each investor's individual needs.
- **Diversification.** A prudent manager of retirement assets keeps the portfolio properly diversified. Holding some of the sponsor's own stock is not banned; concentrating the plan in it at management's request is imprudent.

- **Client brokerage** (the commissions generated by client trades, also called **soft dollars** or **soft commissions**) is an **asset of the client**, because the client's trades pay for it. It must be used to benefit the client, e.g., to buy research that assists the manager in managing client accounts, and the arrangement should be disclosed to the client. Using it for research relevant only to the manager's own holdings, or for personal benefits the member could not otherwise obtain, breaches the duty.
- **Best execution**: seek the most favorable terms reasonably available for each trade. A trader who only executes client orders may owe no fiduciary duty, but the Standard still applies: in that role, loyalty and care mean seeking best execution on each order.
- Trading a client's account more often than its objectives require, in order to generate commissions for the member or the firm, puts their interests ahead of the client's and violates the Standard.
- **Directed brokerage**: when a *client* instructs that its trades go to a particular broker, following the instruction is acceptable because the brokerage belongs to the client. The member should disclose that best execution may not be achieved.
- **Proxy voting**: proxies have economic value, so they must be voted in an informed, responsible way in the clients' interest. Management's wishes do not decide the vote. A **cost-benefit analysis** may show that voting a particular proxy is not worthwhile, so voting every proxy is not required.
- **Trade errors**: a broker that absorbs the cost of its own trading error, with no implied promise of future business, raises no issue.

III(B) Fair Dealing

*Members and candidates must deal **fairly and objectively** with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.*

Fair treatment is not the same as equal treatment. Firms may offer different **levels of service** (e.g., a premium research tier for a fee) as long as the tiers are disclosed to all clients and prospects, are available to anyone willing to pay for them, and do not disadvantage any client. Differences in when e-mails or other messages happen to arrive are a normal part of business.

- Do not discriminate among clients when disseminating recommendations. Delivery channels may differ: e-mail to clients who supplied an address and same-day post to the rest is fair. The duty is owed to clients, so a firm may keep its research for its clients and need not release it to the public.
- Give every client a fair opportunity to act on each recommendation. A client unaware of a changed recommendation should be told of the change before an order for that security is accepted.
- Treat individual and institutional clients fairly and impartially. A member must not exploit his or her position in the industry at clients' expense (e.g., by taking shares of an oversubscribed IPO for personal accounts).
- Clients may not be ranked by account size, fees or trading volume for the order in which they hear of recommendation changes or receive fills.
- **Trade allocation**: when an order is only partly filled or filled in blocks at different prices, allocate **pro rata** (in proportion to each account's order size) across all accounts for which the trade is suitable, at the same average price. Allocation by alphabet, fee level or other arbitrary rule is unfair. So is waiting to see which fills have gained before deciding which accounts get them.
- Tipping portfolio managers of discretionary accounts before the report reaches other clients favors some clients over others. Acting on the tip is also a violation.

Example. A manager's block order for a stock fills in three lots of equal size at \$41.10, \$41.30 and \$41.50. Fair Dealing requires every participating account to receive its pro rata share of all three lots at the average price of \$41.30. Giving the cheapest lot to favored clients would be a violation.

Example. A downgrade goes to every client at the same time. That afternoon the analyst who wrote it walks the firm's largest institutional clients through the report by phone, a service they pay for under the firm's disclosed premium tier. This is fair dealing, because everyone received the recommendation first. If she had told those clients that her private view was less negative than the published one, she would violate Standard III(B): they would be acting on a recommendation that other clients never received.

III(C) Suitability

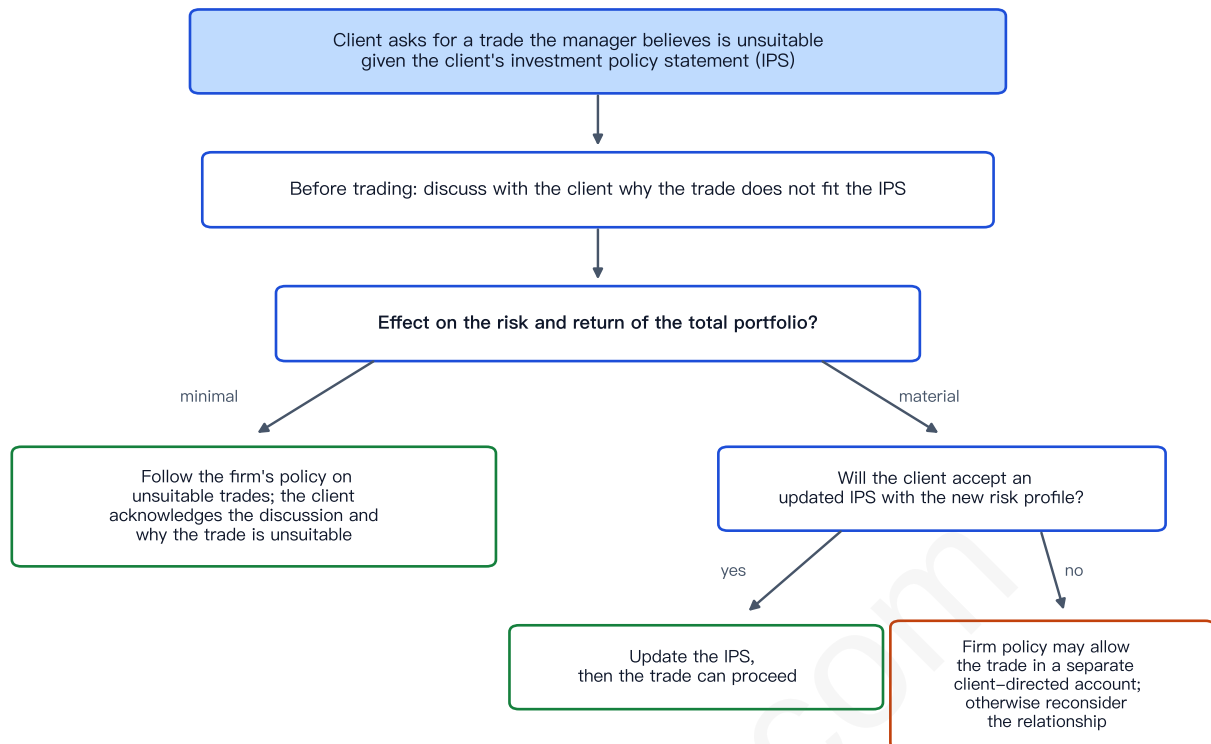
KEY CONCEPT

1. When members and candidates are in an **advisory relationship** with a client, they must: a) Make a **reasonable inquiry** into a client's or prospective client's investment experience, **risk and return objectives**, and **financial constraints** prior to making any investment recommendation or taking investment action and must reassess and update this information regularly. b) Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, **mandates**, and constraints before making an investment recommendation or taking investment action. c) Judge the suitability of investments in the context of the client's **total portfolio**. 2. When members and candidates are responsible for managing a portfolio to a specific **mandate, strategy, or style**, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

- The financial constraints cover liquidity needs, expected cash flows, time horizon, tax, and legal and regulatory circumstances. The information is usually documented in an **investment policy statement (IPS)** gathered at the start of the relationship, and it is reassessed regularly and whenever circumstances change.
- Consider whether the use of **leverage** is suitable for the client.
- Because suitability is judged for the portfolio as a whole, a volatile holding can suit a moderate-risk client if it lowers the risk of the total portfolio.

Under part 2, a fund whose mandate admits only dividend-paying stocks may not buy a non-dividend growth stock, however attractive. The manager of such a fund judges investments against the fund's mandate. Whether the fund suits an individual investor is the concern of the adviser who recommends it.

Unsolicited trade requests that look unsuitable: the member does not execute the trade until he or she has discussed with the client why it does not fit the IPS. If the effect on the total portfolio's risk/return profile is minimal, the member may then follow the firm's policy on unsuitable trades; the client must acknowledge the discussion and why the trade is unsuitable. If the effect is material, the client may agree to revise the IPS and accept the changed risk profile. If the client will not, firm policy may allow the trade in a separate **client-directed account**. Failing other options, the member may need to reconsider the relationship.



Handling an unsolicited trade request that looks unsuitable (Standard III(C))

III(D) Performance Presentation

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

- The Standard covers oral as well as written performance communications.
- The same facts often breach Standard I(C) Misrepresentation too, which counts selective performance data and results that omit accounts among its violations. Standard III(D) is the Standard aimed specifically at performance communications.
- Do not present a new fund's "history" built from the past returns of assets it now holds, or from other accounts, as if the fund itself had earned it.
- Do not cherry-pick. A list of winning picks misrepresents results unless it is the complete list, however accurate each return on it is.
- A firm's stated rules on which accounts enter a composite, and from what date, apply to every account alike; bringing an account in early or leaving one out because of its results misstates performance.
- Adhering to the Global Investment Performance Standards (GIPS) is voluntary, but a claim of GIPS compliance that the firm's calculations do not support misleads clients and prospects about its performance and violates the Standard.
- Do not turn a single fund's or single period's result into a claim about the firm's typical results. Never guarantee future returns, and never suggest, directly or by implication, that past returns can be repeated.
- Stating accurate past results is acceptable. Brief presentations are allowed if **detailed information is available on request** and the presentation indicates that it offers only limited information.

III(E) Preservation of Confidentiality

*Members and candidates must keep information about **current, former, and prospective clients** confidential unless: 1. The information concerns illegal activities on the part of the client, 2. Disclosure is required by law, or 3. The client or prospective client permits disclosure of the information.*

Information may be shared with the CFA Institute **Professional Conduct Program** in an investigation, because the program keeps it confidential. No family tie or private agreement lets a member withhold it. Inside the firm, share client information only with colleagues who work on the client's account. Illegal activity by a client may create an obligation to report it to the authorities.

When unsure whether an exception applies, the member consults compliance or legal counsel. Client data must also be protected: storing identifiable client records on unsecured personal devices or networks is a failure to preserve confidentiality. When a client reveals her own information in an online group or chat the member runs, the disclosure is the client's, not the member's; the member's duty is to take reasonable precautions, such as warning users that posts are visible to all and removing such a post promptly.

