

CFA L2 Candidates

We've been receiving huge number of requests for help in understanding some challenging Case Studies of CFA Institute core.

Here, we are providing some support (in the form of audio explanation) to help all L2 candidates understand the same. The Case Studies all belong to the CFA Institute—we are just providing some support to help understand the concepts involved.

Hope it helps!

Ardy Sobhani Case Scenario

Better Investments, founded by Ardy Sobhani, CFA, five years ago, is an investment adviser serving mostly middle-income clients along with several high-net-worth clients. Sobhani initially worked alone, but because of rapid growth, Better Investments has expanded to 20 employees today. Better Investments continues to add new clients and recently hired a junior analyst, Shigeru Miyagawa.

Miyagawa is registered for Level I of the CFA exams. He recently learned that Sobhani has been an instructor with a CFA exam prep program for many years, so he asks Sobhani if he can provide any tips on the exam. Sobhani responds, “Our prep course providers looked at the curriculum readings and based on this analysis we do not think you should worry about exotic over-the-counter (OTC) derivatives being tested. Instead focus on the core body of knowledge. CFA Institute has a heavier weighting on equities and fixed-income analysis, and I am sure the exam will always have a similar emphasis.” Miyagawa replies, “when I took the practice exam it seemed to have more weight on alternative investments.”

Joli Poundston, a long-time client of Better Investments, is in her late 60s and in poor health. She plans to retire in two years and insisted that Sobhani sell all of her stock holdings during a market low point last year. Poundston then insisted Sobhani invest her assets only in bonds and cash to preserve her capital and reduce her risk exposure. After watching the stock market increase recently, Poundston calls Sobhani to request some equity exposure in her portfolio. Sobhani drafts a note to Poundston telling her “there is no better time to invest in the stock market than right now. With stocks approaching all-time highs, it is foolish not to own stocks and miss out on an opportunity to reap the rewards of a growing market. I recommend that you invest at least 60% of your assets in stocks to take advantage of what is, in my opinion, a rising market environment for the next couple of years.”

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The next day, Sobhani is surprised to see a securities industry regulator appear at his office. The regulator indicates a complaint has been received about Better Investments and asks to see all client investment records so an initial assessment of the issue can be made. Sobhani makes available those client files kept on-site covering the past seven years, as required by local legal statutes. For files older than seven years, he refers the regulator to the clients' brokers. Sobhani asks Miyagawa to respond to any other requests from the regulator and to make careful notes on any comments or recommendations the regulator has concerning compliance issues. The firm's compliance policies and procedures were finalized at the firm's inception, and Sobhani plans to use what he learns from this visit to reflect in these documents any regulatory changes over the past five years.

In a meeting with Spencer Purce, a prospective client who recently sold his business for over \$100 million, Sobhani learns that Purce plans to quit working. Purce asks for ideas on how to invest his sale proceeds to build wealth within a trust structure so that he can pass capital on to his twin sons, who are 19-year-old students. Sobhani tells Purce:

Considering your objectives specifically, I looked at infrastructure projects in developing countries for clients interested in diversifying their portfolios with long-duration projects, consistent cash flow, high operating margins, and a positive correlation to inflation. These types of investments require large up-front cash injections, patience, and the ability to accept a long cash out period. But, there are several benefits to this type of investment that I think are important for you, including diversification, exposure to rapidly growing economies, and returns, which are currently in the 8%–12% range, based on my review of similar investments.

Sobhani advises two clients to diversify their portfolios into real estate. He refers them to a licensed attorney who specializes in real estate investments. Sobhani is paid a referral fee by the attorney, which he fully discloses once a client makes an investment. The attorney offered both clients the opportunity to invest in a loan

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secured by mortgages on three commercial warehouses. One of the clients buys into the lucrative deal, but Sobhani recommends the other client defer his investment because of liquidity constraints. When the liquidity issues are finally resolved, the investment is no longer available.

Reviewing the firm’s bank account, Sobhani notices several unauthorized credit card payments for thousands of dollars. Janis Wilder, Sobhani’s personal assistant, confesses to obtaining a credit card in Sobhani’s name and using this card to fund her personal travels. Local law requires investment advisors to inform their regulators of any employee theft. But, because Wilder is Sobhani’s cousin, he verbally reprimands her: “From now on I will hold the checkbook, and if you ever do something like this again I will report you to the regulators.”

Question 1.

When discussing the CFA examination, did either Sobhani or Miyagawa violate Standard VII—Responsibilities as a CFA Institute Member or CFA Candidate?

- A. Yes, Sobhani violated the Standard.
- B. Yes, both Sobhani and Miyagawa violated the Standard.
- C. No.

Solution:

C is correct.

The information disclosed about the exams by either Sobhani or Miyagawa is not confidential CFA Program information, so they are not in violation of Standard VII. Sobhani's information was based upon his analysis of the readings and is his opinion, and Miyagawa referenced the practice exam, which does not reflect content in the actual CFA exam.

A and B are incorrect because the information disclosed about the exams by either Sobhani or Miyagawa is not confidential program information, so they are not in violation of Standard VII.

Question 2.

Which of Sobhani’s statements to Poundston least likely violates the CFA Institute Standards of Professional Conduct? His statement regarding:

- A. investment timing.
- B. the market forecast.
- C. asset allocation

Solution:**B is correct.**

The market environment forecast is stated as an opinion, not fact, and as such is not a violation of Standard V(B)–Communication with Clients and Prospective Clients. Sobhani’s asset allocation recommendation, a 60% equity allocation, however, is risky and does not relate to the long-term objectives and circumstances of Poundston, so it is in violation of Standard III(C)–Suitability. A high equity allocation for a sick and elderly client who plans to retire soon is not a suitable recommendation, especially to a client who is risk averse and seeking preservation of capital. Finally, Sobhani has violated Standard V(A)–Diligence and Reasonable Basis because his recommendation that Poundston invest a large percentage of her assets in equities in an already highly priced market does not appear to be based on any evidence or analysis.

