CHAPTER 44

APPLICATION OF THE CODE AND STANDARDS LEVEL II

1. (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.**

   Explanation

   Standard IV(A): Loyalty to Employer requires written permission from both the employer and the consulting customer if the work involves competition with the employer. An example of an instance not requiring permission would be if a CFA charterholder who works for a broker wishes to write grants for a nonprofit foundation. In such case, he need not get permission, nor does he need to disclose the compensation. This Standard applies for work that provides either monetary or nonmonetary compensation.

   (Module 44.1, LOS 44.b)

   Related Material

   SchweserNotes - Book 5

2. (B) **truthful, and in accord with the Code and Standards.**

   Explanation

   Standard I(C) Misrepresentation states that "members shall not make any statements, orally or in writing, that misrepresent the member's academic or professional credentials. "In this case, Claudel's statements are truthful, and are not a violation of the Standard. He could have been more clear, but what he said is undeniably correct. Whether Vector understood what he told them is not his problem, as long as he was truthful and did not attempt to deceive them.

   (Module 44.1, LOS 44.b)

   Related Material

   SchweserNotes - Book 5

3. (C) **Bonnet has violated Standard IV(A): Loyalty to Employer, and Claudel has violated Standard I(A): Knowledge of the Law.**

   Explanation

   Bonnet violated several Standards, including IV(A) and II(B), by manipulating stock prices and profiting from that manipulation at the expense of other purchasers. Standard IV(A) requires that employees not act to injure the firm or deprive it of profits, and Bonnet's personal trading and market manipulation crosses well over that line. However, Bonnet did not violate Standard II(A) Material Nonpublic Information because no nonpublic information was involved. Claudel violated Standard I(A) by contributing to Bonnet's plans to break the law. Under the Code and Standards, Claudel cannot knowingly assist others who are violating the Standards or the law, even if he does not profit personally. While Claudel's ethics are in question, nothing he did for Bonnet is likely to affect his independence, and he did not violate Standard I(B) Independence and Objectivity.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

4. (B) **must direct all the trades for clients who do not wish to own health-care stocks to the Parlay Group.**

Explanation

The Standards require that purchased brokerage directly benefits the client. Clients who do not hold health-care stocks get no benefit from Ace's research, so Claudel is obligated to send their trades to the broker with the lowest transaction costs. While disclosing the risks of client-directed brokerage is a good idea, it is not relevant in this case because we are not given any information about client directed trades. Referrals can play no part in the broker-selection process.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

5. (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.**

Explanation

Even though Jackson is not a CFA charterholder, she is nevertheless required to follow the Code and Standards since her firm subscribes to them and has incorporated them in its policy manual.

Standard IV(C) violation is not clear or obvious since the case does not say much about a lack of guidelines or explicit gaps in the policy manual. Under this assumption, Spraetz is not guilty of any supervisory violation. Even though Jackson did not personally trade ahead of purchasing AMD shares for her clients, she had done so in the past and is in violation of Standard VI(B). Spraetz needs to act on it because this violation has only just come to light.

(Module 44.1, LOS 44.a)

Related Material

SchweserNotes - Book 5

6. (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.**

Explanation

Since Spraetz has the authority to hire, fire, reward, and punish Jackson, Spraetz has supervisory duties in addition to being the chief compliance officer of Superior Selection. She must investigate Jackson and report her findings to her superiors and possibly the board. If no action is taken, Spraetz must consider resigning under the CFA Institute Code and Standards. Spraetz is also responsible for setting the policy, preventing and detecting violations, and putting into place reasonable procedures to monitor employees' actions. Her role as the chief compliance officer requires her to take disciplinary actions in order to deter further violations.

(Module 44.1, LOS 44.b)

Related Material

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Glenarm Case Study (Refer to CFA Institute Standards of Practice Casebook for details.)

Peter Sherman, CFA, has recently joined Glenarm Company after spending 5 years at Pearl Investment Management. He is responsible for identifying potential Latin American investments. Previously, Sherman held jobs as a consultant for many Latin American companies and had plans to continue such consulting jobs without disclosing anything to Glenarm.

After resigning, but before leaving his employment at Pearl, Sherman had encouraged Pearl customers to move their accounts to Glenarm. He contacted accounts Pearl had been soliciting for business. He also contacted potential clients that Pearl had rejected in the past as too small or incompatible with the firm's business. Furthermore, he convinced several of Pearl's clients and prospects to hire Glenarm after he joined Glenarm. He also identified materials from Pearl to take with him, such as:

(1) Sample marketing presentations he had prepared.

(2) Computer program models for stock selection.

(3) Research materials on companies he had been following.

(4) A list of companies recommended by Sherman for potential investment which were rejected by Pearl.

(5) News articles for potential research ideas.

7. (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.**

Explanation

Standard IV(A) addresses Loyalty to the Employer and depriving the employer of profit opportunities is a violation of this standard. Because Pearl had no interest in rejected clients and had turned their profit potential down already, soliciting them is not a violation.

Taking away news articles and computer program models is a violation of Standard IV(A) because Sherman took away employer property, which could be used by Pearl or Sherman's replacement. Engaging in independent consulting practice is a violation IV(A) because Sherman not only compromised his independence and objectivity, but also did not obtain explicit written consent of his new employer, Standard IV(B), Additional Compensation Arrangements.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

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

Explanation

An attempt, successful or not, to lure away existing clients of the current employer is a violation of Standard IV(A) as it causes damage to the employer's business.

Others are incorrect because: "After hours" solicitation is not an excuse if it damages the employer's business; the fact that Pearl's clients were agreeable does not absolve Sherman of Standard IV(A) violation; even if Pearl's clients would have followed Sherman to his new employer anyway, Sherman, by soliciting such clients, damaged his employer's business. The focus is on Sherman's actions.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

9. (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.**

Explanation

Jackson has violated Standard III(A) because her first obligation is to her firm's clients. Standard VI(A) addresses precisely these kinds of situations regarding potential conflict of interest. Given this conflict of interest, Jackson also compromised her objectivity in violation of Standard I(B). Her fiduciary duty to her clients takes precedence over her fiduciary duty to AMD's stockholders under the CFA Institute Code and Standards. By not disclosing her relationship with AMD, she also violated Standard IV(B). Making past personal security transactions ahead of purchase of the same securities for her clients has put Jackson in violation of Standard VI(B). This standard clearly prohibits such actions.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

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

Explanation

It is acceptable for Smith to solicit clients for his new employer on his own time as long as he is not in any way competing with his employer. Standard IV(A) prohibits only actions that have the potential to cause harm to Smith's employer.

(Module 44.1, LOS 44.a)

Related Material

SchweserNotes - Book 5

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

Explanation

According to the Standards of Professional Conduct, Jones must disclose to his employer all outside compensation arrangements, describe to his employer in detail the activities that give rise to outside compensation, and obtain written permission from his employer in advance.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5

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

Explanation

Jackson violated Standard III(C) Suitability because she did not consider her clients' financial situation, investment experience, and investment objectives.

(Module 44.1, LOS 44.b)

Related Material

SchweserNotes - Book 5