LOS 97.b — Recommended procedures for compliance

Standard	Recommended practices
III(A)	Send clients, at least quarterly, itemized statements of all securities in custody and all debits, credits and transactions; encourage firm policies that: follow applicable rules and laws, establish each client's investment objectives, consider suitability, diversify, deal fairly with all clients, disclose conflicts and compensation arrangements, vote proxies in the best interest of clients and ultimate beneficiaries, maintain confidentiality, seek best execution
III(B)	Encourage the firm to set compliance procedures for proper dissemination of recommendations and fair treatment of all clients; limit the number of people who know a recommendation is about to be released; shorten the time between the decision and its dissemination; publish guidelines that bar staff who know of a pending recommendation from discussing it or acting on it before release; send new or changed recommendations at the same time to every client who has expressed interest in the security or for whom it is suitable (and, where possible, at the same time inside and outside the firm); keep a list of clients and their holdings; develop and disclose written trade allocation procedures (pro rata, same price); establish systematic account review; disclose available levels of service
III(C)	Written IPS for each client covering type of client and any separate beneficiaries, return and risk objectives, constraints (liquidity, cash flows, time, tax, legal and regulatory) and performance benchmarks; review objectives and constraints periodically
III(D)	Encourage the firm to adhere to the Global Investment Performance Standards (GIPS) ; consider the sophistication of the audience; present a weighted composite of similar portfolios rather than a single account; include terminated accounts (and state when they ended); disclose gross/net of fees and any model results; keep the data and records behind the figures
III(E)	Share client information only with authorized colleagues who also work for that client; follow firm procedures for storing electronic data, and recommend such procedures if the firm has none

LOS 97.c — Violation or not? Quick reference

KEY CONCEPT

Situation	Conclusion
Soft dollars buy research that helps manage client accounts	Conforms (disclose)
Soft dollars buy research relevant only to the manager's personal holdings	Violates III(A)
Client directs its brokerage to a named broker	Conforms
Manager skips a proxy vote after a cost-benefit analysis	Conforms
Clients told of a recommendation in order of account size, with signed consent	Violates III(B)
Pro rata allocation across all suitable accounts	Conforms
Premium service tier, disclosed and open to all	Conforms
New ideas pitched to a prospect before existing clients get them, with no fact-finding	Violates III(B) and III(C)
No client update for several years despite regular mailings	Violates III(C)
New fund advertises returns of its current holdings as "historical"	Violates III(D)
Confidential data shared with the Professional Conduct Program	Conforms
Client's plans mentioned to a colleague not working on the account	Violates III(E)

COMMON EXAM TRAPS

- Client **consent** or **disclosure** does not make an unfair allocation or dissemination practice acceptable.
- Suitability requires *active* updating. A newsletter asking clients to call in is not an update.
- Pro rata allocation is in proportion to each account's order size, never to the size of the account.
- Relabeling a client's objectives (say, from conservative to growth) so that a favored product fits is not an IPS update. The IPS is revised with the client when the client's circumstances or wishes change, and before any trade that relies on the new profile.

EXAM SHORTCUTS

- Client consent or disclosure does not make an unfair allocation or dissemination practice acceptable, so an answer that relies on consent to justify one can be ruled out.

BOTTOM LINE

- Standard III(A) requires loyalty to clients, reasonable care and prudent judgment, with clients' interests placed before the employer's and the member's own, but it does not create a fiduciary duty where none already exists.
- For a pension plan, the duty of loyalty runs to the plan participants and beneficiaries, not to the sponsoring company, its management or its shareholders.

- Client brokerage (soft dollars) is an asset of the client and must be used for the client's benefit, such as research that assists in managing client accounts, while a client's instruction to direct its trades to a named broker may be followed with disclosure that best execution may not be achieved.
- Proxies must be voted in an informed and responsible way in clients' interests, although a cost-benefit analysis may show that voting a particular proxy is not worthwhile.
- Fair dealing is not equal treatment: disclosed service tiers open to anyone willing to pay are allowed, but a partly filled order is allocated pro rata to each account's order size, across all accounts for which the trade is suitable, at the same average price.
- In an advisory relationship, Standard III(C) requires a reasonable inquiry into the client's experience, objectives and constraints before acting, regular reassessment, and a judgment of suitability in the context of the total portfolio; a manager running a portfolio to a mandate acts only within its stated objectives and constraints.
- Standard III(D) requires reasonable efforts to make performance information fair, accurate and complete, and a brief presentation is allowed if detailed information is available on request and the presentation says it gives only limited information.
- Under Standard III(E), confidential information about current, former and prospective clients may be disclosed only if it concerns illegal activities by the client, if the law requires disclosure, or if the client or prospective client permits it, and giving it to the Professional Conduct Program in an investigation is permitted.

QUICK CHECK

Question 1

Lucia Ferraz, CFA, manages the Tessaro Emerging Markets Equity Fund and routes the fund's trades to Blakemore Securities, which gives her soft dollar credits for buying research. In her own personal account, Ferraz holds several high-yield corporate bonds; the fund holds no bonds. She spends some of the soft dollars on reports about emerging-market companies and some on a credit newsletter that covers the high-yield bonds she owns personally. Her use of the soft dollars is:

- A** a violation for both the equity research and the credit newsletter.
- B** not a violation of the Code and Standards.
- C** a violation for the credit newsletter but not for the equity research.

Answer: C

Soft dollars come from client brokerage, which is an asset of the client. Under Standard III(A) Loyalty, Prudence, and Care, they must be used to benefit the client, for example by paying for research that assists in managing client accounts. Emerging-market equity research helps manage the fund and is acceptable; a credit newsletter on bonds that only Ferraz owns benefits her personally and is a violation.

Why the other options are wrong

- **A.** Research on emerging-market companies is directly relevant to the fund's holdings, so buying it with the fund's soft dollars is appropriate.
- **B.** The credit newsletter serves only Ferraz's personal bond holdings; paying for it with client brokerage uses client assets for her own benefit.

Key takeaway Ask whether the soft-dollar purchase benefits the client. Research that helps manage client accounts does; research on the manager's personal holdings does not.

Practice questions

Question 2

Dmitri Olsen, CFA, finishes a research report with a buy recommendation on Harrow Grain Logistics. Some weeks earlier he asked all of his clients for their e-mail addresses. At 11 a.m. he e-mails the report to the clients who supplied an address, and that afternoon he posts printed copies to all clients, who receive them two to four days later. Olsen has:

- A violated the Standards because only some clients received the e-mail.
- B not violated the Standards, because he disseminated the report fairly.
- C violated the Standards because the e-mail went out before the printed report arrived.

Question 3

Gloria Ansel, a retired bus driver who lives on the income from a small annuity, asks Viktor Lindqvist, CFA, to buy 8,000 shares of Quarystone Genetics, a newly formed biotechnology start-up. The purchase would materially change the risk of her portfolio, and Lindqvist believes it is unsuitable given her investment policy statement. Consistent with the Standards, Lindqvist should *most appropriately*:

- A refuse the order because the investment is unsuitable for her.
- B follow his firm's procedure for obtaining her approval of an unsolicited trade.
- C talk with her about whether she wants to revise her investment policy statement.

Question 4

Carden Asset Management launches a new emerging-market debt fund. It correctly calculates the returns over the past four years of each bond now in the fund and, using the fund's current weights, arrives at an average annual return of 14%. Carden's launch advertising describes the fund as having produced 14% a year historically. Under the Standards, Carden's advertising is:

- A in compliance with the Standards.
- B a violation, because the advertisement implies that the firm earned this return.
- C a violation, because the Standards prohibit advertising historical returns on high-risk assets.

Question 5

Tobias Ferrante, CFA, has gathered evidence suggesting that one of his clients is likely laundering money. According to Standard III(E) Preservation of Confidentiality, Ferrante is prohibited from which of the following actions?

- A Report his conclusion to CFA Institute.
- B Report his conclusion to the appropriate government authorities.
- C Neither; both actions are permissible.

Answers: 2. B · 3. C · 4. B · 5. C

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/duties-to-clients/. The full bank has 57 questions on this reading.

credguild.com

ETHICAL AND PROFESSIONAL STANDARDS · READING 98

Duties to Employers

What you'll learn

LOS 98.a Apply Standard IV(A) Loyalty, IV(B) Additional Compensation Arrangements and IV(C) Responsibilities of Supervisors to situations involving professional integrity.

LOS 98.b Recommend practices and procedures that help members, employers and supervisors prevent violations of Standard IV.

LOS 98.c Identify conduct that conforms to Standard IV and conduct that violates it.

MODULE 98.1

Guidance for Standards IV(A), IV(B), and IV(C)

This reading covers Standard IV, Duties to Employers: Loyalty, Additional Compensation Arrangements, and Responsibilities of Supervisors. A candidate must be able to apply each part to a fact pattern, recommend practices and procedures that prevent violations, and tell conduct that conforms from conduct that violates.

Overview — what Standard IV protects

Standard IV Duties to Employers has three parts. **Standard IV(A) Loyalty** protects the employer's business, clients, information and property. **Standard IV(B) Additional Compensation Arrangements** keeps outside benefits from drawing an employee's loyalty or objectivity away from the employer. **Standard IV(C) Responsibilities of Supervisors** makes anyone with authority over others answerable for trying to prevent their violations. The three LOS cover applying the Standards to a fact pattern (LOS 98.a), recommending procedures that prevent violations (LOS 98.b) and sorting conduct into "conforms" and "violates" (LOS 98.c).

Loyalty to an employer never requires a member to break the law, to harm clients or to breach the Code and Standards. Clients' interests rank above the employer's, but members should still weigh how their actions affect the firm's integrity and long-term sustainability.

LOS 98.a — Standard IV(A) Loyalty

*In matters related to their employment, members and candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge **confidential information**, or otherwise cause harm to their employer.*

Harm to the employer includes any activity that injures the firm or deprives it of profit.

Who is an employer? An **employer–employee relationship** exists whenever a person works in the service of another. It does not require a written contract, and it does not require **monetary compensation**. Services exchanged for a benefit (for example, managing a club's reserves instead of paying membership dues) create a relationship in which the member should treat the organization as an employer. A member who is an **independent contractor** rather than an employee must abide by the terms of the agreement with the hiring firm; the contract defines the duties.

Personal life. Loyalty does not mean the employer comes before family or other personal obligations. Employer and employee are expected to discuss such conflicts and balance them with work duties.

Independent practice. Doing the same kind of work outside the job, for **compensation or other benefit**, in competition with the employer is **independent practice**.

- It is not banned. The member must **notify the employer** and obtain the employer's **consent** to all of its terms before the practice begins.
- The notification should fully describe the services: the **types of services** (nature of the activities), the **expected duration** and the **compensation** to be received. It need not disclose confidential information about outside clients. The employer may set lawful terms for the practice.
- Help given with no compensation or other benefit (reviewing a relative's portfolio for free, on one's own time) is not independent practice, so no consent is required. A non-cash benefit, such as free use of a property, counts as compensation.
- A member who already runs an independent practice and then takes a job must obtain the new employer's permission to continue the practice if it competes with the employer.

Leaving an employer. Until the resignation is **effective**, the member must keep acting in the employer's interest. Conduct that can breach the Standard around a departure includes **misappropriation of trade secrets, misuse of confidential information, soliciting the employer's clients** before leaving, **self-dealing** and **misappropriation of client lists**.