A is incorrect because Sobhani has violated Standard V(A)–Diligence and Reasonable Basis as Sobhani’s recommendation that Poundston invest a large percentage of her assets in equities in an already highly priced market does not appear to be based on any evidence or analysis.

C is incorrect because Sobhani’s asset allocation recommendation, a 60% equity allocation, is risky and does not relate to the long-term objectives and circumstances of Poundston, so this recommendation is in violation of Standard III(C)–Suitability.

Question 3.

With regard to his actions related to the regulatory visit, Sobhani most likely violated the CFA Institute Standards of Professional Conduct concerning which of the following?

- A. Client record storage
- B. Junior analyst regulatory interaction
- C. Compliance policies and procedures

Solution:

C is correct.

Standard IV(C)—Responsibilities of Supervisors has been violated. It requires members and candidates with supervisory responsibility to understand what constitutes an adequate compliance system for their firms and to make reasonable efforts to see that appropriate compliance procedures are established, documented, communicated to covered personnel, and followed. “Adequate” procedures are those designed to meet industry standards, regulatory requirements, the requirements of the Code and Standards, and the circumstances of the firm. Once compliance procedures are established, the supervisor must also make reasonable efforts to ensure that the procedures are monitored and enforced. By not updating his compliance policies and procedures since founding his company, Sobhani has violated this standard.

A is incorrect because Standard V(C)—Record Retention states that members and candidates must develop and maintain appropriate records to support their investment analysis, recommendations, actions, and other investment-related communications with clients and prospective clients. Sobhani has met local legal requirements by maintaining records for the required seven years.

B is incorrect because Standard IV(C)—of Supervisors has not been violated. It requires that members and candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, and the Code and Standards by anyone subject to their supervision or authority. Placing the junior analyst in the position of interacting with a regulator may not be the wisest decision but is not necessarily a violation of the Standard. The regulatory meeting appears to be only one of initial discovery concerning a complaint. If the analyst makes thorough notes and makes reasonable observations of this interaction it is likely Sobhani would be able to meet his supervisory responsibilities.

Question 4.

Sobhani's advice to Purce with regards to a potential investment is most consistent with the CFA Institute Standards of Professional Conduct concerning which of the following?

- A. Performance Presentation
- B. Suitability
- C. Diligence and Reasonable Basis

Solution:

A is correct.

Sobhani has only stated historical returns for these types of investments based on research of other similar investments. In addition, he has not promised a specific return, so he is not in violation of Standard III(D)–Performance Presentation. Sobhani is, however, in violation of Standard III(A)–Loyalty, Prudence, and Care because he is required to identify the actual client, who in this case would be Purce and the trust beneficiaries, the twins. From the information provided, there is no evidence that Sobhani knows or has considered the twins’ investment objectives and constraints and thus is also in violation of Standard III(C)–Suitability.

B is incorrect because there is no evidence that Sobhani knows or has considered the investment objectives and constraints of the twins and therefore is in violation of Standard III(C)–Suitability.

C is incorrect because even though Sobhani has disclosed some of the risks related to this type of investment, he has not discussed any country-related risks such as different accounting standards, different business practices, and unstable governments. Standard V(A)–Diligence and Reasonable Basis requires that the manager should ensure that the client’s objectives and expectations for the performance of the account are realistic and suitable to the client’s circumstance and that the risks involved are appropriate.

Question 5.

Concerning his advice related to real estate investments, did Sobhani most likely violate the CFA Institute Standards of Professional Conduct?

- A. Yes, with regard to Referral Fees.
- B. Yes, with regard to Fair Dealing.
- C. No.

Solution:

A is correct.

Standard VI(C)—Referral Fees requires members and candidates to 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 before entry into any formal agreement for services. In this case, Sobhani advises clients of the referral fee arrangement after the fact, thus violating Standard VI(C).

B is incorrect because Sobhani did not violate Standard III(B)—Fair Dealing because he dealt fairly and objectively with his clients, delaying the real estate investment due to liquidity constraints rather than preferential treatment.

C is incorrect because Sobhani violated Standard VI(C)—Referral Fees.

Question 6.

With regard to his actions related to Wilder, Sobhani least likely violated the CFA Institute Standards of Professional Conduct concerning which of the following?

- A. Knowledge of the Law
- B. Conflicts of Interest
- C. Misconduct

Solution:

B is correct.

Sobhani has not violated Standard VI(A)–Disclosure of Conflicts because disclosure of his relationship with Wilder is not required because it would not impair Sobhani’s independence and objectivity nor interfere with his respective duties to clients. But, by not following local law and reporting his cousin’s malfeasance, Sobhani violated Standard I(A)–Knowledge of the Law and as a result also violated Standard I(D)–Misconduct because his actions reflect adversely on his professional reputation and integrity.

A is incorrect because Standard I(A)–Knowledge of the Law states that 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. Even though his cousin has been involved in the theft it does not alleviate the member from following local law, which requires him to report the theft to regulatory authorities.

C is incorrect because Sobhani is in violation of Standard I(D)–Misconduct, which requires that 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. By not following local law and reporting his cousin’s malfeasance, Sobhani violated Standard I(A)–Knowledge of the Law and as a result also violated Standard I(D)–Misconduct because his actions reflect adversely on his professional reputation or integrity.