CHAPTER 2

ETHICS AND INVESTMENT PROFESSIONALISM

by Gerhard Hambusch, CFA

LEARNING OUTCOMES

After completing this chapter, you should be able to do the following:

- **a** Describe the need for ethics in the investment industry;
- **b** Identify obligations that individuals in the investment industry have to clients, prospective clients, employers, and co-workers;
- **c** Identify elements of the CFA Institute Code of Ethics;
- **d** Explain standards of practice (professional principles) that are based on the CFA Institute Code of Ethics;
- **e** Describe benefits of ethical conduct;
- **f** Describe consequences of conduct that is unethical or unprofessional;
- **g** Describe a framework for making ethical decisions.

INTRODUCTION

1

Ethics play an essential role in protecting financial market integrity and the functioning of the investment industry. Financial market integrity refers to financial markets that are ethical and transparent and provide investor protection. Trust in the investment industry is enhanced when workers in the industry make decisions that are ethically sound.

In 2013, a study by CFA Institute and Edelman examined trust by investors in investment managers and explored the dimensions that influence that level of trust.[1] The study found that only about half of the surveyed investors trust investment managers to act ethically. This result is troubling. As Alan M. Meder, CFA, former chair of the CFA Institute Board of Governors, put it earlier, “A tarnished reputation is difficult to clean. . . . The investment profession is built on trust as much as it relies on expertise.”[2]

What do these words mean in practice? When trust is absent, investors are less likely to participate in financial markets. Without investment, investors may be unable to reach their financial goals. Without available capital for companies, economic growth will slow. So, it is important that investors are treated fairly because society benefits from well-functioning financial markets.

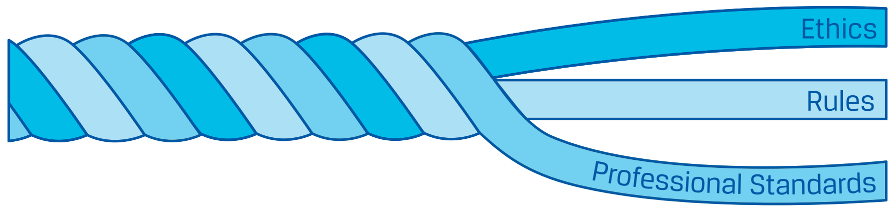
The creation and maintenance of trust depends on the behaviour, actions, and integrity of entities participating in the financial markets. These market participants include companies and governments raising capital, investment firms (companies in the investment industry), rating agencies, accounting firms, financial planners and advisers, regulators, and institutional and individual investors. Ultimately, trust relies on the actions of individuals participating in financial markets, including those working in the investment industry. In short, trust depends on everyone.

Rules are important to the effective functioning of financial markets too; however, rules are unlikely to cover every problematic situation encountered. An individual’s ability to identify, develop, and apply ethical standards when there are no clear-cut rules is, therefore, critical. In the end, trust depends on individuals choosing to comply with rules and to act ethically.

Ethical standards, and some professional standards, are based on principles that support and promote desired values or behaviours. **Ethics** is defined as a set of moral principles, or the principles of conduct governing an individual or a group. Professional organisations, such as CFA Institute, establish codes of ethics and **professional standards** based on fundamental ethical principles to guide practice. Ethics and rules are intertwined; ethical standards help guide the development of rules, and rules help individuals and groups, such as professional associations, think about, develop, and apply ethical standards.

1 CFA Institute and Edelman, “CFA Institute & Edelman Investor Trust Study” (2013): www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2013.n14.1.aspx.

2 Alan M. Meder, “Creating a Culture of Integrity,” CFA Institute (2011): www.cfainstitute.org/learning/products/publications/contributed/Pages/creating_a_culture_of_integrity.aspx.



A culture of integrity based on ethical standards can be built and developed at a personal and business level by applying the following four-step process, as suggested by Meder. This process can be adapted to be relevant for anyone:

1 Set high standards and put them in writing,

2 Get adequate and ongoing training on professional and ethical standards,

3 Assess the integrity of individuals and groups you encounter, and

4 Take action when breaches of integrity and ethical standards are observed.

These steps help individuals to identify, assess, and deal with ethical dilemmas. **Ethical dilemmas** are situations in which values, interests, and/or rules potentially conflict. Sometimes, the ethical dilemma and the appropriate ethical response seem obvious. In other instances, neither the ethical dilemma nor the appropriate ethical response is obvious. To identify and deal with an ethical dilemma, it is useful to be able to consult a framework that guides ethical decision making. An example of such a framework is described in Section 6. Individuals following such a framework are more likely to identify ethical dilemmas and to ensure that they and others around them behave ethically.

2 WHY ETHICAL BEHAVIOUR IS IMPORTANT

Global financial markets have grown in size and complexity over the last few decades. Investment products and financial services offered have also increased in breadth and complexity. Such growth and increased complexity increase the likelihood of ethical dilemmas occurring. This likelihood is further enhanced as organisations and individuals conduct business across borders and under different regulatory and cultural frameworks.

Investment professionals help provide access to and information about these investment opportunities and the financial markets. Investment professionals are involved in making and helping clients make investment decisions and in creating products that help with and add value to the investment decision-making process.

Individuals who work in the investment industry but outside of the investment management functions are also critical to the functioning of the investment industry. These individuals include employees working in fund administration, securities trading and account services, and other support activities—including legal, human resources, marketing, sales, and information technology.

The decisions and actions of all the individuals in the investment industry may directly or indirectly affect clients, prospective clients, employers, and/or co-workers. So these individuals have a responsibility to make ethical decisions and to act appropriately. In other words, they have to be trustworthy.

For example, clients seeking wealth management advice trust that the investment professionals they consult will provide suitable recommendations. Typically, these professionals rely on the support of others to provide investment services to clients. This support may be provided from within the investment firm or, in some cases, by third parties, such as legal or tax consulting firms. Such support also extends to the use of third-party information, such as credit ratings and investment research. When using such support and information, individuals working in the investment industry must be careful and conduct due diligence to ensure the reliability of the information and its sources. If all parties are committed to acting in the best interests of the client, the client's trust in the professional relationship is more likely to be sustained.

It is critical that high ethical standards guide decisions and actions. Investors are unlikely to have confidence in—and more broadly, the public is unlikely to trust in—the fairness of financial markets if there is not a general belief that individuals in the investment industry behave ethically. Some of the factors, including success of the investment industry, affected by ethical standards are shown in Exhibit 1. High ethical standards support these factors, and a breach of ethical standards can undermine them. For example, when investors hear about **insider trading** (trading while in possession of information that is not publicly available and that is likely to affect the price, often referred to as material, non-public information) or misrepresented financial reports, it brings into question the integrity and fairness of financial markets and lowers public trust and investor confidence in them.

Exhibit 1 Factors Affected by Ethical Standards in the Investment Profession

3 OBLIGATIONS OF EMPLOYEES IN THE INVESTMENT INDUSTRY

To establish and maintain high ethical standards, it is critical to understand general obligations to clients, prospective clients, employers, and co-workers. Considering how to meet these obligations will help guide behaviour. Failure of investment professionals to meet these obligations may adversely affect clients, employers, co-workers, and even the financial system as a whole. Negative effects can have far-reaching consequences because of the interconnection among financial system participants. The general obligations to clients, prospective clients, employers, and co-workers are similar for all employees in the investment industry.