KEY CONCEPT

Allowed before leaving (preparations)

Interviewing, signing a contract with a new employer

Leasing office space, buying equipment, arranging a business loan

Registering a new firm with regulators

Not telling the employer that one is preparing to leave

Not allowed before leaving

Soliciting the employer's current clients or prospective clients

Telling current clients about the new firm's lower fees

Organizing a mass resignation of the employer's staff (inducing colleagues to leave with you)

Copying client lists, models, research notes or other files

After leaving. A former employee may contact former clients, unless a valid **non-compete agreement** prevents it, provided the contact details come from memory or public sources (a directory, a website) rather than from records taken from the old firm. Soliciting former clients is not itself a violation, and it needs no permission from the new or old employer. Merely knowing who the former clients are is generally not confidential information, unless an agreement or the law makes it so.

Industry agreements. Where employers have signed an agreement that lets departing brokers take specified client information with them (for example, the US **Protocol for Broker Recruiting**), a member who stays within the terms of that agreement does not violate the Standard.

Social media. Members must follow the employer's **social media** policies. A member who plans to leave must make sure that any social media use (for example, announcing the move on a professional networking profile) complies with the employer's policy on notifying clients about departures.

Employer records. Records created or kept for the employer—such as client lists, models, spreadsheets and research notes—are the employer's property, whatever the medium, including a home computer, tablet or mobile phone. Taking or using them after leaving requires the former employer's permission. A member's **skills, knowledge and experience** are not employer records and may be used elsewhere.

Departure procedures. A member who ignores the employer's legitimate procedures for leaving (for example, the policy to tell clients and introduce the successor) violates Standard IV(A) Loyalty.

Whistleblowing. In isolated cases, a member may act against the employer's interest to protect clients or market integrity, for example by reporting illegal or unethical conduct through an appropriate channel. This is not a breach of loyalty when the action is not for **personal gain** and complies with applicable law. It does not automatically permit disclosure of confidential client information: that information may be disclosed only when it concerns illegal client activity, disclosure is required by law, or the client permits it. Some firms are required to have **whistleblowing** procedures that allow anonymous reporting. Members should know their firm's policy and encourage the firm to adopt best practices.

Common exam traps

- Preparing to compete is permitted. Competing (soliciting clients, taking records) before the resignation takes effect is not.
- Consent is needed for competing independent practice. Preparing for it needs no consent or notice.
- Copying client records for the member's own use violates IV(A), even for a harmless purpose such as sending clients thank-you notes after leaving. Providing records to regulators as part of whistleblowing may be consistent with IV(A) only when the reporting and any disclosure comply with applicable law and the duty to preserve client confidentiality.

LOS 98.a — Standard IV(B) Additional Compensation Arrangements

*Members and candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain **written consent from all parties involved**.*

The term covers more than pay: it includes anything of value a client provides, directly or indirectly, and any benefit a third party provides.

- The consent that matters most is the employer's. When a client or company offers the benefit (for example, a board seat), that party is also involved in the arrangement.
- **Written consent** includes e-mail. Telling a supervisor orally is not enough.
- Typical cases: a client promises a bonus, a holiday home or free club membership if the portfolio beats a benchmark (**performance-linked benefits**); a client offers free use of its facilities for as long as the member covers the account; a broker offers the member discounts on personal trades if the firm keeps its business (even when the firm already pays the lowest available commissions); a company pays a fee for serving on its board.
- The Standard does not require the member to refuse the benefit. It requires written consent before accepting it.
- It does not reach ordinary gifts that are unrelated to the member's services. A relative's long-standing birthday present that predates the client relationship, or taking turns paying for lunch with a client, is not an additional compensation arrangement.

- **Future versus past performance.** A client bonus that depends on how the account performs in the future is an **additional compensation arrangement**, and written consent is needed in advance. A client bonus that rewards performance already achieved is a **gift**; it must be disclosed to the employer under **Standard I(B) Independence and Objectivity**.
- A member hired **part time** should raise any arrangements that may compete with the employer when hired and respect any limits the employer sets.

LOS 98.a — Standard IV(C) Responsibilities of Supervisors

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

The duty covers everyone under the member's supervision or authority, whether or not those people are CFA Institute members or candidates.

- Reasonable efforts cover three stages: preventing violations, detecting the ones that occur, and acting on any that are found. A supervisor who makes reasonable efforts to prevent and detect violations has not violated the Standard just because a subordinate commits one. A supervisor who makes no such effort violates the Standard even if no subordinate ever breaks a rule.
- Supervisors are expected to know the Code and Standards well and to apply them.
- Supervisory duties may be **delegated**, including to people who are not subject to the Standards, but the supervisor **retains supervisory responsibility** for the delegated duties and should instruct the delegates on how to prevent and detect violations.
- **Adequate compliance system.** An adequate **compliance system** satisfies three sets of requirements: those of the Code and Standards, those of regulators, and industry standards. A supervisor who finds the system inadequate must bring it to management's attention and recommend corrective action. If there are no compliance procedures, or the supervisor believes they are inadequate, the member must **decline in writing** to accept supervisory responsibility until the firm adopts adequate procedures. Urging management is necessary but does not replace declining. Resigning, relying on the Code alone or complaining to CFA Institute are not what the Standard asks for. The same applies when a supervisory role comes without the authority to act, for example a compliance head who may not enforce policies or see employees' communications with clients. Without that authority the member cannot make reasonable efforts to prevent and detect violations, so the role should be declined.
- **When a violation is suspected or found**, the supervisor should respond promptly and investigate thoroughly, while increasing supervision of the employee or limiting the employee's activities during the review, and involve compliance. Reporting the matter and warning the employee (a reprimand plus the employee's promise not to repeat the conduct) is not enough on its own.
- Supervisors should apply the same rigor to non-investment policies as to investment policies.

LOS 98.b — Recommended practices and procedures

Loyalty. A member is encouraged to hand the employer a copy of the Code and Standards. Keeping separate social media accounts for personal and professional use is best practice. Firms should avoid incentive and compensation systems that encourage unethical behavior.

Additional compensation. The member should make an immediate **written report** to the employer describing the benefit, including the terms of any oral or written agreement, the nature of the compensation, its amount and its duration. The Standard itself requires only the written consent; describing the nature, amount and duration is

a recommended procedure. Firms should have the offering party confirm the details of the additional compensation, including any performance incentives.

Supervisors. A member should recommend that the employer adopt a **code of ethics** and encourage the employer to give it to clients. The code of ethics should be kept separate from the detailed compliance procedures, because mixing the two can dilute the ethical message.

KEY CONCEPT

Adequate **compliance procedures** should:

- be clearly written and easy to understand;
- designate a **compliance officer** whose authority is clearly defined;
- include a system of checks and balances;
- define the scope of the procedures and the conduct they allow;
- explain how violations are reported and what sanctions apply;
- structure incentives so that unethical behavior is not rewarded (for example, not paying supervisors on the firm's total trading volume).

Once the program exists, the supervisor should distribute it to the relevant staff, update it as needed, keep educating staff and issue reminders, require **professional conduct evaluations** (for example, as part of each performance review) and review employee actions to monitor compliance and spot violations. The Standard does not require formal hearings after a violation.

Example. Daria Vint, CFA, becomes head of credit research at a firm with no written compliance procedures and no professional conduct evaluations. She asks management to adopt clearly written procedures that name a compliance officer and set out how violations are reported. Management refuses. She should put in writing that she declines supervisory responsibility until the firm adopts adequate procedures, while continuing to press for the procedures and documenting her requests.

LOS 98.c — Quick guide: conforms or violates?

KEY CONCEPT

Conduct	Conforms / Violates
Leasing office space for a future firm before resigning	Conforms
Offering current clients a fee discount to follow the member to a new firm before leaving	Violates IV(A)
Contacting former clients after leaving, using public directories	Conforms
Using research notes written for the former employer, without permission	Violates IV(A)
Paid evening consulting after getting the employer's written permission	Conforms
Accepting a client's performance bonus after only oral disclosure	Violates IV(B)

Conduct	Conforms / Violates
Board fee accepted after e-mail approval from compliance	Conforms
Delegating supervision and assuming the responsibility has passed	Violates IV(C)
Supervisor who restricts a suspect trader and refers the matter to compliance	Conforms
Supervisor who only warns an employee after finding a violation	Violates IV(C)
Announcing a move to a new firm on social media against the employer's client-notification policy	Violates IV(A)

EXAM SHORTCUTS

- Ask when a client bonus is earned: one that depends on future performance is an additional compensation arrangement needing written consent in advance under Standard IV(B), while one that rewards performance already achieved is a gift to be disclosed under Standard I(B).

BOTTOM LINE

- Under Standard IV(A), an employer–employee relationship exists whenever a person works in the service of another, with no written contract or monetary compensation required.
- Independent practice that competes with the employer for compensation or other benefit is allowed only after the member notifies the employer of the types of services, expected duration and compensation and obtains the employer's consent before the practice begins.
- Until a resignation is effective, a member may prepare to compete, for example by interviewing, leasing office space or registering a new firm, but may not solicit the employer's current or prospective clients, induce colleagues to leave, or copy client lists, models or other files.
- After leaving, and absent a valid non-compete agreement, a member may contact former clients using memory or public sources, while records created or kept for the employer remain its property in any medium.
- Whistleblowing against the employer's interest to protect clients or market integrity is not a breach of loyalty when it is not for personal gain and complies with applicable law.
- Under Standard IV(B), a benefit that competes with the employer's interest, or that might reasonably be expected to create a conflict of interest with it, may be accepted only with written consent, e-mail included, from all parties involved.
- Under Standard IV(C), a supervisor must make reasonable efforts to prevent, detect and act on violations by anyone under his or her supervision or authority, and delegating supervisory duties does not transfer the supervisory responsibility.
- A member asked to supervise where compliance procedures are absent or inadequate must decline in writing to accept supervisory responsibility until the firm adopts adequate procedures.

QUICK CHECK**Question 1**

Oscar Brennan, CFA, is a credit analyst at Halcyon Bank. A friend who runs an independent investment advisory practice asks Brennan to help review her clients' portfolios on evenings and weekends, for a fee. Under the Standard concerning loyalty, under what conditions may Brennan accept?

- A** Brennan must tell Halcyon the terms of the arrangement and obtain Halcyon's consent.
- B** Brennan must disclose the extra pay to Halcyon but does not need Halcyon's consent.
- C** Under none, because the arrangement would put Brennan in competition with Halcyon.

Answer: A

Under Standard IV(A) Loyalty, before engaging in independent practice for compensation, members must notify the employer of the services to be provided, their expected duration and the compensation, and must obtain the employer's consent before starting.

Why the other options are wrong

- **B.** Disclosure alone is not enough; the employer's consent is required before the paid work begins.
- **C.** Independent practice is not prohibited outright; it is allowed once the employer consents.

Key takeaway Paid outside advisory work: notify the employer (services, duration, pay) and obtain consent.

