



ETHICS IN THE INVESTMENT INDUSTRY

Learning Module 4
CFA Code of Ethics &
Standards of Practice
Handbook

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Learning Outcomes

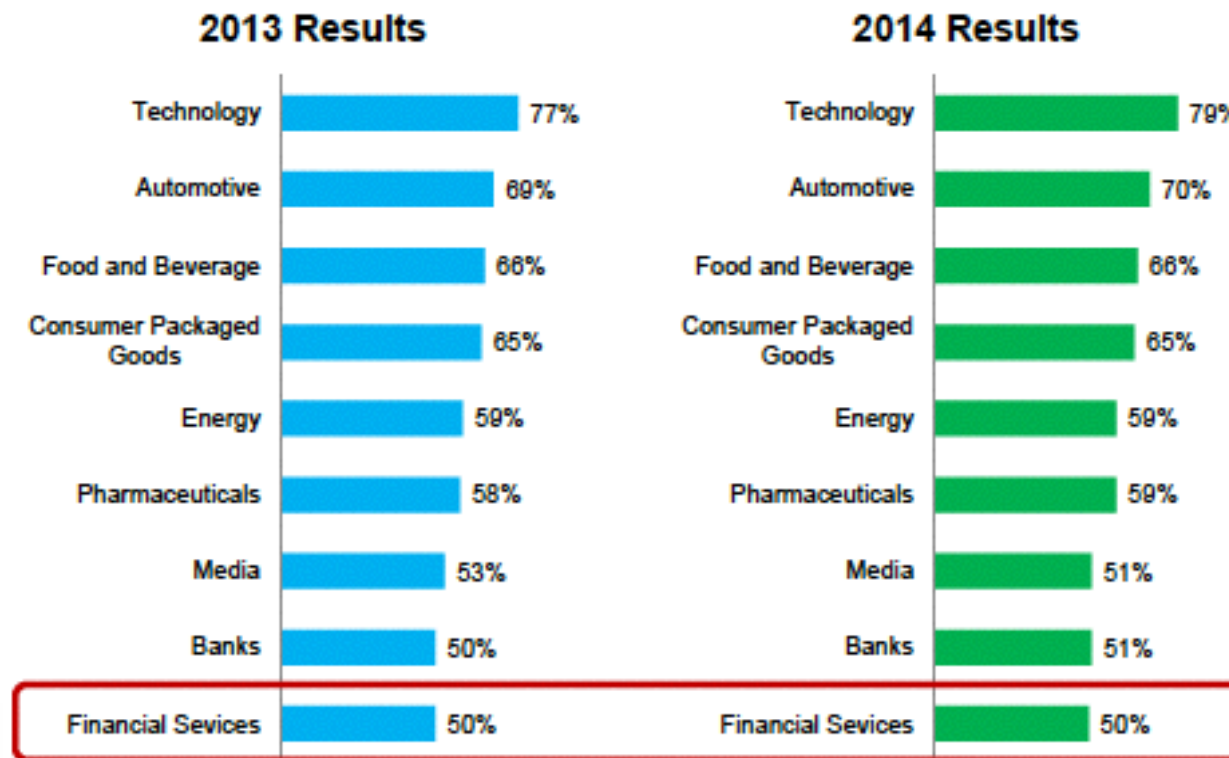
- Understand why ethics are fundamental to market integrity
- Describe the different influences and circumstances on unethical conduct
- Describe an ethical decision making framework, and how to resolve ethical dilemmas
- Describe the code of ethics, and identify the standards of professional conduct
- Identify if unethical behavior has occurred in relation to the CFA Institute Code of Ethics and Standards of Professional Conduct

Ethical Landscape

- Market collapse in 2008-09 was devastating to faith and confidence in the investment industry
- Functioning capital markets depend on trust. Trust is earned through ethical conduct Ethics are fundamental to market integrity
- Clients demand ethical conduct from managers - not just good performance