3.1 Obligations to Clients

The client relationship is critical to the functioning of the investment industry. Therefore, all individuals working in the investment industry, whether involved directly or indirectly with clients, have an obligation to act competently and carefully when fulfilling their responsibilities. Fulfilling this obligation means using the required professional knowledge and skills, managing risks that can affect client interests, safeguarding client information, and treating clients consistently, fairly, and respectfully.

Identifying and managing conflicts of interest is a significant challenge. A **conflict of interest** arises when either the employee's personal interests or the employer's interests conflict with the interests of the client. Conflicts of interest can also arise when the employee's and the employer's interests conflict. Individuals working in the investment industry are expected to place the client's interests above their own and their employer's interests. For example, a financial planner or an investment adviser may help clients to plan and achieve their personal financial goals by advising on investment, risk, cash flow management, and retirement planning. Clients place great trust and confidence in this advice. Financial planning and investment advice result in a much higher level of responsibility than that associated with a financial salesperson committed to selling specific investment products or brands.

As an adviser, the investment professional should have detailed knowledge of the range of investment products available in the market. The adviser also has a professional obligation to exercise independent judgment when identifying and advising on suitable investment products and to pursue the best interest of the client at all times. Particular care must be taken to ascertain whether an adviser's interests have the potential to conflict with the investment goals and best interest of a client. For example, an adviser identifies a number of products that are suitable for a client. The adviser may be tempted to recommend the product that generates the highest commission to the adviser when some of the other products would actually be better suited to the client's investment goals. In this conflict of interest, the adviser may inappropriately make a decision based on adviser interest and not act in the client's best interest.

The exception to the rule that those working in the investment industry should put the interests of a client first is when this would harm the integrity of financial markets. For example, trading on insider information on behalf of clients will benefit client interests financially but ultimately will harm all investors by eroding investor confidence in the financial markets.

Conflicts of interest are inevitable. They present ethical dilemmas that need to be appropriately dealt with. Depending on the circumstances, they can be dealt with in different ways. In some cases, an individual may choose to avoid the conflict by rejecting an assignment. For example, an investment professional may decline to prepare a research report on a company in which the professional owns a significant number of shares. In other cases, an individual may choose to disclose a conflict to other relevant parties who can then decide what action is appropriate. The solution is important, but the critical first step is to identify conflicts of interest and to recognise that they result in potential ethical dilemmas.

Have you ever faced a conflict of interest in your work? Even if you have not faced one yet, be aware that employees in all parts of the investment industry face potential conflicts of interest. Investment professionals and support staff alike must remain alert to conflicts that may arise.

He bought ten thousand shares of his friend Robert's company for John Smith's portfolio in order to help Robert avoid a hostile takeover.

She bought ten thousand shares of another stock for John Smith's portfolio that was better aligned with his investment goals.

She overheard information at work that would cause ABC company's stock prices to fall. She called her broker and sold her shares before the news was made public.

He overheard information at work that would cause ABC company's stock prices to fall. He kept the information to himself and did not act on it.

Some examples of conflicts of interest are presented in Exhibit 2. In each example, the individual chose to act in his or her own interest rather than that of the client and/or employer. As you read these examples, consider how the individual could have more appropriately responded to the conflict of interest.

Exhibit 2 Examples of Conflicts of Interest

The following are examples of conflicts of interest involving investment professionals.

- An investment manager excessively trades assets held in the client's portfolio in order to earn higher trading commissions. This excessive trading (often referred to as churning) results in high trading costs to the client and reduces the client's return after transaction costs and is not in the client's best interest.
- A broker receives a large buy order from a client. Before executing the client's order, the broker executes a personal buy order (also known as front running) in order to benefit from increasing market prices caused by the client's large buy order.

Exhibit 2 (Continued)

The following are examples of conflicts of interest involving support staff.

- When learning about a change in a share recommendation, an individual in the printing office of a research firm immediately phones family members so they can act on the information prior to the firm's clients. The individual is not acting in the best interest of his or her employer or the employer's clients.
- A receptionist at an investment firm hears that a company's CEO will be fired. Anticipating downward pressure on the company's share price, the receptionist sells personal shares in the company before the news is made public.

3.2 Obligations to Employers

Obligations to employers include providing services as agreed on in an employment contract, following or executing supervisory directives as required, and maintaining professional conduct.

Obligations also include loyalty, professional competence, and care. **Loyalty**, in the context of the employment relationship, incorporates the expectation that employees will work diligently on behalf of their employer, will place their employer's interests above their own, and will not misappropriate company property. Misappropriation of company property, whether small or large in monetary terms, is unethical. Examples of misappropriation include making excessive claims on expense reports and using company assets for personal purposes. Misappropriation may occur when an employee has access to company assets that are difficult to protect, particularly trade secrets and intangible assets, such as client lists, stock selection models, the company's employee compensation structure, or portfolio management procedures.

Another aspect of loyalty is drawing attention to possible conflicts of interest to prevent loss of client trust.

Employees are expected to carry out their assigned responsibilities with competence and care. The efficient operation of the company can be compromised if employees do not act competently and carefully. If an employee does not feel capable of carrying out a task, he or she should either develop the necessary skills, work with others to complete it, or decline the task. This situation may not immediately seem like an ethical dilemma, but when an individual accepts responsibility to complete a task, he or she has an ethical obligation to be capable of completing the task efficiently and with the appropriate level of knowledge, care, and skill.

3.3 Obligations to Co-Workers

Individuals in the investment industry are obliged not only to treat clients and their employer with fairness and respect but also to apply the same principles to their co-workers. It is also critical that individuals work competently and carefully. If individuals do not perform their work carefully and competently, they may adversely affect the tasks of co-workers and the overall success of a team. In a worst-case scenario, the lack of competence and care by one worker can reflect on others and result in the loss of trust in one or more co-workers and perhaps even in their dismissal. These are far-reaching consequences that co-workers should not have to face. By contrast, ethical conduct—including competence, care, and respect towards co-workers—not only contributes to the achievement of client and employer goals but can also enhance your career as you develop social and communication skills and, in some cases, team leadership skills.

Obligations to co-workers extend beyond competent and careful work. In addition to fostering your own professional development, you have an obligation to support the professional development of co-workers, which includes helping co-workers understand, promote, and follow ethical practices as well as encouraging others to adhere to professional obligations, such as the preservation of client confidentiality.

Some employees' responsibilities in a company may include a supervisory role. Supervisors are expected—in addition to fulfilling the obligations of all employees—to execute supervisory duties responsibly, which includes ensuring compliance with ethical, legal, professional, and organisational standards. Supervisory obligations are important to preventing, detecting, and managing violations of standards that put the client's trust at risk. Supervisory duties should only be assumed, however, if the work environment provides the requisite structural and procedural controls to prevent and detect violations. If there is a vulnerability or failure in organisational structure or process that affects the ability to supervise others responsibly, then supervisory obligations cannot be fulfilled. In such circumstances, an employee should document all issues and refrain from assuming supervisory duties until the required structural and procedural controls have been established. Supervisory obligations can add significant complexity to an investment professional's legal and ethical obligations to clients, employers, and co-workers.