Practice questions**Question 2**

Amelia Ross, CFA, has just joined Harrowby Trust as a trust officer. She learns that Harrowby routes all its securities trades through her cousin, a registered broker, whose commissions match the lowest rate available from other brokers. Her cousin tells her that if Harrowby keeps sending him its business, he will give her a large discount on all of her personal trades. Ross:

- A** must refuse the arrangement.
- B** must obtain written consent from all parties involved before accepting the arrangement.
- C** need not inform her employer, because Harrowby is paying the lowest available commissions.

Question 3

Arjun Mehta, CFA, leads a team of credit analysts at a regional bank; none of the analysts is a CFA charterholder or candidate. Mehta has several times urged the bank's senior partners to adopt a compliance system to make sure that applicable laws and regulations are followed, but they have rejected each proposal. Mehta should *most appropriately*:

- A** take no further action, because by urging the bank to adopt a compliance system he has met his obligations.
- B** decline in writing to accept supervisory responsibility until an adequate compliance system is adopted.
- C** report the bank's inadequate system in a written complaint to the CFA Institute Professional Conduct Program.

Answers: 2. B · 3. B

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/duties-to-employers/. The full bank has 61 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 99

Investment Analysis Recommendations and Actions

What you'll learn

LOS 99.a Apply Standard V (Diligence and Reasonable Basis; Communication with Clients and Prospective Clients; Record Retention) to situations involving investment analysis, recommendations and actions.

LOS 99.b Recommend practices and procedures that help prevent violations of Standards V(A), V(B) and V(C).

LOS 99.c Identify conduct that conforms to Standard V and conduct that violates it.

MODULE 99.1

Guidance for Standards V(A), V(B), and V(C)

This reading covers Standard V, Investment Analysis, Recommendations, and Actions: Diligence and Reasonable Basis, Communication with Clients and Prospective Clients, and Record Retention. A candidate must be able to apply each part to a fact pattern, recommend practices that help prevent violations, and tell conduct that conforms from conduct that violates.

LOS 99.a — Applying Standard V to investment analysis, recommendations and actions

Standard V has three parts, each governing a different stage of the research-and-advice process: doing the work (V(A)), telling clients about it (V(B)) and keeping the evidence (V(C)).

Standard V(A) Diligence and Reasonable Basis

*Members and candidates must: 1. Exercise **diligence, independence, and thoroughness** in analyzing investments, making investment recommendations, and taking investment actions. 2. Have a **reasonable and adequate basis**, supported by **appropriate research and investigation**, for any investment analysis, recommendation, or action.*

How much work is "enough" depends on the member's **investment philosophy**, his or her **role in the investment decision-making process** and the **resources and support** the employer provides; the level of research also differs with the product or service offered. Before recommending or acting, a diligent analyst typically weighs global and national economic conditions, the company's financial results and operating history, the stage of the business cycle, a fund's fees and historical results, the limitations of any quantitative model used, and whether peer-group comparisons are appropriate for valuation.

Relying on others' research. A member may base a recommendation on **third-party research** or on the firm's own research department, but V(A) still requires **reasonable and diligent efforts** to judge whether that research is **sound**: review its assumptions, how rigorous the analysis was, how timely it is, and whether its recommendations are objective and independent. A member who has made that review and found no reason to doubt the research may use it. A rumor, a tip overheard at a lunch, or a single article in the popular press is not a reasonable and adequate basis.

Quantitative research. The **limitations of any quantitative model** used are one of the factors to consider before making a recommendation. Scenario testing is a recommended firm procedure: written procedures should set a minimum level of scenario testing for computer-based models, with standards for the range of scenarios, model accuracy over time and the sensitivity of cash flows to assumptions and inputs. A conclusion drawn from too short a data period, or a blanket instruction to swap one style of stock for another across all accounts regardless of client needs, lacks a reasonable basis.

Pressure to issue a favorable view. If an analyst's own diligent research does not support a positive rating, issuing one anyway (for example, to help the firm's investment banking business) violates V(A), because the published view has no reasonable basis. It also violates Standard I(B) **Independence and Objectivity**, because the analyst let others' interests override his or her judgment.

Example. An analyst has lost all her working papers for a report due tomorrow. She takes the company's own projections, trims them by a figure she "remembers", and pastes in charts from another firm's report without credit. She (1) has no reasonable basis (V(A)), (2) presents others' work as her own (Standard I(C) **Misrepresentation: plagiarism**), and (3) issues a report with no supporting records (V(C)).

Standard V(B) Communication with Clients and Prospective Clients

KEY CONCEPT

Members and candidates must: 1. Disclose to clients and prospective clients the **nature of the services** provided, along with information about the **costs** to the client associated with those services. 2. Disclose to clients and prospective clients the **basic format and general principles of the investment processes** they use to analyze investments, select securities, and construct portfolios and must **promptly disclose any changes** that might materially affect those processes. 3. Disclose to clients and prospective clients **significant limitations and risks** associated with the investment process. 4. Use **reasonable judgment** in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients. 5. **Distinguish between fact and opinion** in the presentation of investment analysis and recommendations.

Key applications:

- **Reasonable judgment about what to include.** An analyst may emphasize some matters, touch briefly on others and omit some altogether, provided there is a reasonable basis for those choices. A temporary event years ago that was quickly reversed may reasonably be left out; heavy recent selling by insiders is a factor a reasonable investor would want and should be included.
- **Tailoring to the audience.** A report written for a specific group of clients with known needs can generally leave out more basic facts than a report for a wide audience. This flexibility covers background facts only: every research report, whatever its audience, must still describe the **basic characteristics** of the security analyzed. Sending a report only to the clients for whom the idea is relevant is allowed.
- **Fact versus opinion.** Historical data ("earnings have grown about 8% a year for five years") is fact. A projection must be presented as an opinion ("we expect", "could", "our estimate is"). Writing that a future event "will" happen turns an opinion into an apparent fact and violates V(B); so does turning management's optimism into a certainty.
- **Form of communication.** A recommendation may be short (a buy list, an e-mail, a brief note). V(B) does not require a detailed report with every recommendation, but clients must be informed that the full analysis supporting it is available. V(B) does not require analysts to issue explicit buy or sell ratings on every security they cover.
- **Changes in the process.** A material change in strategy, models or style must be communicated promptly, together with any newly identified risks and limitations. The same applies when the risk characteristics of an investment or strategy change significantly.
- **All forms of communication.** V(B) covers every means of communicating with clients (meetings, calls, e-mails, messages), not only written research reports.

- **Costs.** Client-facing members describe the services and their costs when the relationship begins and again whenever the services or costs change. Specific money amounts are not required (a percentage fee may make that impossible), but the cost information must be reasonably detailed, including costs from third parties used to deliver the services.
- **Risks and limitations.** For nontraditional products (such as structured securities or allocation strategies), members must explain the investment-specific risk factors. In all cases, members should clearly communicate potential gains and losses in terms of total returns. Projections from quantitative models must come with the model's limitations and key assumptions; expectations produced by statistical models are not facts. When projected results are shown, they should cover a range of scenarios, including ones that run against the expected trend: a strategy built on a currency's appreciation should also show what happens if that currency depreciates. Two examples of inherent limitations are **liquidity** (the ability to exit an investment without significant extra cost) and **capacity** (the ability of a strategy or vehicle to absorb more money without lowering the returns it can earn).

Example. Brackenhill Partners markets a small-cap fund whose stocks have always been picked by its founding manager. When she retires, stock selection passes to a three-person committee, which also starts adding large-cap shares to the fund. Marketing updates the website and the pitch book for prospects the same week. Existing clients hear about the changes only at their annual reviews, several months later. Both changes can materially affect the investment process, so V(B) required prompt notice to current clients as well as prospects, together with any new risks, such as returns that may now depart further from the fund's small-cap benchmark.

Standard V(C) Record Retention

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

Records are the evidence behind V(A). When a client, the firm or a regulator later questions a recommendation or a trade, the file shows what analysis supported it and that the action followed the client's mandate. Without the file, even sound work cannot be demonstrated.

- Records can be in **any medium**: paper, electronic files, e-mails, messages and posts. The Standard does not say where they must be stored, so scanned copies kept off-site are acceptable.
- Records **belong to the firm**. A member who changes employers may not take them without permission. To reissue research at a new firm, the member must **re-create the supporting records** from public sources or information obtained from the covered company. Memory of files left behind is not a record.
- Where a regulator or firm policy sets a retention period, follow it. Where neither applies, the Standard recommends keeping records for **at least seven years**.
- Keeping records is generally the **firm's responsibility**, but a member must make sure the required records exist.

LOS 99.b — Practices and procedures that help prevent violations**KEY CONCEPT****Standard****Recommended practices**

V(A)	A policy that research and recommendations must have a basis that can be substantiated as reasonable and adequate; detailed written guidance on research and due diligence; periodic review of third-party research (assumptions, rigor, timeliness, objectivity and independence); measurable criteria for research quality, with analyst pay linked to them; minimum scenario testing for computer-based models (range of scenarios, accuracy over time, sensitivity to inputs); policies for evaluating outside information providers and external advisers, including how often reviews are repeated
V(B)	Because choosing the relevant factors is a judgment call, keep records of the nature of the research and be ready to supply more information if a client or other user of the report asks
V(C)	If no regulation or firm policy sets a period, keep records for at least seven years; record keeping is generally the firm's responsibility

If a member thinks the firm's procedures fall short (for example, records may not be kept long enough), the right step is to **raise the issue with a supervisor or the compliance department** and suggest improvements. Refusing to work and keeping personal copies of firm records at home are not appropriate responses. Taking copies home can itself conflict with Standard IV(A) **Loyalty**.

The Standards call for diligence, attribution of others' work and supporting records. Legal review of each report is not among their requirements or recommended procedures.

LOS 99.c — Conduct that conforms versus conduct that violates**KEY CONCEPT****Situation****Conclusion**

Recommendation based on the firm's research department's work, after reviewing it and finding no reason to doubt it	Conforms to V(A)
Recommendation based on an outside broker's report for general distribution, after reviewing it and finding no reason to doubt it	Conforms to V(A)
Changing a rating because of a colleague's offhand comment	Violates V(A)
Trading all discretionary accounts on a vague, unverified overheard rumor after a quick web search	Violates V(A)

Situation	Conclusion
Research analyst e-mails a buy recommendation to all clients after careful work	Conforms
Using factual data from a recognized statistical service	No attribution needed, but data copied from a colleague's table should be checked for accuracy
"Company X will cut its dividend"	Violates V(B): a forecast stated as fact
A fee not disclosed in the client agreement	Violates V(B): cost of services not disclosed
Reissuing reports from memory at a new employer	Violates V(C)
Warning a client about the price impact of a quick liquidation, then executing	No violation

COMMON EXAM TRAPS

- **Suitability** (Standard III(C)) applies when advising a particular client. A research analyst publishing a general recommendation is judged under V(A); suitability for each recipient is not required.
- A vague, unverified rumor is generally not established **material nonpublic information** (MNPI). Materiality depends on specificity, reliability and likely price impact, so overheard information *can* be MNPI when it is specific and reliable.
- V(A) judges the work done before a recommendation, not how the investment turns out. A loss after careful, well-documented analysis is not a violation, and a gain does not cure a recommendation that rested on a tip or a hunch.

