44 APPLICATION OF THE CODE AND STANDARDS LEVEL II

Jacques Claudel, a CFA Institute member, represents Vector Funds, a U.S.-based fund manager, in Canada. Although Vector Funds is properly licensed to deal in all Canadian and U.S. securities, its primary objective is to sell United States funds to Canadian institutional investors seeking diversification into the U.S. dollar. While it would be willing to do so if requested by its clients, Vector has not placed trades in Canadian securities since Claudel began working there two years ago.

Prior to joining Vector's Canadian operations, Claudel was an independent asset manager handling the funds of wealthy individuals and small institutions. Most of these accounts remain under his management, under the business name Coup de Gras. Claudel is unclear as to whether his consulting work is in competition with his new employer, as the accounts under his management are invested strictly in Canadian securities, while Vector has not traded Canadian securities. However, just to be on the safe side, he obtained written permission from Vector to continue serving his former clients. His former clients were not notified.

Claudel receives cash compensation for most of the accounts he handles independently, but for one he receives a new car for his personal use every two years, and for another he is compensated with a one-week, expenses-paid holiday in the European country of his choice.

As part of his responsibility, Claudel makes trades for some of his Canadian clients. He runs all of his trades through two brokers, Ace Equity Traders and the Parlay Group. Ace offers some of the best research available on health-care stocks, but charges fairly hefty commissions. Parley has some of the cheapest commissions in Toronto, but provides no research of value to Claudel.

Henri Bonnet, CFA, a friend of Claudel's, works on the floor of the Vancouver Stock Exchange. He asks Claudel to establish an account for him at Coup de Gras. Claudel learns that it is Bonnet's intention to manipulate the prices of penny stocks he trades on the exchange, and profit from the price movements in the account at Coup de Gras. Claudel sets up the account, but advises Bonnet that he "will have nothing to do" with the manipulation scheme beyond placing trades as Bonnet directs.

Claudel is currently pursuing a master's degree in financial economics in the evenings. During the interview with Vector and on his resume he indicated that he "attended Victoria University," giving his estimated date of graduation. He is not sure whether Vector understood that he did not have his master's degree.

1. Which of the following statements about consulting work is CORRECT?
   (A) In some circumstances the employee must receive the employer's written permission prior to receiving additional compensation from parties other than the firm. This requirement applies to both monetary and non-monetary compensation.
   (B) In all cases the employee must receive the employer's written permission prior to receiving additional compensation from parties other than the firm. This requirement applies to both monetary and non-monetary compensation.
   (C) In some circumstances the employee must receive the employer's written permission prior to receiving additional compensation from parties other than the firm. This requirement applies to monetary compensation only.

2. Claudel's statement about his education background is:
   (A) truthful, but not in accord with the Code and Standards.
   (B) truthful, and in accord with the Code and Standards.
   (C) not truthful, and not in accord with the Code and Standards.

3. Which of the following statements is CORRECT?
   (A) Bonnet has violated Standard III(B): Fair Dealing, and Claudel has violated Standard I(B): Independence and Objectivity.
   (B) Bonnet has violated Standard II(A): Material Nonpublic Information, and Claudel has not violated Standard III(A): Loyalty, Prudence, and Care.
   (C) Bonnet has violated Standard IV(A): Loyalty to Employer, and Claude! has violated Standard 1(A): Knowledge of the Law.

4. Assuming that both Ace Equity Traders and the Parlay Group offer best execution, Claude!:
   (A) must disclose to clients whether client-directed brokerage will prevent him from getting the best execution.
   (B) must direct all the trades for clients who do not wish to own health-care stocks to the Parlay Group.
   (C) can select the broker that refers the most business back to him, as long as any research purchased benefits the client whose account is being traded.

5. Patricia Spraetz is the chief financial officer and compliance officer at Super Selection Investment Advisors. Super Selection is a medium-sized money management firm which has incorporated the CFA Institute Code of Ethics and Standards of Practice into the firm's compliance manual.