3.4 Identifying Your Obligations

The complexity of the investment industry and the variety of roles, functions, and services that constitute it can make identifying and fulfilling duties and obligations to clients, employers and co-workers a challenge. You might want to put the following questions to your supervisor or manager to help identify key obligations and ethical dilemmas that may arise:

1. What is my role in the company and in what way do I contribute to its success?
2. To whom do I owe a duty or an obligation?
3. What potential individual and organisational conflicts of interest should I be aware of?
4. What measures do I need to take to ensure I have sufficient competence to fulfil my role?
5. What supervision can I expect?

These questions are intended to identify major obligations, but they are not comprehensive. They can be adapted to identify and consider standards applicable to any employee's work environment.

ETHICAL STANDARDS

4

Laws and regulations help to ensure that those working in the investment industry fulfil their obligations. They also help protect the integrity of the financial system and promote fairness and efficiency of financial markets. However, laws and regulations alone are not sufficient to protect the financial system. Some of the reasons for this include the following:

- Laws and regulations may not extend to all areas of finance and can be vague or ambiguous, making their interpretation a challenge.
- Laws and regulations are often slow to catch up with market innovations.
- Activities that occur in different jurisdictions can be complicated by inconsistencies in legal obligations in different countries.
- Situations may arise in which no applicable law exists or the existing law is inconclusive.
- The effectiveness of laws and regulations depends on how market participants interpret and comply with them.

The need for ethical standards is particularly apparent in situations in which vague or ambiguous legal rules provide room for unethical behaviour that could affect the integrity of the investment industry and result in a loss of clients' and/or investors' trust. To protect the financial system in these cases, ethical standards should guide the behaviour of market participants. The principles embedded in codes of ethics and professional standards should help guide the behaviour of industry participants and allow them to adapt to a continuously changing investment industry.

Section 4.1 describes why codes of ethics and professional standards exist. As an illustration, Section 4.1.1 describes the Code of Ethics and Standards of Professional Conduct developed by CFA Institute to guide how investment professionals are expected to behave. Section 4.1.2 describes how the code can be adapted and applied to the behaviour of others working in the investment industry.

4.1 Codes of Ethics and Professional Standards

The topic of ethics is challenging to discuss because, to a large extent, individuals' ethical outlooks are personal moral philosophies. These ethical outlooks are related to upbringing; culture; social, economic, and legal environment; and personal and professional circumstances. One distinct characteristic of a profession is adherence to a code of ethics and standards of professional conduct that are typically set by a professional association. This adherence helps ensure that common ethical standards are applied across a wide group of people. Engineers, accountants, lawyers, and doctors, for example, have ethical and professional standards they are expected to adhere to. Standards vary around the world because professional associations are not typically global in nature.

4.1.1 *How the Code of Ethics Guides Investment Professionals*

In the investment industry, CFA Institute is recognised globally as the association of investment professionals that awards the CFA (Chartered Financial Analyst) charter. CFA Institute has developed its Code of Ethics and Standards of Professional Conduct (Code and Standards) on the premise that a fundamental set of ethical principles should govern and guide the professional conduct of those participating in the investment industry. As a preeminent global association for investment professionals, CFA Institute requires its members and CFA and CIPM (Certificate in Investment Performance Measurement) candidates to comply with the Code and Standards, regardless of the country in which they live or the regulatory regime under which they practice. The Code and Standards represent the core values of CFA Institute and its members and have served as a model for ethical standards of investment and other financial professionals since the 1960s.

The Code and Standards should be viewed and interpreted as an interwoven tapestry of ethical requirements, outlining conduct that constitutes fair and ethical business practices. Adhering to the ethical principles underlying the Code and Standards will help protect the integrity of financial markets and promote trust in the investment profession. The CFA Institute Code of Ethics is shown in Exhibit 3; it reflects fundamental ethical principles applicable to the investment industry professional. This code includes ethical principles that can be adapted for use by others working in the investment industry. These principles are described in Section 4.1.2.

It is important that individuals working in the investment industry understand how investment professionals should behave because of the potential consequences of any unethical or unprofessional actions.

Exhibit 3 The CFA Institute Code of Ethics

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation must:

- 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**.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.

Exhibit 3 (Continued)

- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity and viability of the global capital markets for the ultimate benefit of society.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

The CFA Institute Standards of Professional Conduct, contained in the *Standards of Practice Handbook,* expands on the Code and provides guidance about important issues relevant to the investment professional.[3] Fundamental ethical and professional principles that are applicable to the investment industry professional include the following:

- *Client interests are paramount.* As previously discussed, individuals working in the investment industry have the obligation to place client interests ahead of personal interests or the interests of employers. In some circumstances, duty to maintain the integrity of capital markets (financial markets) will take precedence.
- *Exercise diligence, reasonable care, and prudent judgment.* In fulfilling their professional responsibilities, those working in the investment profession should strive to work to the best of their ability, utilising the knowledge, skill, judgment, discretion, and experience that they would apply in the management and disposition of their own interests under similar circumstances.
- *Act with independence and objectivity.* Those working in the investment industry should carry out their professional responsibilities in a thoughtful and objective manner, free from any obligations, encumbrances, or biases, such as gifts or relationships that may influence their judgment.
- *Avoid or disclose conflicts of interest.* As discussed in Section 3.1, conflicts between client interests and the personal interests of the employee or employer should be avoided or managed through disclosure so that all relevant stakeholders are aware of these conflicts and their potential effects on the relationship with the client. Disclosures must be prominent and made in plain language and in a manner designed to effectively communicate the information.
- *Make full and fair disclosure.* Transparency and good communication are key elements in building trust with investors and allowing clients to make intelligent and informed decisions. Those in the investment industry who make false or misleading statements harm investors and reduce investor confidence in financial markets.

3 The *Standards of Practice Handbook* can be accessed at www.cfapubs.org/toc/ccb/2014/2014/4.

- *Engage in fair dealing.* All clients in similar situations should be treated fairly regardless of whether one client has more assets, pays more fees, or has a closer relationship. Fair treatment of all stakeholders maintains the confidence of the investing public in the investment industry.
- *Protect confidential information.* Confidential information of clients, employers, counterparties, and other stakeholders must be diligently protected.

The Code and Standards, which are intended to guide the investment professional, can help guide all participants in the investment industry to identify, promote, and follow high ethical standards.

4.1.2 How the Code of Ethics May Guide All Employees in the Investment Industry

The Code of Ethics and the ethical principles embedded in it may seem overwhelming. Key aspects of potential relevance to you are summarised in Exhibit 4. An explanation of each of the four aspects follows the exhibit.

Exhibit 4 Selected Aspects of the CFA Institute Code of Ethics

- Act with integrity.
- Use competence, diligence, and reasonable care.
- Act with respect and in an ethical manner.
- Use independent judgment.