EXAM SHORTCUTS

- Standard V(A) judges the work done before a recommendation, so the investment's later loss or gain does not by itself decide whether the Standard was violated.

BOTTOM LINE

- Standard V(A) requires diligence, independence and thoroughness, and every analysis, recommendation or action must rest on a reasonable and adequate basis backed by appropriate research and investigation.
- How much research is enough depends on the member's investment philosophy, role in the decision-making process and the employer's resources and support.
- A member may rely on third-party or the firm's own research after a reasonable and diligent review of its assumptions, rigor, timeliness, objectivity and independence, but a rumor, an overheard tip or a single popular-press article is not a reasonable basis.
- Standard V(B) requires members to disclose the nature and costs of their services, the general principles and basic format of their investment process with prompt disclosure of material changes, and significant limitations and risks.

- A projection must be presented as an opinion, so writing that a future event will happen violates Standard V(B), while a short recommendation is allowed if clients are told that the full analysis is available.
- Under Standard V(C), records in any medium belong to the firm, and a member who changes employers must re-create supporting records from public sources or the covered company rather than rely on memory.
- Where no regulation or firm policy sets a retention period, records should be kept for at least seven years.
- Suitability under Standard III(C) applies when advising a particular client, while a research analyst publishing a general recommendation is judged under Standard V(A).

QUICK CHECK

Question 1

Marisol Vega, CFA, runs a one-person advisory practice. She frequently bases client recommendations on research bought from several outside providers. The Code and Standards *most likely* require Vega to:

- A** carry out her own research instead of depending on outside providers.
- B** name each outside provider whose research supports a recommendation.
- C** make reasonable efforts to confirm that the outside research has a sound basis.

Answer: C

Under Standard V(A) Diligence and Reasonable Basis, members who rely on third-party research must make reasonable and diligent efforts to determine that the research is sound, for example by reviewing its assumptions, rigor, timeliness and independence. Standard V(A) is about checking that the research is sound; it does not require her to name each provider in her recommendations.

Why the other options are wrong

- **A.** Relying on third-party research is allowed; the Standards do not require members to produce all research themselves.
- **B.** Naming each outside provider is not a requirement of Standard V(A); what the Standard requires is diligence about whether the research is sound.

Key takeaway A member who uses third-party research must make reasonable and diligent efforts to check that it is sound (Standard V(A)).

Practice questions

Question 2

Ines Moreau, CFA, is writing a report on Aldercrest Power. Over the past year, four of the six utilities in its region cut their dividends roughly in half to fund capital spending, and Moreau reasons that Aldercrest will face similar pressure. Her report states: "Aldercrest will reduce its dividend from \$3.20 to \$1.60 a share by the third quarter to pay for its capital program. Investors who buy at today's price of about \$64 could earn a total return above 18%." With respect to Standard V(B) Communication with Clients and Prospective Clients, Moreau:

- A violated the Standard by promising a specific investment return.
- B violated the Standard by failing to distinguish opinion from fact.
- C did not violate the Standard.

Question 3

Dominic Ashe, CFA, recently left a large bank's research department to open his own equity research boutique. All of the files supporting his earlier reports stayed with the bank. Relying on his detailed memory of those files, Ashe rewrites several of his former reports, publishes them under his new firm's name and signs up several clients as a result. Ashe has not reconstructed any supporting records. Ashe is *most likely*:

- A not in violation of any Standard.
- B in violation of Standard V(A) Diligence and Reasonable Basis.
- C in violation of Standard V(C) Record Retention.

Answers: 2. B · 3. C

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/investment-analysis-recommendations-and-actions/. The full bank has 33 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 100

Conflicts of Interest

What you'll learn

LOS 100.a Apply Standard VI (Avoid or Disclose Conflicts, Priority of Transactions, Referral Fees) to situations involving professional integrity.

LOS 100.b Recommend practices and procedures that prevent violations of Standard VI, such as disclosure policies, blackout periods and pre-clearance.

LOS 100.c Identify conduct that conforms to Standard VI and conduct that violates it.

MODULE 100.1

Guidance for Standards VI(A), VI(B), and VI(C)

This reading covers Standard VI, Conflicts of Interest: Avoid or Disclose Conflicts, Priority of Transactions, and Referral Fees. A candidate must be able to apply each part to a fact pattern, recommend procedures that prevent violations, and tell conduct that conforms from conduct that violates.

LOS 100.a — Applying Standard VI to real situations

Standard VI groups three rules about **conflicts of interest**: situations in which a member's own interests, or the interests of the member's firm, could pull against the duty owed to clients, prospective clients or the employer.

Standard VI(A) Avoid or Disclose Conflicts

*Members and candidates must **avoid** or make **full and fair disclosure** of all matters that could reasonably be expected to impair their **independence and objectivity** or interfere with respective duties to their clients, prospective clients, and employer. Members and candidates must ensure that such disclosures are **prominent**, are delivered in **plain language**, and communicate the relevant information effectively.*

Actual and potential conflicts should be avoided where that is reasonably possible; a conflict that cannot reasonably be avoided must be disclosed in full. A single line in fine print buried in a long legal appendix does not meet the Standard.

Disclosure lets clients and prospects judge motives and potential biases for themselves. The **most common conflict** requiring disclosure is actual **ownership of stock** in companies the member recommends or that clients hold. Toward the employer, members must give the employer enough information to assess how a conflict affects it, must take reasonable steps to avoid conflicts, and must report any conflict promptly once it arises.

The test is *reasonableness*: would a client or employer reasonably want to know this fact to judge whether the member's advice might be biased? Typical matters that must be disclosed:

KEY CONCEPT

Matter

Ownership of stock in a company the member recommends or that clients hold, including shares held in a trust in which the member has a financial interest and the power to vote (**beneficial ownership**)

Why it must be disclosed

The most common conflict: gains or losses on the position could bias the recommendation

Matter	Why it must be disclosed
Firm's material ownership of the covered issuer's securities	The firm benefits if the price rises
Market maker role, investment banking / corporate finance relationship , underwriting, M&A advisory work	The firm has a business interest in the issuer
Serving on the issuer's board of directors (member or senior firm officers)	Board members owe duties to the company and its shareholders
Paid consulting work for the covered company	Direct financial link to the issuer
Compensation arrangements that could create incentives at odds with clients' objectives: special compensation arrangements, bonus programs, commissions and incentives (e.g., a bonus tied to short-term trading profits in a long-term fund)	Clients should know how the professional is paid. Disclose when acting in an advisory capacity, and update the disclosure after a significant change in compensation structure

The Standard reaches only matters that could reasonably be expected to impair independence and objectivity or interfere with duties. A fact that gives neither the member nor the firm any financial interest in the issuer or any duty to it does not meet that test. Examples are a neighbor's holding in which the member has no interest, a relative's past job unrelated to the analysis, and firm property unrelated to the issuer.

Disclosure rather than refusal. VI(A) does not require an analyst to decline an assignment or to sell a position in the covered stock; full and fair disclosure of the holding meets the Standard. Inherited shares are treated like purchased shares: the analyst must tell the employer and disclose the holding in subsequent research.

Who needs to hear it. Conflicts that affect duties to the employer (e.g., a board seat or an unpaid committee role at an institution whose assets the firm manages) must be disclosed to the employer; conflicts that could bias advice go to clients and prospects as well. The disclosure goes in every communication the conflict could color: a member paid in a company's shares for promotional work discloses the holding in the promotional material as well as in any research report.

Standard VI(B) Priority of Transactions

*Investment transactions for **clients and employers** must have **priority** over investment transactions in which a Member or Candidate is the **beneficial owner**.*

Client transactions also take priority over transactions made on behalf of the **member's firm** (e.g., proprietary trading). Personal transactions include any transaction in which the member is a **beneficial owner**: the member's own account and any account in which he or she has a financial interest, such as shares held in a trust for the member.

- A member may trade for his or her own account only once clients and the employer have been given adequate opportunity to act on a recommendation (e.g., after client orders have been executed).
- **Front-running** is trading ahead of client orders, or ahead of a recommendation's release, to profit from them. It violates VI(B).
- **Family accounts that are client accounts** (family members who are fee-paying clients of the firm) are treated exactly like other client accounts: they are neither favored nor disadvantaged, and they may trade as soon as the recommendation has been disseminated to clients. If the member also has a beneficial interest in such an

account, the firm's pre-clearance and reporting requirements for personal holdings apply to it as well, and the account still may not be favored over other clients.

- If a security is not suitable for any client (e.g., a speculative stock for a manager whose only responsibility is a high-grade bond fund, or futures that none of the clients may hold), the member may trade it personally without first offering it to clients.
- Members must not act on information about **pending trades** for personal gain; the overriding test is that personal trades **do not disadvantage any client**. By that test, a personal trade is not prohibited merely because it runs against the firm's recommendation, such as selling shares the firm rates "buy".
- If investors ask, members must give them full disclosure of the firm's **personal trading policies**.
- **IPO / hot issues**: members can avoid IPO conflicts by not participating. Members should not take shares of an oversubscribed new issue for their own accounts when that could reduce client allocations, even if clients are told and do not object.

Standard VI(C) Referral Fees

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

- Both directions count: fees the member receives for referring clients out *and* fees the member pays to others who refer clients in. The payer can be the member's own employer: a bonus for sending clients to another unit of the same firm must still be disclosed to those clients.
- **All types of consideration** must be disclosed; **non-cash benefits** count (free services, gifts, fee discounts); disclose their **nature and estimated value**.
- **Timing**: disclosure must be made **before** the client or prospect enters into an agreement for services, so the client can judge the full cost of the service and any partiality in the recommendation. A packet delivered only after someone has become a client comes too late.
- The Standard does not require disclosing what share of the member's business comes from referrals.

LOS 100.b — Procedures that prevent Standard VI violations

Firms and members should build controls so that conflicts are identified, avoided where possible, and disclosed when not.

Recommended procedures for VI(B):

- If the firm has not yet adopted the procedures below, members should urge it to do so.
- **Limitations on employee participation in equity IPOs.**
- **Restrictions on participation in private placements**: strict limits on employee purchases and proper supervisory procedures, because private placements raise the same kind of conflict as IPOs.
- **Blackout periods** (restricted periods) before client trades for employees involved in investment decision-making, so that no one front-runs client orders. How strict the blackout should be depends on the **size of the firm and the type of security**.
- **Reporting procedures**: **pre-clearance** procedures, duplicate trade confirmations, and disclosure of beneficial ownership positions and personal holdings.

Recommended procedures for VI(C):

- Members should urge their firms to set clear procedures for compensation received for referrals, and should give their employers **updates at least quarterly** on referral arrangements.