   Karen Jackson is a portfolio manager for Super Selection. She is not a CFA charterholder. Jackson is friendly with David James, president of AMD, a rapidly growing biotech company. James has provided Jackson with recommendations in the biotech industry, which she buys for her own portfolio before buying them for her clients. For three years, Jackson has also served on AMD's board of directors. She has received options and fees as compensation.

Recently, the board of AMD decided to raise capital by voting to issue shares to the public. This was attractive to board members (including Jackson) who wanted to exercise their stock options and sell their shares to get cash. When the demand for initial public offerings (IPO) diminished, just before AMD's public offering, James asked Jackson to commit to a large purchase of the offering for her portfolios. Jackson had previously determined that AMD was a questionable investment but agreed to reconsider at James' request. Her reevaluation confirmed the stock to be overpriced, but she nevertheless decided to purchase AMD for her clients' portfolios.

Which of the following statements concerning Super Selection is CORRECT?

(A) Spraetz, in her capacity as a supervisor, violated Standard IV(C) by not preventing violations by Jackson.

(B) Jackson did not violate the CFA Institute Code of Ethics and Standards since she is not a CFA charterholder.

(C) All employees of a firm are bound by CFA Institute's Code and Standards if they are incorporated in the company's policies manual, and the firm subscribes to them explicitly.

6. Patricia Spraetz is the chief financial officer and compliance officer at Super Selection Investment Advisors. Super Selection is a medium-sized money management firm which has incorporated the CFA Institute Code of Ethics and Standards of Practice into the firm's compliance manual.

Karen Jackson is a portfolio manager for Super Selection. She is not a CFA charterholder. Jackson is friendly with David James, president of AMD, a rapidly growing biotech company. James has provided Jackson with recommendations in the biotech industry, which she buys for her own portfolio before buying them for her clients. For three years, Jackson has also served on AMD's board of directors. She has received options and fees as compensation.

Recently, the board of AMD decided to raise capital by voting to issue shares to the public. This was attractive to board members (including Jackson) who wanted to exercise their stock options and sell their shares to get cash. When the demand for initial public offerings (IPO) diminished, just before AMD's public offering, James asked Jackson to commit to a large purchase of the offering for her portfolios. Jackson had previously determined that AMD was a questionable investment but agreed to reconsider at James' request. Her reevaluation confirmed the stock to be overpriced, but she nevertheless decided to purchase AMD for her client's portfolios.

Which of the following actions are most appropriate for Spraetz?

(A) If, after her investigation Spraetz finds that Jackson has committed violations, Spraetz' must report them to senior management and seek legal counsel for possible legal and regulatory implications. If the upper management does not follow through and take action, Spraetz has fulfilled her supervisory duties and need not take any further action.

(B) Even though Spraetz does not supervise Jackson, as the compliance officer of the firm she is responsible for identifying violations. Spraetz is not responsible for preventing them and should not go beyond their documentation for senior management. Thus, she should record the violations but need not take any further action.

(C) Spraetz, as the chief compliance officer, must set company policy in clear terms and monitor the actions of the employees. In case of violations, she should investigate thoroughly, initiate disciplinary action, and issue guidelines that must be followed in order to prevent future violations. She must not only detect violations through a continuous monitoring process but also provide guidance for proper conduct consistent with the firm's policy manual.

7. Which of the following statements concerning Sherman's actions is CORRECT?

(A) Sherman did not violate Standard IV(A) since members can engage in independent consulting practice as long as their employer policy does not specifically prohibit it.

(B) Sherman did not violate Standard IV(A) by soliciting clients that were rejected by Pearl either because they were too small or unsuitable as long as winning their business did not adversely affect Pearl.

(C) Sherman did not violate any Standard by taking away the news articles from his previous employer, Pearl, for potential research ideas.

8. Sherman's attempt to lure away clients from Pearl while he was still employed at Pearl is:

(A) a violation of Standard IV(A) because it undermined Pearl's business and its profit opportunities and caused damage to Pearl's business.

(B) not a violation of Standard V(A) because it was conducted "after hours" on Sherman's own time.

(C) not a violation of Standard IV(A) because they would have followed Sherman to his new firm anyway, and no harm to Pearl was done as a result.