The Code requires investment professionals to act with *integrity* and to place the integrity of the financial markets and the investment profession before personal or employer interests. Integrity also applies to the client relationship. The obligations to avoid or manage conflicting interests and to prioritize client interests serve this relationship and promote public trust in the investment industry. It is important that all employees in the investment industry act with integrity and act with the primacy of clients' interests in mind.

The Code requires investment professionals to act with *competence*, *diligence*, and *reasonable care*. Because financial markets, investment tools, and related services are constantly evolving, employees must continuously strive to maintain and improve their knowledge and competence, as well as that of others. Personal education and skill development will help employees meet these responsibilities competently and diligently.

The Code requires the investment professional to *respect* clients, employers, co-workers, and other investment professionals. Treating others with respect is relevant to all investment industry employees. This requirement complements the CFA Institute vision of promoting equitable, free, and efficient financial markets. Acting respectfully and in an ethical manner contributes to building and maintaining public trust in financial markets.

The Code requires investment professionals to subscribe to the fundamental value of *independent judgment*, which is closely related to the values of competence and care. Development and maintenance of independent judgment is critical to protect clients' trust in the investment industry and financial markets. Work and opinions should be unaffected by any potential conflict of interest or other circumstance adversely affecting objectivity and independence. Potential conflicts of interest include, for example, gifts offered to professionals by clients or related business partners or compensation incentives to sell financial products and services. To maintain independent judgment, the management of such circumstances includes avoidance or disclosure of conflicts of interest and the personal maintenance of impartial and honest judgment (i.e., objectivity).

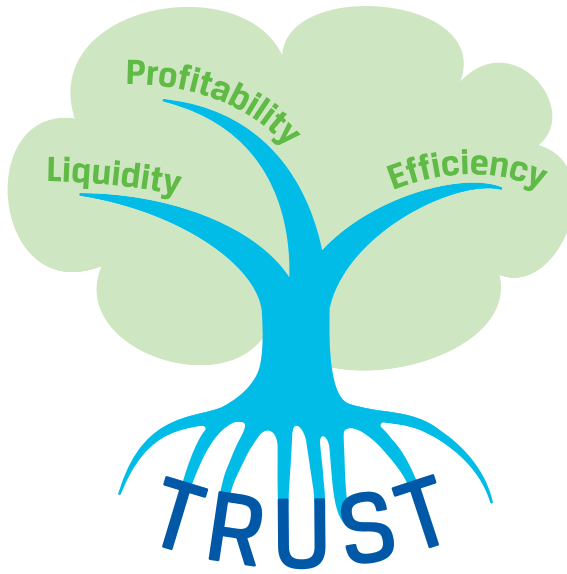
Following ethical principles has benefits. Similarly, violating ethical principles has consequences. The next section describes potential benefits of ethical behaviour and potential consequences of unethical conduct.

5 BENEFITS OF ETHICAL CONDUCT AND CONSEQUENCES OF UNETHICAL CONDUCT

Unethical behaviour, whether legal or not, can have significant consequences for the financial system and the economy. Compliance with ethical standards is important to prevent financial crises that can affect economic development and society's welfare. Accordingly, one of the benefits of complying with ethical standards is the increased stability of the financial system and thus of the entire economy. Importantly, ethical standards complement existing legal obligations, professional standards of conduct, and organisational policies and procedures to prevent behaviour that can affect other industries and even the global economy.

5.1 Benefits of Ethical Conduct

The liquidity, profitability, and efficiency of markets and economies are rooted in trust.



Investment industry employees behaving ethically increase investors' trust in the industry and strengthen the fairness of financial markets. This trust increases market participation and market efficiency (by which prices adjust quickly to reflect new information about the value of assets in the market place), which, in turn, helps investors achieve their investment goals.

Increased market participation benefits all market participants and stakeholders. These benefits include increased liquidity (investors are able to trade assets without affecting prices significantly) and increased market efficiency. Increased market participation also promotes public awareness and understanding of the financial system. This understanding, in turn, leads to additional participation in and efficiency of financial markets.

Increased market efficiency and trust can increase access to equity and debt funding and decrease the cost of capital for companies and governments requiring capital. Increasing the availability of capital and decreasing the cost of capital may positively influence the profitability and growth of companies as well as the development of the investment industry and the overall economy.

Increased market efficiency and participation can directly support the goals of companies in the investment industry. These goals include economic objectives, such as profitability and share value, and non-economic objectives, such as reputation and customer satisfaction. In addition, an employee following ethical standards is less likely to take excessive or unauthorised risk or to misappropriate company assets. The misappropriation can be of tangible assets (for example, using the company car for personal trips without authorisation) or intangible assets (for example, sharing information about customers or company research). If employees behave ethically, their actions are less likely to have far-reaching (including legal) consequences for their employer.

Compliance with ethical standards increases trust in investment professionals and in the entire investment industry. Without trust, the public is unlikely to use investment professionals to manage investments, to obtain advice on issues related to financial goals, or to provide services to support the overall investment process. Therefore, compliance may enhance employment security and increase certainty in career development. Complying with ethical standards may directly and positively affect a professional's position, compensation, and reputation. It may also provide indirect benefits through the increased reputation and business success of a professional's team and entire firm, thereby providing long-term career and skill set development opportunities. Compliance will be further discussed in the Investment Industry Documentation chapter.

5.2 Consequences of Unethical Conduct

When ethical and professional standards are violated, there can be significant consequences. These consequences include failure to achieve goals on behalf of a client or an employer, negative effects on the entire investment industry through reduced market participation, and a loss of trust in the integrity of financial markets and the investment profession. Such consequences can have long-lasting effects on the investment industry and the economy.

5.2.1 *Consequences for Industry and Economy*

When people in the investment industry act unethically, it can lead to changes in the behaviour of market participants. If investors lose trust in the investment industry, they may cease to invest; potential consequences include companies being unable to raise capital in financial markets, investment firms losing business or even going out of business, and the economy slowing down. Unethical and/or illegal behaviour can be responsible for these kinds of negative consequences. For example, former US businessman Bernard L. Madoff ignored his duty to put his clients' interests first when he turned an allegedly legitimate wealth management firm into a Ponzi scheme, in which investors were paid with money from other investors as investment returns.[4] Madoff thereby acted deceitfully and defrauded clients. The unveiling of this fraud in 2008 resulted in Madoff being sentenced to 150 years in prison and caused a widespread loss of investor trust in investment industry professionals.

In addition to the immediate consequences of unethical behaviour on companies in the investment industry and their clients, the transmission of financial shocks from one company to another can be dangerous for interconnected companies and, potentially, for the economy and the financial system. Therefore, the consequences of unethical behaviour at one company can affect other companies (and their clients) despite them not being involved in the unethical behaviour. For example, if a company goes bankrupt as a result of unethical behaviour, the company's unfulfilled liabilities could result in a widespread crisis for a larger group of related companies, thereby potentially damaging the economy. Such spillover or financial contagion may result in decreased economic output, increased unemployment, and reduced long-term economic growth expectations.