Industry Trust Rankings

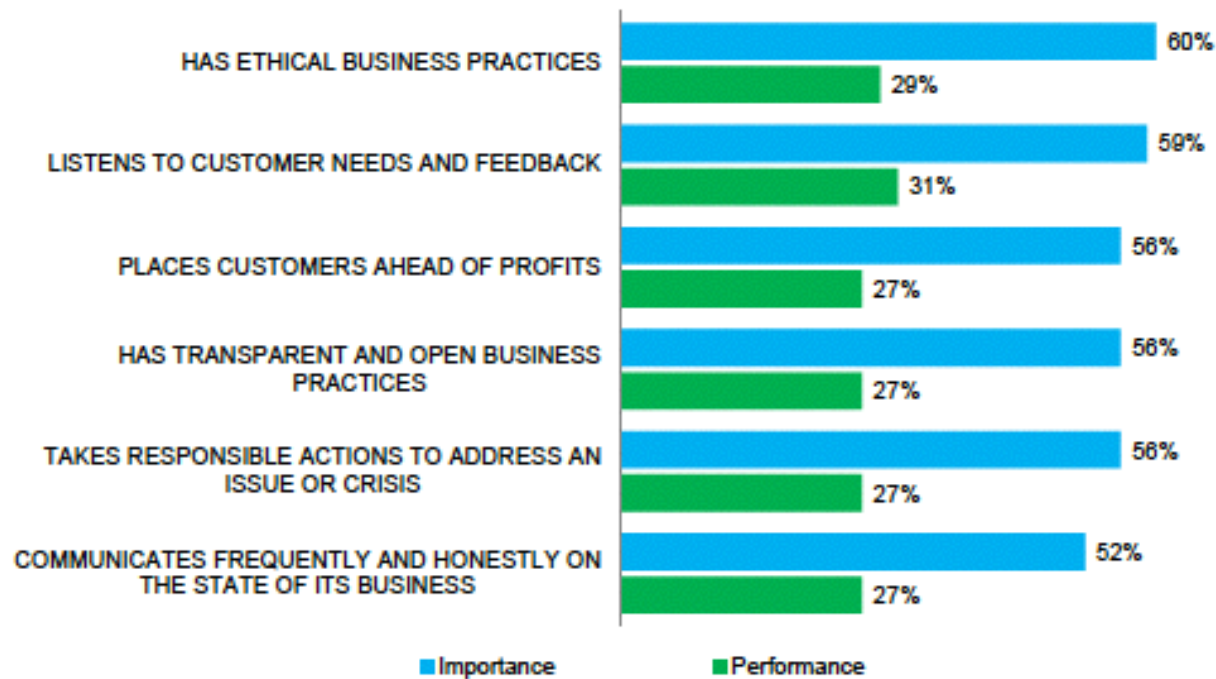
- How much do you trust the following industries to do what is right?