- Where a firm allows referral fees, it should have clear **approval procedures** and policies on the **nature and value** of referral compensation received.

COMMON EXAM TRAPS

- Allowing "small" or "limited" front-running is never an acceptable control.
- VI(B) ranks client and employer trades ahead of the member's own; III(B) Fair Dealing requires fair treatment among clients. A manager who allocates profitable block trades to his own account violates VI(B), and pushing the losing trades onto the largest client accounts is likely a III(B) violation as well.

LOS 100.c — Conduct that conforms and conduct that violates

KEY CONCEPT

Conduct	Verdict
Analyst owns the covered stock and discloses the holding in the report	Conforms to VI(A)
Analyst joins an unpaid investment committee of an institution whose assets are managed by her firm and tells no one	Violates VI(A)
Analyst buys, for an account she funds and controls for her child, a stock she has just upgraded, before the report reaches clients	Violates VI(B): she is the beneficial owner of the account, so the trade is hers, and it comes ahead of the clients; small size is irrelevant
Manager advises clients to sell, lets their orders execute, then sells her own position	Conforms to VI(B)
Manager buys for himself just before large client purchases	Violates VI(B) (front-running)
Planner mentions referral payments only in a welcome kit sent after the client signs	Violates VI(C): disclosure must come before the agreement
Member takes an equal share of a hot IPO alongside clients who agree	May violate VI(B) despite consent

Example. Anneliese is a fixed income analyst whose only duty is a municipal bond fund. She finds a small biotech stock she likes for herself. Because the stock could never be held by the fund, VI(B) does not require her to offer it to anyone first; she may buy it (subject to firm pre-clearance rules). If she later started covering biotech stocks, a personal holding would then have to be disclosed under VI(A) and client trades would take priority under VI(B).

Four Standards deal with benefits and conflicts that look alike. The trigger decides which one applies:

KEY CONCEPT

Trigger	Standard	Required step	Who is told
Client's gift for results already achieved	I(B) Independence and Objectivity	Disclose, before accepting if possible	Employer
Benefit tied to future performance, or outside pay that competes or may conflict with the employer's interest	IV(B) Additional Compensation Arrangements	Written consent before accepting	All parties involved, above all the employer
Holding, relationship or pay scheme that could reasonably be expected to impair independence and objectivity or interfere with duties	VI(A) Avoid or Disclose Conflicts	Avoid where reasonably possible; otherwise disclose	Clients, prospects and employer, as relevant
Compensation received from or paid to others for recommending products or services	VI(C) Referral Fees	Disclose before the client or prospect agrees to the service	Employer, clients and prospects, as appropriate

EXAM SHORTCUTS

- To tell look-alike benefits apart, start from the trigger: a client's gift for results already achieved falls under I(B), a benefit tied to future performance or competing outside pay under IV(B), a holding, relationship or pay scheme that could impair independence and objectivity under VI(A), and pay for recommending products or services under VI(C).

BOTTOM LINE

- Standard VI(A) requires members to avoid conflicts where reasonably possible and otherwise to make full and fair disclosure in prominent, plain-language form, so a line of fine print buried in a legal appendix does not meet it.
- The conflict that most often requires disclosure is the member's own stock ownership in a company he or she recommends or that clients hold, including beneficial ownership through a trust, and disclosing the holding meets the Standard without declining the assignment or selling the stock.
- Market making, investment banking relationships, board seats held by the member or senior firm officers, paid consulting work for the issuer, and compensation arrangements that could create incentives at odds with clients' objectives must be disclosed.
- Under Standard VI(B), transactions for clients and employers have priority over those in which the member is the beneficial owner, client transactions also come before the firm's proprietary trading, and front-running violates the Standard.
- Fee-paying client accounts of family members are treated exactly like other client accounts, neither favored nor disadvantaged.
- A member may trade personally in a security that is not suitable for any client without first offering it to clients, the overriding test being that personal trades do not disadvantage any client.

- Standard VI(C) requires disclosure of any compensation, consideration or benefit, cash or non-cash, received from or paid to others for recommending products or services, with its nature and estimated value, before the client or prospect enters into an agreement for services.
- Recommended procedures for Standard VI(B) include limits on employee participation in equity IPOs, restrictions on private placements, blackout periods before client trades, and reporting procedures such as pre-clearance and duplicate trade confirmations.

QUICK CHECK

Question 1

Rosalind Mercer, CFA, is an analyst at the investment bank Carrow & Pike. Her manager asks her to initiate coverage of Summit Ridge Ales. Carrow & Pike's corporate finance group has advised Summit Ridge on every acquisition it has made over the last nine years, and two of Carrow & Pike's senior partners serve as Summit Ridge directors. According to the Standards of Professional Conduct, may Mercer write the report?

- A Yes, if she keeps her analysis independent and objective.
- B No, because the conflicts are too significant.
- C Yes, if she discloses the board seats and the advisory work.

Answer: C

Standard VI(A) requires members to disclose to clients and prospects matters that could reasonably be expected to impair objectivity. It does not prohibit an analyst with potential conflicts from writing the report; the investment banking relationship and the directorships must be disclosed.

Why the other options are wrong

- **A.** Independence and objectivity are required, but they do not replace disclosure: clients must be told about the relationships so they can judge the report.
- **B.** The Standard does not bar the analyst from writing the report; it requires the conflicts to be disclosed.

Key takeaway Conflicts rarely forbid the work. They require disclosure.

Practice questions

Question 2

A brokerage firm is adding blackout periods to its personal-trading procedures for employees involved in investment decision-making. Under the recommended procedures for Standard VI(B) Priority of Transactions, how strict the blackout requirement should be depends *most* on:

- A** the size of the firm and the type of security.
- B** each employee's seniority and length of service.
- C** the number of clients and the average account size.

Question 3

Priya Natarajan is an estate-planning attorney. Colin Ashby, CFA, a wealth manager, regularly sends his clients to her for estate work. In exchange, Natarajan prepares the wills and trust documents for Ashby's own family without charging him. Natarajan has just been awarded the CFA charter and become a member of CFA Institute. Under the Standards, Natarajan must:

- A** tell prospective clients referred by Ashby about the free legal work and its estimated value.
- B** tell prospective clients referred by Ashby about the free legal work, but not its value.
- C** stop doing legal work for Ashby's family without charge.

Answers: 2. A · 3. A

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/conflicts-of-interest/. The full bank has 42 questions on this reading.

ETHICAL AND PROFESSIONAL STANDARDS · READING 101

Responsibilities as a CFA Institute Member

What you'll learn

LOS 101.a Apply Standard VII (Conduct as Participants in CFA Institute Programs; Reference to CFA Institute, the CFA Designation, and the CFA Program) to situations involving members and candidates.

LOS 101.b Recommend practices that help prevent violations of Standards VII(A) and VII(B).

LOS 101.c Identify conduct and statements that conform to Standard VII and those that violate it.

MODULE 101.1

Guidance for Standards VII(A) and VII(B)

This reading covers Standard VII, the responsibilities of CFA Institute members and CFA candidates: VII(A) governs conduct as participants in CFA Institute programs, and VII(B) governs how members and candidates refer to CFA Institute, the designation and the CFA Program. A candidate must be able to apply both parts to a fact pattern, recommend practices that prevent violations, and tell conduct that conforms from conduct that violates.

LOS 101.a — Applying Standard VII to members and candidates

Standard VII protects the value of CFA Institute programs and of the CFA designation. It has two parts.

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

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

Conduct covered by VII(A) includes:

- **Giving or receiving assistance (cheating)** on any CFA Institute exam, or offering to do so (for example, offering someone an advance look at exam questions, even if the offer is refused). Exam convention: cheating on any exam, not only a CFA Institute exam, is treated as VII(A) conduct. Current practice: Standard VII(A) covers conduct that affects CFA Institute, the CFA designation and CFA Institute programs, so cheating on an unrelated exam falls outside it. Such cheating is a Standard I(D) Misconduct matter only when that exam is part of the member's or candidate's professional activities.
- **Violating the rules and policies** of the CFA Program. A candidate who breaks any exam policy (for example, the rules on **calculators, personal belongings** or the **Candidate Pledge**) has violated VII(A).
- **Disclosing confidential exam information** to candidates or to the public. This covers specific questions, and also the **broad topic areas or formulas that were tested or not tested**. The obligation continues after the exam and after the testing window closes. Discussing the curriculum itself, as opposed to the exam, in study groups or online forums is allowed.
- **Improperly using the CFA designation** to further personal or professional goals.
- **Misrepresenting information** on the **Professional Conduct Statement (PCS)** or in connection with the CFA Institute Professional Development Program.

VII(A) does not restrict **expressing opinions**. Members and candidates may criticize CFA Institute, the CFA Program, pass rates, exam difficulty or CFA Institute's advocacy positions. An honestly held opinion, even a harsh or mistaken one, is neither dishonesty, fraud or deceit nor an act that reflects adversely on professional

reputation, integrity or competence, so it does not violate Standard I(D) **Misconduct** either.

Members who **volunteer** in the CFA Program (for example, as question writers, graders or proctors) must not ask for, or disclose, information about exam questions (whether under consideration or actually used), the grading process or the way questions are scored.

Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program

*When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not **misrepresent or exaggerate** the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.*

Membership and the right to use the designation. To remain an **active member** and keep the right to use the designation, a charterholder must (1) **pay annual membership dues** and (2) **file the annual Professional Conduct Statement**. A member who does not meet both is not active and may not use the CFA designation: unlike a university degree, the right to use it is not permanent. Nothing prevents a former charterholder from stating the facts of past status (e.g., "I was awarded the CFA charter in 2011"), as long as he or she does not imply the designation is currently held. How many attempts it took to pass the exams has no bearing on membership status.

Candidacy. References to **candidacy in the CFA Program** must not misrepresent or exaggerate what candidacy means. A candidate may describe it accurately, for example by naming the level for which he or she is registered ("Level II candidate in the CFA Program"), and may state facts such as the levels passed, the years in which they were passed, that each level was passed on the first attempt, or that the whole program was completed in three years. Claiming superior ability because of such facts is not permitted.

What is prohibited:

- Implying a **partial designation**: there is no partial CFA designation, so "CFA Level II" or "Level I CFA" after a name is not allowed.
- Making **promotional promises or guarantees tied to the designation**: over-promising individual competence or future investment results (higher returns, lower risk, better service), or claiming superior ability because the exams were passed quickly or on the first attempt. A guarantee of returns is also a **Misrepresentation** regardless of any reference to the designation.

What is allowed: stating that one is a charterholder, describing accurately what the designation requires (three levels of exams, work experience, commitment to the Code and Standards), and stating that holding the charter reflects a commitment to high ethical standards.