An example of financial contagion occurred in 2008. As a consequence of unethical behaviour, in the form of aggressive mortgage lending by some market participants, along with other financial events, the US housing and stock markets declined. As a

4 Ponzi schemes are named after Charles Ponzi, who defrauded many people in the United States in the 1930s. Typically in a Ponzi scheme, a plausible but semi-secretive method for earning returns is presented but, in fact, there is no such method. Fictitious returns are reported and payments are made to investors using cash receipts from other investors. The scheme falls apart and is revealed when there are no new investors and/or investors begin to request withdrawals rather than reinvesting their supposed earnings.

result, the US-based global investment firm Lehman Brothers went bankrupt.[5] These events led to a liquidity crisis (a shortage of available funds) in financial markets. The ensuing global financial crisis almost resulted in the bankruptcy of American International Group (AIG), a large multinational insurance company, which required a regulatory bailout to survive. The crisis negatively affected many more companies and reduced the output and growth expectations of several economies around the world. This extreme case demonstrates how unethical behaviour—such as aggressive mortgage lending—by some market participants can lead to the bankruptcy of a company and a negative impact on other interlinked companies, their clients, and the entire financial system.

5.2.2 *Consequences for Clients*

When people in the investment industry act unethically, clients may suffer both financially and emotionally. They may receive inappropriate investment advice or services, lose confidence in the investment profession and in financial markets, lose personal wealth and current or future income, and experience personal distress.

Unethical behaviour resulting in inappropriate investment advice or services may expose clients to excessive risks, ownership of unsuitable assets, lack of diversification, inflated costs of investment management services, and unjustified transaction and management costs. For example, excessive trading of client assets to maximise trading commissions will result in clients incurring excessive transaction costs and may result in clients owning assets that are not consistent with their objectives and needs. Because of the central role of trust in a client relationship, the violation of legal and ethical standards generally decreases a client's trust in investment professionals and possibly in the investment industry as a whole. Violations related to financial market transactions (for example, insider trading) further decrease a client's trust in the integrity of financial markets.

In all of these cases of unethical behaviour, clients can lose wealth and income. For example, if a client owns shares in an investment bank and there is a trading scandal, the value of the shares may fall and the client may lose money. The client may also suffer a decrease in current income because of lower dividend payments. In addition, the client's future income can be reduced if retirement funds have been affected. Faced with financial damage to wealth and income, clients can experience a great level of personal distress along with severe mistrust in the investment industry, whether that mistrust is justified or misplaced.

5.2.3 *Consequences for Employers*

From an employer's point of view, the consequences of violations of ethical standards include negative effects on current and future client relationships, loss of reputation and company value, and legal liabilities and increased scrutiny by regulators, which creates additional administrative and analysis costs. The worst-case scenario includes going out of business. Often, ethical violations become apparent externally only when the conduct results in legal scrutiny, including threat of lawsuits, legal charges, and

5 A 2,200-page, 9-volume report issued 11 March 2010 by the court-appointed examiner of Lehman Brothers identified various questionable, but not necessarily illegal, activities undertaken by the firm.

prosecution. Because clients associate a company's employees with the company's brand, illegal or unethical conduct can result in a loss of company reputation that can damage or destroy current and future client relationships.

In some cases, an employer can face closure because of the unethical and/or illegal behaviour of one or more individuals within the company. US energy and commodity trading company Enron, for instance, collapsed in 2001 as a result of unethical, aggressive accounting practices, which were later identified to be illegal. As a result, Enron CEO Jeffrey K. Skilling received a 24-year prison sentence. In addition, Arthur Andersen, Enron's audit firm, was negatively affected and later dissolved because of questions of integrity with respect to some of its partners involved in the Enron audit. In a different case, unethical and ultimately illegal behaviour by former British derivatives trader Nicholas Leeson single-handedly caused losses exceeding £800 million, resulting in the bankruptcy of the United Kingdom's oldest investment bank, Barings Bank, in 1995. Leeson, who had executed unauthorised trades, was sent to prison for six-and-a-half years. Interestingly, if the back-office accounting person had refused to comply with Leeson's orders on accounting matters, the losses might have been identified earlier, when they were significantly lower. These extreme examples show how the unethical behaviour of a few individuals can have detrimental effects on coworkers and employers.

A loss of reputation can result in a loss of company profits and a loss of shareholder value. In cases of illegal conduct, a company in the investment industry may be held liable for financial losses sustained by customers or other market participants. If prosecuted, the employer may also be subject to fines and loss of operating licences and may be obliged to pay compensation to clients or other market participants for financial losses. These consequences can result in additional loss of company value, which is amplified if the company loses the right to provide some investment services. The employer's profits may further decrease as a result of expenditures required to assess, manage, and prevent future occurrences of compliance failures. Lastly, a company may become subject to increased regulatory scrutiny and required to use company resources to administer and provide additional costly analysis and information.

5.2.4 *Consequences for Individuals*

For the individual, the legal, professional, personal, and economic consequences for violating ethical standards can be significant. In circumstances where there has been a breach of ethical standards that results in legal scrutiny, the individual may be subject to civil or criminal prosecution. The consequences can include expenses to defend a prosecution, fines, imprisonment, and loss of current and future employment in the investment industry. Unethical behaviour resulting in legal offences includes investment fraud, insider trading, accounting fraud, and unauthorised decision making, all of which can result in significant prison sentences for the perpetrator.

In addition to the previously mentioned cases involving Jeffrey Skilling of Enron, Nicholas Leeson of Barings Bank, and Bernard Madoff, each of whom received long prison sentences, other examples illustrate the consequences of unethical and/or illegal behaviour for individuals. For instance, US businesswoman Martha Stewart was accused of making false statements to federal investigators about a suspiciously timed share sale. Although she was not charged with insider trading, she was charged with conspiracy, obstruction of justice, and perjury. In 2004, she was found guilty of some of these charges and sentenced to a five-month prison term and fined US$30,000. In

2007, she settled a civil action suit for insider trading brought by the US Securities and Exchange Commission (SEC) by paying a fine of US$195,000 and accepting a five-year ban on serving as an officer or director of a public company.

Consequences of breaches of ethical and professional standards also include disciplinary action by the employer and/or a professional or regulatory body and disapproval from clients, colleagues, and the industry peer group. This discipline can result in the decreased ability to advance a career because of a loss of reputation, which has personal and economic consequences. In particular, the individual can suffer a loss of income as a result of a restricted ability to provide current or future services. The individual could also face the loss of job and career and even alienation of family and friends.

6 FRAMEWORK FOR ETHICAL DECISION MAKING

Given the potential consequences of unethical behaviour, it is important that individuals use a framework to help them make ethical decisions. The four-step process identified by Alan Meder, CFA (discussed in the Introduction) represents a simple and useful framework. A more detailed framework is shown in Exhibit 5. Note that even though the points in the framework are numbered, they may be addressed in a different order depending upon the situation. Reviewing the outcome should conclude the process and provide feedback for the next time the framework is applied.