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Trust Gaps

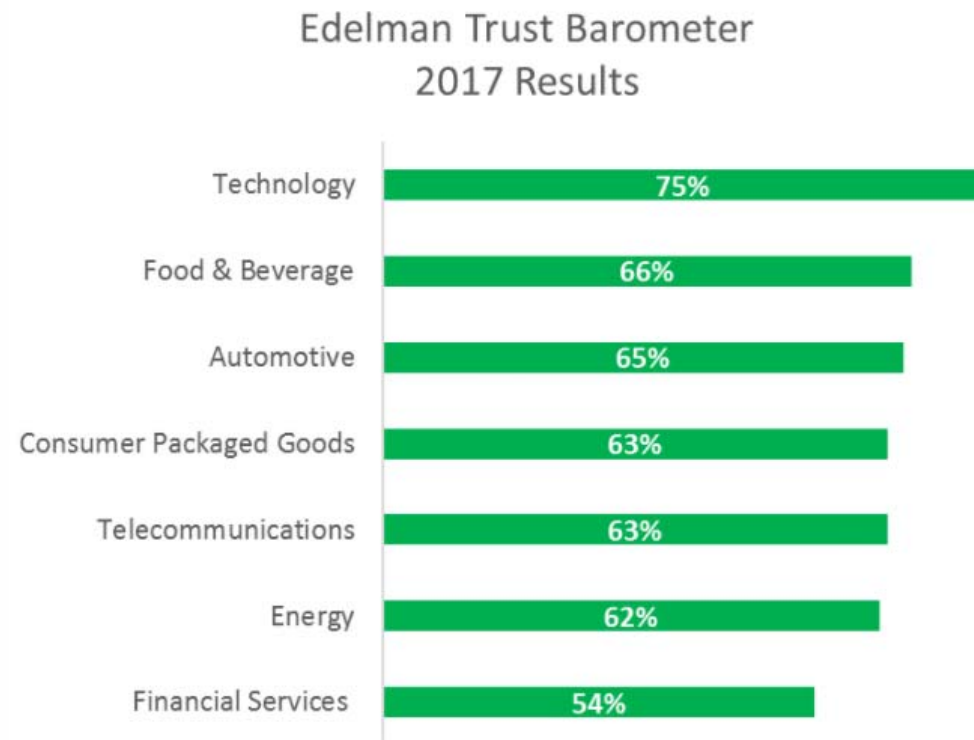
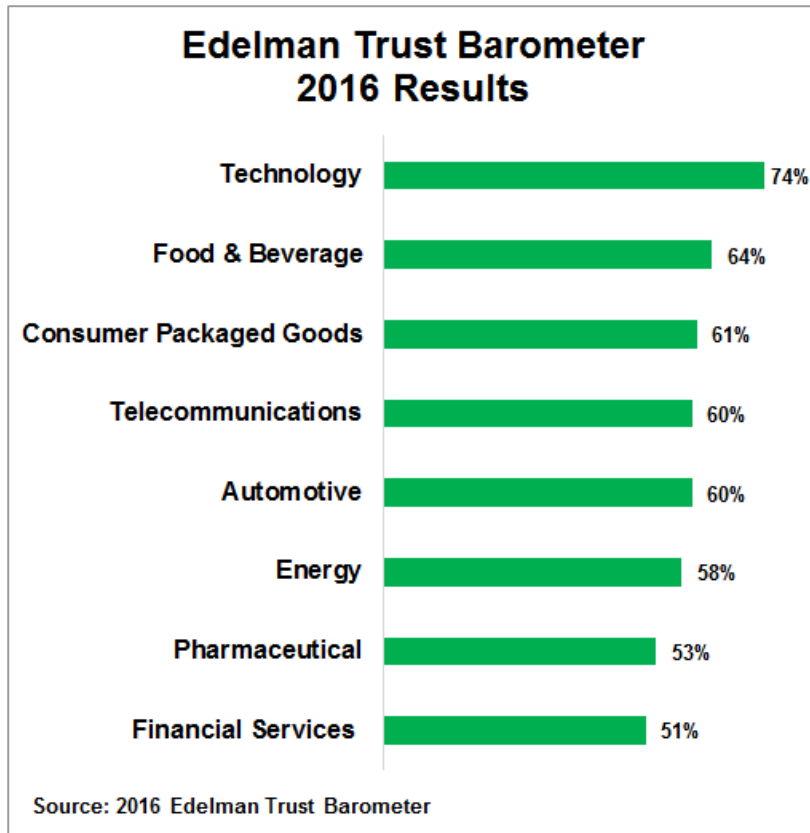
How important are each of the following actions to build trust?



Source: 2014 Edelman Trust Barometer®



Has anything changed?



<https://blogs.cfainstitute.org/marketintegrity/2017/02/28/2017-edelman-trust-barometer-shows-overall-decline-but-financial-services-improves/>



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Influences on unethical conduct

- Which has more influence on whether a person will engage in unethical conduct?
- Disposition: A person's moral character.
- Situation: Outside circumstances.

Situational v. Dispositinal

- Studies have shown that situational influences have more to do with a person's ethical behaviour than a person's character.
- “Under the right conditions good people can be induced, seduced and initiated to act unethically.”
- - Emeritus Prof. Phillip Zimbardo, Stanford University
- See Milgram experiment: <https://www.youtube.com/watch?v=yr5cjyokVUs>

Circumstances influencing unethical behaviour

- Which of the following situational circumstances will influence a person to engage in unethical conduct?
 - A. Obedience to authority
 - B. Conformity with others
 - C. Incrementally engaging in unethical behaviour
 - D. Following group decisions
 - E. Over confidence in ability to act appropriately
 - F. Responding to incentive.

Obedience to Authority

- We are less likely to take part in unethical actions on our own than when requested by a supervisor
- We want to please authority - might lead us to carry out instructions without thinking about the ethical implications
- Supervisors rarely directly ask us to perform unethical activities, instead they infer it based on *incentives*.
- **Rationalisations:**
 - “I want to be a team player” “I want to be loyal”
 - “I was just following orders”

Conformity

- We often take our cues from our “reference group” about the proper way to act
- We become acculturated to behaviour and we assume that this behaviour is normal and acceptable
- We conform our judgements to the judgements of our reference group
- **Rationalisations:**
- “Everybody else does it, so it must be okay” “It’s how you succeed around here”

Incrementalism

- “The Slippery Slope”
- Unethical behaviour often occurs when we subconsciously lower our standards over time through small changes in our behaviour
- **Rationalisations**: “Just this one time”
- “It doesn’t really hurt anyone” “It’s not a big deal”