Using the designation after a name

KEY CONCEPT

Acceptable	Not acceptable	Why
Kim Ortega, CFA (dues paid and Professional Conduct Statement filed this year)	Kim Ortega, CFA (dues unpaid)	Only an active member may use the designation
Kim Ortega, Chartered Financial Analyst (active member)	Kim Ortega, CFA Level III	There is no partial designation

LOS 101.b — Practices that help prevent violations

- Errors in references to the designation or to candidacy are common, so members should make sure their **firms are aware of the proper references** to a member's CFA designation or candidacy, and firms should review résumés, business cards, websites and marketing materials before use.

WORKED EXAMPLE: REVIEWING A CANDIDATE'S BIOGRAPHY

Tomas Reyes passed Levels I and II of the CFA Program on his first attempts and is registered for the Level III exam. His firm's draft website biography reads: "Tomas Reyes, CFA Level II. Tomas is a Level III candidate in the CFA Program. Having passed each level on the first attempt, he can deliver higher returns than his peers." Decide which statements conform to Standard VII(B) and how the biography should be corrected.

Step 1. "CFA Level II" after his name implies a partial designation. No partial CFA designation exists, so this violates Standard VII(B).

Step 2. "Level III candidate in the CFA Program" describes his candidacy accurately by naming the level for which he is registered, so it conforms.

Step 3. Stating that he passed each level on the first attempt is a fact and is allowed. Promising higher returns because of it ties a promise of future investment results to his exam record and violates Standard VII(B).

Step 4. Members should make sure their firms know the proper references to the designation and to candidacy, and the firm should review the biography before it is used.

Result. A corrected biography reads: "Tomas Reyes is a Level III candidate in the CFA Program. He passed Levels I and II on his first attempts."

LOS 101.c — Conduct that conforms versus conduct that violates

KEY CONCEPT

Statement or act	Conclusion
"I passed Level II of the CFA Program in 2016."	Conforms (fact, no partial designation)
"I passed all three levels on my first attempt." (true)	Conforms
"Kim Ortega, CFA Level I"	Violates VII(B)
Business card shows "CFA" although annual dues have not been paid	Violates VII(B)
"Earning the charter proves my superior ability."	Violates VII(B)
All analysts are charterholders, "so we give better service than our rivals"	Violates VII(B) only because of the promise of better service; stating the fact is fine
Posting remembered exam questions after the window closes	Violates VII(A)

Statement or act**Conclusion**

Blog listing topics that were left off the exam	Violates VII(A)
Public criticism of pass rates or advocacy positions	Conforms
Dues unpaid, Professional Conduct Statement filed	Not active; may not use the designation
False answers on the annual Professional Conduct Statement	Violates VII(A)
Bringing a prohibited item into the exam room	Violates VII(A)

COMMON EXAM TRAPS

- Misstating other résumé facts, such as a college major, is a Standard I(C) Misrepresentation issue; only statements about CFA Institute, the designation or candidacy fall under VII(B). One résumé can breach both.

BOTTOM LINE

- Conduct that breaches Standard VII(A) includes cheating, or offering to help someone cheat, on a CFA Institute exam, breaking CFA Program rules and policies, disclosing confidential exam information, improperly using the CFA designation and misrepresenting information on the Professional Conduct Statement.
- Confidential exam information includes specific questions and the broad topic areas or formulas that were or were not tested, the obligation continues after the testing window closes, and discussing the curriculum itself is allowed.
- Standard VII(A) does not restrict expressing opinions, so criticizing CFA Institute, the CFA Program, pass rates or CFA Institute's advocacy positions is allowed.
- To remain an active member and keep the right to use the CFA designation, a charterholder must pay annual membership dues and file the annual Professional Conduct Statement.
- No partial CFA designation exists, so a title such as "CFA Level II" is not allowed, but a candidate may state facts such as the levels passed, the years they were passed and that each was passed on the first attempt.
- Claiming superior ability, or promising higher returns, lower risk or better service, because of the designation or exam results violates Standard VII(B).
- Stating that one is a charterholder, describing accurately what the designation requires, and stating that holding the charter reflects a commitment to high ethical standards are allowed.
- Members should check that their firms know how to refer correctly to a member's CFA designation or candidacy.

QUICK CHECK**Question 1**

Tariq Haddad, a Level III candidate, takes part in an online forum where candidates discuss curriculum readings in depth during the study season. Four days after his testing window closes, frustrated by difficult questions, he posts several exam questions he remembers and asks other members how they answered them and why. Several other candidates respond by posting questions they remember. Haddad and the other candidates are *most likely*:

- A** not in violation, because the posts appeared only after the testing window had closed.
- B** in violation, because they disclosed confidential information about the exam.
- C** in violation, because they discussed curriculum topics in a public forum ahead of the exam.

Answer: B

Under Standard VII(A) Conduct as Participants in CFA Institute Programs, confidential information about the exam may not be disclosed, and that obligation continues after the exam and after the testing window has closed. Posting remembered exam questions is therefore a violation; discussing the curriculum itself in the forum beforehand was not.

Why the other options are wrong

- **A.** Confidentiality of exam content does not expire when the testing window closes.
- **C.** Discussing the curriculum itself before the exam is permitted; the violation is disclosing exam content.

Key takeaway Curriculum discussion is allowed. Exam content stays confidential with no time limit.

Practice questions**Question 2**

A regional broker has just hired Mei Tanaka and Callum Reid. Each cleared both Level I and Level II at the first try, and neither business card refers to the CFA Program. Tanaka's marketing materials accurately describe the requirements of the CFA Program and add: "Because I cleared the first two levels at the first try, my clients can expect better results than other advisers deliver." Reid's materials say only, and truthfully, that he cleared the first two levels at the first try. Has either new hire violated the CFA Institute Standards of Professional Conduct?

- A** Only one of them has violated the Standards.
- B** Both of them have violated the Standards.
- C** Neither of them has violated the Standards.

Question 3

Anika Sorensen, CFA, learned in March that a national securities regulator had opened an investigation into her trading practices. When she completes her annual Professional Conduct Statement in May, she answers "no" to the question asking whether she is the subject of any regulatory investigation. Sorensen has *most likely* violated:

- A Standard VII(A) Conduct as Participants in CFA Institute Programs.
- B Standard V(C) Record Retention.
- C no Standard, because the investigation has not yet reached a conclusion.

Answers: 2. A · 3. A

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/responsibilities-as-a-cfa-institute-member/. The full bank has 25 questions on this reading.

credguild.com

ETHICAL AND PROFESSIONAL STANDARDS · READING 102

Application of the Code and Standards: Level I

What you'll learn

LOS 102.a Evaluate practices, policies and conduct against the CFA Institute Code of Ethics and Standards of Professional Conduct.

LOS 102.b Explain why particular practices, policies and conduct do or do not violate the Code and Standards.

MODULE 102.1

Ethics Application

This reading tests two skills: evaluating practices, policies and conduct against the Code and Standards, and explaining why a given act does or does not violate them.

This reading applies the whole Code and Standards to short cases. It introduces no new rules; the skill tested is recognizing which Standard a fact pattern touches and whether the conduct crosses the line. Three questions help with every case: (1) whose interests are at stake (market, clients, employer, CFA Institute)? (2) which fact decides the outcome? (3) what should the member have done instead?

LOS 102.a — Evaluating practices, policies and conduct against the Code and Standards

Standard I: Professionalism

KEY CONCEPT

Standard	Key judgment in application cases
I(A) Knowledge of the Law	On learning of illegal or unethical conduct, the member first tries to stop it through supervisors or compliance. If that fails, the member must dissociate (e.g., ask to be reassigned, refuse to work on the affected clients, resign from a board). A partial fix is not enough: if some clients are still affected, the member must not keep working on those accounts. The Code and Standards do not require reporting to regulators unless the law requires it, although it may be advisable. Ignoring red flags (e.g., money-laundering indicators because the client is well connected) or forging signatures for convenience is a violation.
I(B) Independence and Objectivity	Gifts, political contributions or benefits intended to win business or influence judgment violate the Standard.
I(C) Misrepresentation	No guaranteeing returns on risky investments; no omission of material facts (e.g., key staff named in a proposal who have since left must be disclosed); no false statements such as claiming financing that does not exist. Plagiarism: charts, text or models copied from others must be attributed. Two exceptions: projections, statistics and tables from recognized financial and statistical reporting services may be used without acknowledgment, and models or research by colleagues at the member's own firm may be used without naming colleagues who have left, as long as the member does not present that work as solely his or her own.

Standard**Key judgment in application cases**

I(D) Misconduct	Has two parts: no professional conduct involving dishonesty, fraud, or deceit , and no act that reflects adversely on professional reputation, integrity, or competence. The second part reaches only work-related professional responsibilities and professional activities; acts outside the member's professional capacity are not covered. Minor offenses committed during civil disobedience to express personal beliefs are not necessarily a violation. Using an error-correction process to put personal money into a client account to flatter performance is deceit.
I(E) Competence	Accepting a new role (e.g., supervisory duties) requires taking steps to gain the needed competence.

Standard II: Integrity of Capital Markets

- II(A) **Material Nonpublic Information.** Overheard takeover news, or a regulator's reaction shared with a small group of analysts (**selective disclosure**), may not be acted on. The **mosaic theory** permits acting on a conclusion built from public information and nonmaterial nonpublic observations.
- II(B) **Market Manipulation.** Violations include misleading the market about liquidity (e.g., listing fake shareholders to meet exchange requirements), spreading false information, and trading to create artificial prices or volume. **Block trades** to limit price impact in a thinly traded stock are legitimate.

Standard III: Duties to Clients

- III(A) **Loyalty, Prudence, and Care.** Members cannot contract out of their duties to clients: client agreements may not excuse the firm from acting in clients' best interests or restrict clients' legal claims. For a self-directed, execution-only account the duties are narrower than in an advisory relationship, but the member must still act in good faith and describe the services honestly. How the firm will act if the account has a margin shortfall is a term the client can negotiate when the account is opened. A client may be charged expenses incurred to lower that client's total costs, but never expenses that benefit other clients or the member personally. **Soft dollars** (client brokerage) may pay only for research and services that benefit clients. Office furniture and personal expenses do not qualify.
- III(B) **Fair Dealing.** Recommendation changes must be disseminated fairly to all clients for whom they are relevant, at the same time or as close to it as practicable; answering follow-up questions afterward is acceptable. A fee-based premium service is allowed if all clients know it exists and it never delivers recommendation changes ahead of other clients; disclosing the service does not make early delivery acceptable.
- III(C) **Suitability.** Investigate a client's circumstances before acting, even on a client-requested change. Tax advantages do not excuse excessive risk.
- III(D) **Performance Presentation.** Do not present separate-account composites as a new fund's long track record. A **brief presentation** must make detailed information available on request and say that it offers only limited information.
- III(E) **Preservation of Confidentiality.** Protect client data; downloading client files to unsecured personal systems is a breach, and a compliance head whose controls allowed such a download may also be in breach. *Exception:* confidentiality does not prevent a member from cooperating with a CFA Institute **Professional Conduct Program (PCP)** investigation, because the PCP keeps the information confidential.