Exhibit 5 A Framework for Ethical Decision Making

1. Identify the Ethical Issue(s) and Relevant Duties/Obligations
2. Identify Conflicts of Interest
3. Get the Relevant Facts
4. Identify Applicable Ethical Principles
5. Identify Factors That Could Be Affecting Judgment
6. Identify and Evaluate Alternative Actions
7. Seek Additional Guidance (this may occur earlier in the decision making process or not at all)
8. Act and Review the Outcome

This framework is based on "A Framework for Thinking Ethically" from the Markkula Center for Applied Ethics at Santa Clara University (www.scu.edu/ethics/practicing/decision/framework.html).

Exhibit 6 illustrates the application of the framework using a scenario that is fictional but realistic. Some guideline questions and possible responses are included in Exhibit 6 to help you see how to use the framework. As you read through the exhibit, consider how you would answer the questions posed and go through the framework if you were in the situation. For example, are you able to identify additional alternative actions?

Exhibit 6 Application of a Framework for Ethical Decision Making

Several colleagues and their friends from outside of the office go out after work with Carlos, a newly hired employee. The more experienced employees tell the "new guy" to charge the meal and drinks to the company credit card. Carlos's colleagues tell him the friends are "prospective clients" and that they have charged similar outings on the card before, and the boss always approves the charges.

Carlos is confused. During orientation, the presenter from human resources made it clear that it is against company policy to charge personal expenses on the company's credit card. Based on the orientation, he wonders if using the company credit card would be wrong. But if it is common practice at his firm, maybe it is okay? Use of the framework may help him make an ethically sound decision.

1 Identify the Ethical Issue(s) and Relevant Duties/Obligations

- What is the ethical dilemma?

  Is it appropriate to use the company credit card to pay for the dinner with colleagues and their friends?

- To whom is a duty owed, or who might be affected by the decision? Often a decision is easier if you can put a face to the party that might be affected.

  Carlos owes a duty to his employer, which includes displaying loyalty, following its policies, and acting with integrity. His decision will potentially affect his relationships with his employer, his boss, and his colleagues.

- Are any duties in conflict, and which duty takes precedence?

  In some situations, duties to multiple parties may exist for the individual facing the dilemma. In this case, Carlos's sole duty is to his employer.

2 Identify Conflicts of Interest

- Are personal interests affecting the decision/action?

  In this case, Carlos may struggle with wanting to fit in with his new colleagues versus following his understanding of the policies of the employer.

3 Get the Relevant Facts

- What are the relevant facts in the situation?

(continued)

Exhibit 6 (Continued)

During the orientation, limitations on the use of the company credit card were identified.

During the dinner, more experienced colleagues have told him it is okay to use the card for business expenses of this nature. The friends were identified by them as prospective clients.

- Are there any facts not known that should be known?

  Carlos would like to know the company policies on allowable client entertainment expenses and for classifying and documenting someone as a potential client. He would like to know if the friends are in fact prospective clients.

- Other questions that might be asked in fact gathering include, What resources are available to learn more about the situation? Is there enough available information to make a decision?

  In this situation, Carlos does not have the luxury of gathering more information about the policy. Carlos may wonder if the friends actually represent prospective clients for the company but may find it difficult to question his colleagues further. As a result of the orientation, Carlos is concerned that charging the meal to the card may be in violation of the company policy and be unethical.

4 Identify Applicable Ethical Principles

- What are the fundamental ethical principles involved in the situation?

  Carlos is expected to act with integrity in using the resources of his employer. He should use reasonable care in determining if the friends represent prospective clients. He should use independent judgment. He should treat his colleagues with respect, but this does not mean he cannot question their guidance.

5 Identify Factors That Could Be Affecting Judgment

- What factors are affecting judgment? Outside factors, such as authority figures, a vocal group, and incentives, can affect judgment. Internal factors, such as overconfidence and rationalization, can also affect judgment.

  Carlos may be influenced by his more experienced colleagues. He may rationalise that it is just one dinner and unimportant. He should pause and think through his decision before acting.

6 Identify and Evaluate Alternative Actions

- What are the options? Have creative options been identified?

  Carlos's options include

  - *complying with his colleagues' request and charging the dinner to the company card.*

Exhibit 6 (Continued)

- *complying with his colleagues' request and charging the dinner to the company card but indicating that he will speak to the boss about it the next day.*
- *charging the dinner to his personal card.*
- *charging the dinner to his personal card and indicating that he will speak to the boss about it the next day.*
- *declining and suggesting that it is better for a more senior colleague to charge the dinner.*
- *declining and suggesting that those in attendance split the bill.*

- What criteria affect choosing among options? How should conflicts of interest be managed? How will an alternative affect the relevant parties identified in Step 1?

  Carlos wants to behave ethically and abide by company policy. He also wants to be on good terms with his colleagues. If Carlos chooses to pay with either the company card or his personal credit card and talk to the boss, he may end up paying the entire bill personally. He may not be willing or able to do this. Furthermore, if he ends up paying the entire bill personally, he may distrust his colleagues and their advice in future. If he indicates that he is going to speak with the boss or declines to pay, it has consequences for his relationships with his colleagues. They may not view him as a trusted member of the team. Speaking to the boss may affect his colleagues. Paying also has consequences for his relationships. The colleagues may lose respect for him and his boss may disapprove. This consequence may result in censure or even dismissal.

- If a particular alternative was shared with a respected individual or reported to a wider audience, what is the expected response?

  The orientation should lead him to understand that using the company card is unacceptable and would reflect poorly upon him. Carlos might be uncomfortable sharing the decision to charge the company card. Carlos might feel more comfortable sharing other decisions.

7 Seek Additional Guidance

- Would discussing the issues with a supervisor, colleagues, or legal (compliance) personnel be appropriate or helpful?

  Seeking guidance to gather more facts about company policy or discussing the issue with a supervisor, colleague, or compliance officer would be helpful but not possible in this case. Carlos has to make a decision and act now based on the decision available.

(continued)

Exhibit 6 (Continued)

8 Act and Review the Outcome

- How did the decision turn out, and what has been learned from this specific situation?

This framework is based on “A Framework for Thinking Ethically” from the Markkula Center for Applied Ethics at Santa Clara University (www.scu.edu/ethics/practicing/decision/framework.html).

A framework for ethical decision making and the application of ethical principles will hopefully assist individuals in addressing ethical dilemmas.

Exhibit 7 includes further examples of ethical dilemmas to which this framework might be applied. As you read them, consider how you would apply the framework and what actions you would take in the circumstances described.