Group Think v. Independent Thinking

- Being in a group lessens our individual feelings of accountability and responsibility
- Our moral doubts are assuaged by the group's concurrence
- **Rationalisations:**
- “We are a good and wise group”
- “This is the way it has always been done”

Overconfidence

- We tend to believe that we are more honest and fair-minded than our peers and competitors
- This often leads us to make decisions that have ethical implications without engaging in serious reflection
- **Rationalisation:**
- “I am more ethical than they are, it won’t happen to me”

Framing

- Objectives are often framed to focus on one factor (e.g. Stock price, Bonuses)
- We often overlook or justify behaviour if it leads to the achievement of that goal or objective
- **Rationalisations:**
- “That is the way they do it at Firm X, so it must be okay” “If we do not do it, someone else will”
- “Smart people created the incentive structure, Im just responding to it”



ETHICAL FRAMEWORK AND THINKING

Effective Ethical Thinking

- Starts with:
- Becoming more conscious about your thoughts and behaviours, to increase the likelihood that you will notice and act on ethical issues before they become destructive
- Recognising that ethical dilemmas are a normal and predictable part of most jobs
- Discussing approaches for dealing with ethical issues

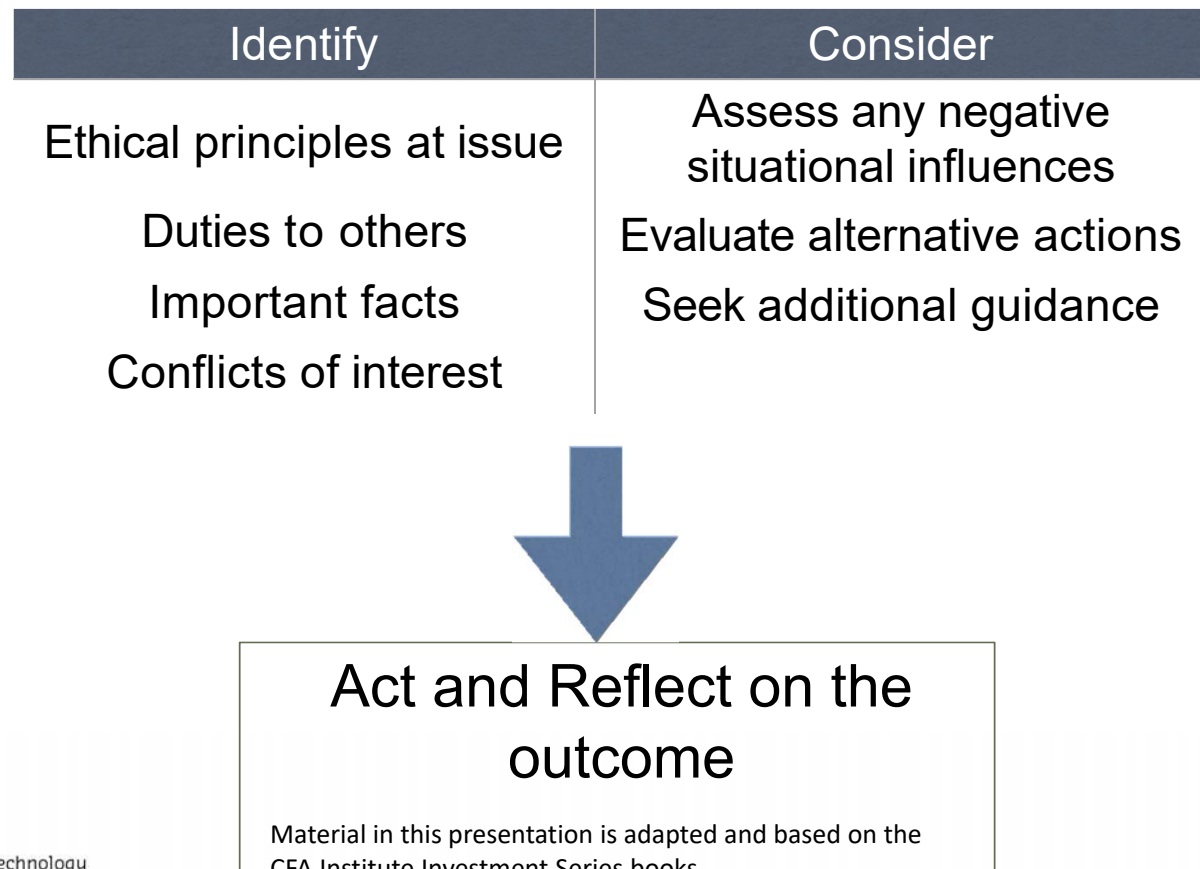
Sample Case

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

Fundamental Ethical Principles


- Clients interests come first
- Avoid / manage conflicts of interest Full and fair disclosure
- Fair dealing
- Reasonable care and prudent judgement Maintain independence and objectivity
- Such principles must be considered when developing a framework for ethical decisions