Standard IV: Duties to Employers

- IV(A) **Loyalty**. While still employed, a member may not disparage the current employer or solicit for a future employer, and may not take client lists or other employer property (even to send thank-you notes). Before performing outside work that could compete with the employer, including advisory work for which any benefit is received, the member must obtain the employer's permission. Whistleblowing to regulators to protect clients is not a loyalty violation.
- IV(B) **Additional Compensation Arrangements**. Any benefit that competes with or could create a conflict with the employer's interest (a bonus from a company seeking coverage; perks from a broker tied to the volume of employer business) requires **written consent** from all parties involved. When the outside party has already made its offer in writing, the employer's written consent is what remains.
- IV(C) **Responsibilities of Supervisors**. Make reasonable efforts to prevent and detect violations by all persons supervised, including those who are not CFA charterholders: distribute the compliance program, send periodic reminders, and include professional conduct in performance reviews. Without adequate procedures or authority, **decline supervisory responsibility** in writing.

Standard V: Investment Analysis, Recommendations, and Actions

- V(A) **Diligence and Reasonable Basis**. Analysis must be independent and thorough; relying on another analyst's unsupported work is also a violation. Numbers supplied by company management must be reviewed critically. Research from third parties may be used after a reasonable and diligent review of whether it is sound: its assumptions, the rigor of the analysis, how timely it is, and the objectivity and independence of its recommendations. Firms should set criteria for evaluating external advisers and outside information providers and say how often the reviews are repeated.
- V(B) **Communication with Clients and Prospective Clients**. Disclose methodology changes and distinguish fact from opinion. Reports need not give every area equal emphasis.
- V(C) **Record Retention**. Keep written client records up to date.

Standard VI: Conflicts of Interest

- VI(A) **Avoid or Disclose Conflicts**. Disclose personal holdings in stocks one covers (to the employer, and in research sent to clients) and time-consuming outside roles such as a trusteeship of a large endowment (to the employer); disclose payments from subadvisers to clients.
- VI(B) **Priority of Transactions**. Clients and the employer come first. Front-running client orders, tipping friends and family ahead of client trades, allocating winning block trades to personal accounts after the close (losers to large clients), or giving family members priority are violations. Personal transactions, those in which the member is a beneficial owner, follow client and employer transactions. Family accounts that are fee-paying client accounts are treated like any other client account, neither favored nor disadvantaged.
- VI(C) **Referral Fees**. Disclose to clients and prospects any benefit received for referrals and any benefit given to others for referring clients (including a share of fees paid to a bank or landlord that refers clients, and rewards such as fee discounts, gifts or hospitality for clients who refer others).

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

- VII(A) Conduct as Participants in **CFA Institute Programs**. Candidates may share general impressions of difficulty, but not specific questions or **which topics were or were not tested**. Soliciting such information is also a violation.

- VII(B) Reference to CFA Institute, the **CFA Designation**, and the **CFA Program**. There is no "CFA Level I" or "CFA Level II" designation. A candidate may state that he or she is a "Level II Candidate in the CFA Program" or has passed a given level. A member whose dues are unpaid may not use the designation, and a firm may not describe all its senior staff as charterholders if any of them is not an active member.

LOS 102.b — Explaining why conduct does or does not violate the Standards

Most application questions offer three outcomes: *no violation*, *violation of the right Standard*, and *violation of a plausible but wrong Standard* (or the right Standard for the wrong reason). The explanation must name the deciding fact:

Some Standards cover neighboring ground. Ask what the conduct is about: a misstatement of any kind, performance figures, or what clients are told about the process; fairness among clients, or the member's own trades against clients'. (Gifts, outside pay, conflicts and referral fees are compared in the Standard VI notes.)

Standards that are often confused

Standard	What it governs	Typical breach
I(C) Misrepresentation	Any knowing misstatement or omission in professional activities, including plagiarism and false guarantees	Promising a fixed return on a stock fund; copying another analyst's chart without credit
III(D) Performance Presentation	Performance information for clients and prospects: fair, accurate and complete	Showing only the best accounts as the firm's record; implying past returns will be repeated
V(B) Communication with Clients and Prospective Clients	Services and costs, the investment process and changes to it, risks and limitations; fact versus opinion	Not telling clients about a switch to a new valuation model; stating a forecast as fact
III(B) Fair Dealing	Fairness among clients when disseminating recommendations and allocating trades	Giving favored clients a rating change first; allocating the best fills to the largest accounts
VI(B) Priority of Transactions	Order of trades: clients and employer before accounts the member beneficially owns	Buying for one's own account ahead of a client order or a pending recommendation

KEY CONCEPT**Deciding fact in the stem****Typical conclusion**

Information came from a general newswire

Public, so II(A) is not the issue; look at priority of transactions or fair dealing instead

Member told a relative before acting for clients or employer

VI(B) Priority of Transactions

Member receives a benefit tied to employer business

IV(B): obtain written consent

A client's bonus rewards results already achieved and carries no condition on future performance

I(B): a client gift, disclosed to the employer; IV(B) written consent applies when the bonus depends on future performance

Member refers clients or shares fees for referrals

VI(C): disclose to clients and prospects

Member serves on outside boards or owns stock under coverage

VI(A): disclose to the employer, and to clients and prospects when it could affect research or advice

Management revised the analyst's numbers

V(A): the analyst must review them independently

Only general topics of the exam were shared

Still VII(A) if they reveal which topics were tested or not tested

Example. An analyst learns from a radio broadcast that an issuer will buy back shares at a premium, first come, first served. She tenders her sister's shares first and the pension clients' shares an hour later. The information is public, so II(A) is not the issue. Putting a family account ahead of clients violates VI(B) Priority of Transactions.

COMMON EXAM TRAPS

- "Resign" or "refuse the benefit" is usually too extreme when disclosure or written consent solves the conflict.
- The mosaic theory makes many "wait until it is announced" answers wrong when the pieces were nonmaterial or public.

EXAM SHORTCUTS

- If the information in a stem came from a general newswire, it is public, so Standard II(A) is not the issue and the answer usually lies in priority of transactions or fair dealing.

BOTTOM LINE

- Application questions test which Standard a fact pattern touches and whether the conduct crosses the line, and the explanation must name the fact that decides the outcome.

- Under Standard I(A), a member who cannot stop a violation through supervisors or compliance must dissociate, and a partial fix that leaves some clients affected is not enough.
- Members cannot contract out of their duties to clients, so a client agreement may not excuse the firm from acting in clients' best interests or restrict clients' legal claims.
- Soft dollars may pay only for research and services that benefit clients, never for office furniture or personal expenses.
- A fee-based premium service is allowed if all clients know it exists and it never delivers recommendation changes ahead of other clients, and disclosing the service does not make early delivery acceptable.
- Under Standard IV(B), a benefit that competes with or could create a conflict with the employer's interest needs written consent from all parties involved, and when the outside party has already made its offer in writing, the employer's written consent is what remains.
- Putting a family member's account ahead of clients violates Standard VI(B) even when the information acted on is public.
- Candidates may share general impressions of exam difficulty but not specific questions or which topics were or were not tested, and soliciting such information also violates Standard VII(A).

QUICK CHECK

Question 1

Kwame Mensah, CFA, finds that his manager has breached a national securities regulation. Mensah raises the matter with his firm's compliance department, which does nothing about it. Under the Code and Standards, Mensah is required to:

- A** report the breach to the securities regulator.
- B** confront his manager and try to stop the breach.
- C** dissociate himself from his manager's activity.

Answer: C

Under Standard I(A) Knowledge of the Law, Mensah has already tried to stop the violation by going to compliance. Because that failed, he must dissociate from the activity; one way is to request a move away from the work involved. Reporting to regulators is not something the Code and Standards demand unless applicable law requires it, and a personal confrontation with his manager is not required either.

Why the other options are wrong

- **A.** Reporting to regulators may be advisable, but the Code and Standards do not require it unless the law does.
- **B.** He has already made a reasonable attempt to stop the violation through compliance; a personal confrontation is not required.

Key takeaway Escalate internally first; if that fails, dissociate. Reporting to authorities is required only when the law requires it.

Practice questions

Question 2

Dmitri Volkov, CFA, an investment adviser, uses soft dollars generated by client trades to pay for two things: a subscription to a macroeconomic research service that he uses in managing client portfolios, and new leather chairs for the reception area where he meets clients and prospects. Under Standard III(A) Loyalty, Prudence, and Care:

- A only one of the two purchases is a violation.
- B both of the two purchases are violations.
- C neither of the two purchases is a violation.

Question 3

Imogen Achterberg, CFA, runs portfolios for about 350 private clients and has little spare research capacity. Several of her largest clients ask her to add a 4% to 6% allocation to emerging market local-currency bonds, so she plans to base her bond selections on reports bought from an outside research provider that specializes in that sector. In judging whether the provider's research gives her a reasonable basis, the factor Achterberg should *least likely* rely on is:

- A the assumptions behind the provider's analysis and how rigorous that analysis is.
- B the high return its model portfolio earned last year.
- C how timely the research is and whether its recommendations are objective and independent.

Question 4

Tariq Haddad and Lena Vogt each cleared the Level I exam and have registered to sit for Level II. The headline of Haddad's online professional profile reads "Tariq Haddad, CFA Level I." Vogt's résumé describes her as a "Level II Candidate in the CFA Program." Under Standard VII(B) Reference to CFA Institute, the CFA Designation, and the CFA Program:

- A Haddad violated the Standard, but Vogt did not.
- B Vogt violated the Standard, but Haddad did not.
- C Both Haddad and Vogt violated the Standard.

Answers: 2. A · 3. B · 4. A

Why each answer is right and why each other option is wrong: credguild.com/cfa/level-1/notes/ethics/application-of-the-code-and-standards-level-i/. The full bank has 28 questions on this reading.

Keep going at credguild.com

The notes are the start. These are free on the site and do what a PDF cannot:

- **Diagnostic test:** 36 questions weighted like the exam, a score in each topic and the topics to start with.
credguild.com/cfa/level-1/diagnostic/
- **Practice questions:** 398 free questions with full explanations, scored as you answer. A free account answers any question in the bank, up to 50 new questions a day. credguild.com/cfa/level-1/practice/
- **Notes:** every reading of the 2027 curriculum, with worked examples and exam traps, on the site and as a PDF. credguild.com/cfa/level-1/notes/
- **Study plan:** pick your exam window and weekly hours and get a week-by-week schedule.
credguild.com/cfa/level-1/plan/
- **Mock exam:** 180 questions in two sessions, on the 2027 topic weights; the first one is free with an account.
credguild.com/cfa/level-1/mock/
- **Cheat sheet and formula sheet:** every reading's bottom line and every formula, by topic.
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Found a mistake? Email hello@credguild.com.