Exhibit 7 Examples of Ethical Dilemmas

- An employee in the sales and marketing department of an investment adviser is asked by his supervisor to prepare a marketing brochure highlighting a particular investment product that generates higher fees for the adviser than comparable investment products.
- An administrative assistant for a portfolio manager is asked by one of the manager’s long-time clients, who the assistant knows well, to provide him with the manager’s investment recommendations before other clients.
- An operations manager for an investment firm is responsible for hiring a consultant to address internet security issues. She is considering hiring a consulting company that is owned and operated by a college friend.
- An individual in the printing office of a research firm is considering phoning friends and family to inform them of changed investment recommendations so they can act on the information before the firm’s clients can.
- A consultant for a public pension fund completes a preliminary analysis of investment firms that responded to a request for proposal of services. He is told to include on the shortlist a firm that provides sporting event tickets to pension plan personnel.
- An employee in the accounting/billing department of an investment firm is asked by the senior partner of the firm, who also sits on the board of a local charity, to provide names and contact information of all the firm’s clients for the purpose of soliciting charitable donations to that charity.
- A paralegal in the legal department of a bank that is assisting with bankruptcy filings for one of the bank’s clients owns shares of the client and is considering selling them before the news is made public.

Exhibit 7 (Continued)

- A portfolio manager tells her assistant that she and 7 of the 10 other portfolio managers in the firm are leaving to form their own firm. She asks the assistant to join the new firm and to put together a list of current clients with their phone numbers and other personal details.
- A research assistant for a pension fund is considering sharing some investment research and economic forecasts received by the fund with the advisory board of the endowment for his church.
- A long-time assistant is asked by a senior manager, who is being let go, to copy several company files for the manager's job search. The files contain research reports that the manager wrote, marketing presentations containing the manager's performance record, and spreadsheets that the manager created.
- An employee in the operations department of an investment firm responsible for negotiating cell phone service for company employees is considering renewing the contract with the firm's existing carrier without any further investigation. He is familiar with their service, comfortable with the customer service representative of the carrier, and very busy with the pending move of the firm's offices.
- An employee in the accounting department is responsible for processing expense reports for a senior manager. Because the manager often does not have receipts for such items as meals and cab fare, the employee has learned to override the accounting system for these minor expenses. The manager asks the associate to process his latest expense report, which does not have receipts for larger expenses. When the employee asks for the receipts, the manager tells him he lost them and to "just override the system like you usually do."
- While attending the sponsor's exhibit area at an investment industry conference, an employee of the compliance department of a large investment firm visits the booth of a compliance software vendor and enters her name into a raffle by dropping her business card into a jar. The employee wins an iPad from the vendor. The employee discovers that her firm and the vendor are in the final stages of negotiating a long-term business relationship.
- An employee receives a check made out to him from a hotel as reimbursement for an uncomfortable night at the hotel. The employee's company paid for the hotel stay.

In each of these examples, at least one person is facing an ethical dilemma. Using a framework for ethical decision making and applying ethical principles may help those individuals to first identify the ethical dilemmas and then to navigate their way through them.

SUMMARY

- Trust is essential to the functioning of the investment industry—trust in the behaviour, actions, and integrity of participants in the financial markets. Trust depends on participants complying with rules and acting ethically.
- Rules are helpful but are unlikely to cover every situation encountered. In the absence of clear rules, ethical principles can help guide decision making and behaviour.
- Ethical reasoning and decision making become more important as increased opportunities for ethical dilemmas arise in increasingly complex expanding and globally interconnected financial markets.
- A culture of integrity, at a business or personal level, can be built using a four-step process:
  1. Set high standards and put them in writing
  2. Get adequate and ongoing professional and ethics training
  3. Assess the integrity of individuals and groups encountered
  4. Take action when integrity breaches are observed
- Investment professionals have to meet various obligations to serve their clients' interests and to comply with applicable laws, rules, regulations, and ethical standards. Compliance with ethical standards benefits financial markets, clients, employers, co-workers, and employees within the investment industry.
- The CFA Institute Code of Ethics sets ethical standards for investment professionals.
- Fundamental ethical and professional principles applicable to the investment industry include the following:
  - Make client interests paramount.
  - Exercise diligence, reasonable care, and prudent judgment.
  - Act with independence and objectivity.
  - Avoid or disclose conflicts of interest.
  - Make full and fair disclosure.
  - Engage in fair dealing.
  - Protect confidential information.
- All employees in the investment industry should act with integrity; use competence, diligence, and reasonable care; act respectfully and ethically; and use independent judgment.

- Benefits of ethical conduct in the investment industry are many but begin with trust. Increased trust in the fairness of financial markets and the ethical conduct of market participants leads to increased market participation. Increased market participation leads to increased liquidity, increased market efficiency, and increased availability of capital at a reduced cost. As a result, the overall economy thrives.

- Violations of legal and ethical standards can have significant negative consequences for clients, investment professionals, investment firms, the investment industry, financial markets, and the global economy.

- A framework for ethical decision making, such as the one listed here, can help individuals make ethical decisions:

  1. Identify the ethical issue(s) and relevant duties and obligations.
  2. Identify conflicts of interest.
  3. Get the relevant facts.
  4. Identify applicable ethical principles.
  5. Identify factors that could be affecting judgment.
  6. Identify and evaluate alternative actions.
  7. Seek additional guidance.
  8. Act and review the outcome.

CHAPTER REVIEW QUESTIONS

1 Maintaining high ethical standards in the investment industry will *most likely* result in:

A decreased market efficiency.

B fewer conflicts of interest.

C increased market participation.

2 Maintaining high ethical standards in the investment industry will *most likely*:

A increase the fairness of financial markets.

B decrease the stability of the financial system.

C decrease the complexity of financial markets.

3 Which of the following *most likely* represents potential violation of ethical principles due to a conflict of interest?

A An analyst writes a research report about a company for which he owns a significant number of shares.

B A financial salesperson, who sells specific investment products, recommends an investment product to a client and is paid a commission on the sale.

C An employee sells her own shares of a company after placing a client's order to sell shares of the same company.

4 In fulfilling obligations to their employer, employees should:

A be careful in carrying out their responsibilities.

B accept and diligently complete any assigned task.

C balance their personal interests with their employer's interests.

5 If the required structural and procedural controls have not been established, then an employee should:

A refrain from assuming supervisory duties.

B notify the appropriate regulatory authorities.

C perform their supervisory duties with utmost care.

6 Which of the following outcomes of acting with high ethical standards will *most likely* directly benefit both clients and investment professionals?

A Enhanced employment security

B Reduced risk of adverse legal consequences

C Increased trust in the fairness of financial markets

7 For individuals working in the investment industry, ethical standards are *most* needed when:

A legal obligations are ambiguous.

B market innovations are infrequent.

C different jurisdictions have unambiguous and similar laws.

8 According to fundamental ethical and professional principles applicable to the investment industry, which group should have their interests ranked first?

A Clients

B Employers

C Co-workers

9 The fundamental ethical principle to act with independence and objectivity is *best* upheld when:

A client confidentiality is maintained.

B personal education and professional development are undertaken.

C work and opinions are unaffected by any potential conflict of interest.

10 According to fundamental ethical and professional principles for the investment industry, trading on insider information on behalf of clients is:

A not allowed.

B allowed only if the trade benefits the client.

C allowed only if the trade is disclosed as a conflict of interest.

11 Which of the following is *most likely* a potential effect of unethical behaviour by people in the investment industry?

A Increased employment

B Decreased economic output

C Decreased regulatory scrutiny

12 Unethical behaviour by investment professionals may lead to higher:

A employment.

B long-term growth expectations for the economy.