9. Patricia Spraetz is the chief financial officer and compliance officer at Super Selection Investment Advisors. Super Selection is a medium-sized money management firm which has incorporated the CFA Institute Code of Ethics and Standards of Practice into the firm's compliance manual.

Karen Jackson is a portfolio manager for Super Selection. She is not a CFA charterholder. Jackson is friendly with David James, president of AMD, a rapidly growing biotech company. James has provided Jackson with recommendations in the biotech industry, which she buys for her own portfolio before buying them for her clients. For three years, Jackson has also served on AMD's board of directors but has never notified Super Selection of this fact. She has received options and fees as compensation.

Recently, the board of AMD decided to raise capital by voting to issue shares to the public. This was attractive to board members (including Jackson) who wanted to exercise their stock options and sell their shares to get cash. When the demand for initial public offerings (IPO) diminished, just before AMD's public offering, James asked Jackson to commit to a large purchase of the offering for her portfolios. Jackson had previously determined that AMD was a questionable investment but agreed to reconsider at James' request. Her reevaluation confirmed the stock to be overpriced, but she nevertheless decided to purchase AMD for her clients' portfolios.

Which of the following statements is NOT correct?

(A) Jackson violated Standard IV(B) regarding Disclosure of Additional Compensation by not disclosing additional compensation in the form of cash and stock options received from AMD, as its board member to her employer.

(B) Jackson violated Standard VI(A) regarding Conflicts of interest by not disclosing her board membership and ownership of stock options to her employer.

(C) Jackson did not violate Standard III(A) on Fiduciary Duty to clients because she was bound by her fiduciary duty to AMD and its stockholders as a board member. Therefore, when she reversed her decision to buy AMD shares for Super Selection's clients, portfolios on James' request, her obligation to AMD took precedence.

10. Alpha Asset Management manages portfolios for clients with more than $10 million in assets. Bob Smith, a portfolio manager at Alpha, is planning to leave Alpha to set up company Beta Investment Management, to focus exclusively on clients with less than $10 million in assets. While he is still employed at Alpha, Smith begins to solicit (on his own time) potential clients with less than $10 million in assets — clients that Alpha has previously rejected for being too small. According to the Standards of Professional Conduct IV(A) related to duties to employer, Smith's solicitation of these clients is:

(A) unacceptable as he may not engage in any activities to go into business while he is still employed by Alpha.

(B) acceptable as he is not in competition with his current employer.

(C) unacceptable since the fact the Beta will not be in competition with Alpha is irrelevant.

11. Jim Jones is an equity research analyst at Gamma funds. Because of his expertise in the telecommunications field, a Chinese telecommunications provider hires Jones as a consultant to help them identify potential investors. According to the Standards of Professional Conduct IV(A) related to duties to employer, Jones must:

(A) describe to his employer in detail the activities related to this consulting arrangement.

(B) obtain verbal permission from his employer to engage in this consulting arrangement.

(C) refuse this consulting arrangement.

12. Karen Jackson is a portfolio manager. Jackson is friendly with David James, president of Acme Medical, a rapidly growing biotech company. James has provided Jackson with recommendations in the biotech industry, which she buys for her own portfolio before buying them for her clients. For three years, Jackson has also served on Acme Medical's board of directors. She has received options and fees as compensation.

Recently, the board of Acme Medical decided to raise capital by voting to issue shares to the public. This was attractive to board members (including Jackson) who wanted to exercise their stock options and sell their shares to get cash. When the demand for initial public offerings (IPO) diminished, just before Acme Medical's public offering, James asked Jackson to commit to a large purchase of the offering for her portfolios. Jackson had previously determined that Acme Medical was a questionable investment but agreed to reconsider at James' request. Her reevaluation confirmed the stock to be overpriced, but she nevertheless decided to purchase Acme Medical for her clients' portfolios.

Did Jackson violate Standard III(C) Suitability concerning portfolio recommendations and actions?

(A) Yes, because she did not consider the appropriateness and suitability of investment recommendations or actions for each portfolio or client.

(B) Yes, because she did not deal fairly with all clients.

(C) No.