Ethical Decision Making Framework



Resolving Ethical Dilemmas

- Ethical issues are normal and predictable
- Be more conscious about thoughts in order to notice and act on ethical issues before they become problems
- Be aware of and address negative situational influences Apply ethical decision-making framework
- Live and breathe fundamental ethical principles
- Know your duties / gather relevant facts / manage conflicts
- Discuss with colleagues



CFA INSTITUTE CODE OF ETHICS AND STANDARDS OF PROFESSIONAL CONDUCT



The Code and Standards

The CFA Institute maintains a Code of Ethics and Standards of Professional Conduct as an ethical benchmark for investment professionals.

The Code of Ethics maintains that you must:

- Place the integrity of the profession and the interest of clients above your own interests
- Act with integrity, competence, and respect Maintain and develop your professional competence

The Standards of Professional Conduct cover:

- I. Professionalism
- II. Integrity of the capital markets
- III. Duties to clients and employers
- IV. Investment analysis and recommendations
- V. Conflicts of interest and your responsibilities

I. Professionalism

A. Knowledge of the Law

B. Independence and Objectivity

- Use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities....

C. Misrepresentation

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

D. Misconduct

- 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.

Example

- William recommends the purchase of a mutual fund that invests solely in long-term Australian Government securities. He makes the following statements to his clients:
- Statement 1: The payment of the bonds is guaranteed by the Australian Government, therefore the default risk of the bonds is virtually zero.
- Statement 2: If you invest in the mutual fund, you will earn a 10% rate of return each year.
- Did William's statements violate any ethical standard?

II. Integrity of Capital Markets

A. Material Non-Public Information

- Mosaic Theory: Note that analysts are free to act on the collection and piecing together of information (public and/or non-public non-material) without risking violation

B. Market Manipulation

- Potentially if proven: <http://www.abc.net.au/news/2018-01-30/cba-allegedly-involved-in-rigging-key-market-interest-rate/9375832>

Example

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

III. Duties to Clients

- A. Loyalty, prudence and care
- B. Fair dealing
- C. Suitability
- D. Performance presentation
- E. Preservation of confidentiality



Example

- Lynn is an investment officer at the Lester Trust Company. She has an advisory customer who has talked to her about giving approximately \$50,000 to charity in order to reduce income taxes. Lynn is also treasurer of the Home for Indigent Widows (HIW), which is planning its annual giving campaign. HIW hopes to expand its list of prospects, particularly those capable of substantial gifts.
- Lynn recommends that HIW's vice president call on her customer and ask for a donation in the \$50,000 range.
- Did Lynn violate any ethical standards?

IV. Duties to Employers

- A. Loyalty
- B. Additional compensation arrangements



V. Investment Analysis, Recommendations and Actions

- A. Diligence and reasonable basis
- B. Communication with clients and prospective clients

Example

- Richard is a mining analyst for East Bank Securities. He has just finished his report on Boisy Bay Minerals. Included in his report is his own assessment of the geological extent of mineral reserves likely to be found on the company's land. Richard, who has no formal training in geology, completed this calculation on the basis of core samples from the company's latest drilling.
- According to Richard's calculations, the company has more than 500,000 ounces of gold on the property. Richard concludes his research report as follows: "Based on the fact that the company has 500,000 ounces of gold to be mined, I recommend a strong BUY."
- Did Richard violate any ethical standards?

VI. Conflicts of Interest

- A. Disclosure of conflicts
- B. Priority of transactions
- C. Referral fees



Summary

- Under the certain conditions good people can be induced to act unethically
- Doing the 'right' thing is more than just complying with the law
- Clients, employers, the profession, and the market come before you as an individual
- Transparency is key: "Sunlight is the best disinfectant"

Additional Resources

- Presentation Source:
- <http://www.cfainstitute.org/ethics/codes/pages/index.aspx>
- <http://www.cfainstitute.org/ethics/integrity/training/Pages/index.aspx>
- <http://www.cfainstitute.org/learning/products/onlinelearning/Pages/62901.aspx>