C cost of capital for those companies requiring capital.

13 The last step in an ethical decision-making process should be to:

A assess how a decision turned out and learn from it.

B assess how others might view a possible course of action.

C determine whether the decision is affected by outside factors.

14 A breach of ethical standards *most likely* results in:

A higher public trust.

B reduced financial market efficiency.

C fulfilment of clients' investment goals.

15 According to fundamental ethical and professional principles for the investment industry, conflicts of interest with:

A clients should be avoided.

B clients and employers should be avoided.

C clients and employers should be avoided or disclosed.

16 Decreased cost of capital may lead to the growth of:

A only the investment industry.

B only companies seeking capital in financial markets.

C the investment industry, companies seeking capital in financial markets, and the overall economy.

17 Which of the following *best* describes an internal factor that could affect judgment in ethical decisions?

A Incentives

B Rationalization

C Authority figures

ANSWERS

1 C is correct. By maintaining high ethical standards, trust in the fairness of financial markets will increase, thereby increasing market participation. A is incorrect because the end result of maintaining high ethical standards should be increased market efficiency. B is incorrect because high ethical standards help individuals deal with potential conflicts of interest but do not affect the quantity of those inherent conflicts.

2 A is correct. By maintaining high ethical standards, investors' trust in the investment industry will increase as will trust in the fairness of financial markets. B is incorrect because high ethical standards help prevent financial crises and increase the stability of the financial system. C is incorrect because high ethical standards do not affect the complexity of financial markets. The increasing complexity of global financial markets increases the need for high ethical standards to deal with the resulting increase in ethical dilemmas.

3 A is correct. The analyst preparing a research report about a company when there is an ownership interest, unless the interest is clearly insignificant, has a conflict of interest. The analyst's personal interests might affect his or her ability to write an unbiased, objective report, which is contrary to the interests of his or her employer and the employer's clients. B is incorrect because there is a different level of responsibility associated with a financial salesperson, who is committed to selling specific investment products, and an investment adviser, who is helping clients to plan and achieve their personal financial goals. C is incorrect because although acting prior to executing a client's order (front running) represents a violation of an ethical principle due to a conflict of interest, it may be appropriate for an employee to act *after* executing the client's order.

4 A is correct. Being careful in carrying out their responsibilities is an obligation of all employees. The efficient operations of a company can be compromised if employees do not act competently and carefully. B is incorrect because employees should not accept a task if they lack the appropriate level of knowledge or skill to carry it out, if they have a conflict of interest, or if they are concerned about an ethical issue. C is incorrect because loyalty, an obligation owed to employers, includes an expectation that employees act in their employer's interests when fulfilling their work obligations.

5 A is correct. Supervisory duties should only be assumed when the work environment provides the requisite structural and procedural controls to prevent and detect violations. Supervisors are expected to execute supervisory duties responsibly, which includes ensuring compliance with ethical, legal, professional, and organisational standards. B and C are incorrect because if deficiencies are detected, the employee should document all issues and refrain from assuming supervisory duties until controls have been established. The employee does not necessarily have an obligation to notify the appropriate regulatory authorities.

6 C is correct. Acting with high ethical standards increases clients' trust in the fairness of financial markets, thus promoting market efficiency, which, in turn, helps clients achieve their investment goals. This outcome also benefits investment professionals because increased trust from clients increases the likelihood that clients will seek their advice, thus enhancing the security of their employment. A and B are incorrect because enhanced employment security and the reduced risk of adverse legal consequences benefit investment professionals directly and only indirectly may benefit clients.

7 A is correct. Ethical standards are most needed when legal obligations are ambiguous. The need for ethical standards is particularly apparent in situations in which vague or ambiguous legal rules provide opportunities for unethical behaviour. B is incorrect because laws and regulations are often slow to catch up with market innovations. So, in the case of frequent market innovations, the need for ethical standards would be great. But in an environment with infrequent market innovations, the need is not so apparent. C is incorrect because activities that occur in different jurisdictions can be complicated by inconsistencies in legal obligations, which would make the need for ethical standards important. But in different jurisdictions where legal obligations are unambiguous and similar, the need for ethical standards is not as great.

8 A is correct. Individuals working in the investment industry have the obligation to place client interests ahead of personal interests or the interests of employers. B and C are incorrect because although individuals in the investment industry have an obligation to employers and co-workers, the clients' interests come first.

9 C is correct. Conflicts of interest can adversely affect objectivity and independence by creating a bias that may affect judgment. A is incorrect because maintaining client confidentiality is related to the fundamental ethical principle of protecting confidential information. B is incorrect because undertaking personal education and professional development is related to the fundamental ethical principle of acting with diligence and reasonable care.

10 A is correct. Trading on insider information is not allowed because it will harm all investors by eroding investor confidence in the trading markets. B is incorrect because trading on insider information is a case in which the duty to maintain the integrity of financial markets takes precedence over the client's interests. Therefore, even if the trade would benefit the client, it is a violation of fundamental ethical and professional principles. C is incorrect because trading on insider information is not allowed whether or not it is disclosed. A conflict of interest may not be present and is not the issue.

11 B is correct. Unethical behaviour in the investment industry may lead to a loss of investor confidence, which may reduce the availability of capital to companies and lead to decreased economic output. A is incorrect because *decreased* rather than increased employment is a potential result of unethical behaviour in the investment industry. C is incorrect because unethical behaviour typically results in an *increase* in regulatory scrutiny.

12 C is correct. Unethical behaviour by investment professionals may lead to companies finding it difficult to raise capital in financial markets, thereby leading to a higher cost of capital. If high ethical standards are maintained,

access to equity and debt funding will likely increase and the cost of capital for companies requiring capital will decrease. A and B are incorrect because unethical behaviour by investment professionals may result in lower economic output, lower employment, and reduced long-term growth expectations for the economy.

13 A is correct. The last step in an ethical decision-making process should be to assess how a decision turned out and to learn from it. B and C are incorrect because assessing how others might view a possible course of action and determining whether the decision is affected by outside factors occur earlier in the decision-making process.

14 B is correct. A breach of ethical standards can undermine the factors, such as market efficiency, affected by ethical standards. A and C are incorrect because both higher public trust and fulfilment of clients' investment goals are supported by high ethical standards.

15 C is correct. Conflicts of interests with clients and employers may arise in the course of business. Conflicts should be avoided or managed through disclosure so that all relevant stakeholders are aware of these conflicts and their potential effects on the relationship. A and B are incorrect because, although it is preferable to avoid conflicts of interest, it is not always possible to avoid or eliminate them. In situations lacking that ability, an employee should prominently disclose the conflicts in plain language to effectively communicate the information.

16 C is correct. Decreased cost of capital may positively influence the growth of the companies requiring capital as well as growth in the investment industry and the overall economy. A and B are incorrect because the benefits of lower cost of funds is not limited to only the companies raising funds and the investment industry.

17 B is correct. Internal factors that may affect judgment include overconfidence and rationalization. A and C are incorrect because they are both external factors, not internal. External factors that affect a person's judgment include authority figures, vocal groups, and incentives.