Chapter 2: Ethics and Investment Professionalism

Introduction

Ethics is an integral part of ensuring the integrity of the financial market, which refers to it being ethical, transparent, and providing investor protection. This is an essential element of the determination of investor trust. Without it, people are less likely to participate in financial markets, investment is less likely to occur, and economics can not grow.

1. Ethical Standards: standards based on principles that support and promote desired values and behaviors.
    a. Ethics: a set of moral principles, or the principles of conduct governing an individual or a group.
    b. Professional Standards are explicit ethical standards to be practiced within a profession.
2. A culture of integrity based on ethical standards can be created by following the process below:
    a. Set high standards and put them in writing.
    b. Get adequate and ongoing professional training on professional and ethical standards.
    c. Assess the integrity of individuals and groups you encounter.
    d. Take action when breaches of integrity and ethical standards are observed.
3. Ethical Dilemmas: situations in which values, interests, and/or rules potentially conflict.

Why Ethical Behavior Is Important

1. Factors Affected by Ethical Standards in the Investment Profession:
    a. Investor confidence
    b. Integrity of the investment profession
    c. Integrity of financial markets
    d. Clients' investment goals
    e. Clients' trust
    f. Public trust
    g. Efficiency of financial markets
    h. Fairness of financial markets
    i. Success of the investment industry

Obligations of Employees in the Investment Industry

1. Obligations to Clients
    a. The ethical obligation that investment professionals have to their clients can be achieved by using the required professional knowledge and skills, managing risks that can affect client interests, safeguarding client information, and treating clients consistently, fairly, and respectfully.
    b. Conflict of Interest: arises when either the employee's personal interests or the employer's interests conflict with the interests of the client. This can also be true for employer and employee interests.

        i. Professionals in the investment industry are expected to place the interests of the client above their own, as well as above their employer's. The exception to this being when the client's interests conflict with the integrity of financial markets.
    c. Terminology:
        i. Churning: excessive trading on the part of an asset manager to increase fees, which results in higher transaction costs and lowers the returns of the client.
        ii. Front Running: the purchasing of stock by an asset manager who is subsequently going to buy that same stock for a client, their goal being to profit off the increase in stock price resulting from their client's purchase.

2. Obligations to Employers
    a. The ethical obligation that investment professionals have to their employers can be achieved by providing services as agreed on in an employment contract, following or executing supervisory directives as required, and maintaining professional conduct. These obligations also include loyalty, professional competence, and care.
        i. Loyalty can be defined as 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.

3. Obligations to Co-Workers
    a. Obligations that individuals working in the investment industry have to their co-workers include competence, care, respect, (helping co-workers understand, promote, and follow ethical practices), and encouraging others to adhere to professional obligations.
    b. Supervisory Roles:
        i. Requires ensuring compliance with ethical, legal, professional, and organizational standards.
        ii. Supervisory roles should only be created and assumed if the proper structural mechanisms are in place for handling breaches of compliance.

Ethical Standards

1. Introduction:
    a. Laws and Regulations help to ensure the integrity, fairness, and efficacy of financial systems and those that work within the investment industry. However, they are not sufficient for the following reasons:
        i. Laws and regulations may not extend to all areas of finance and can be vague and ambiguous, make their interpretation a challenge.
        ii. Laws and regulations are often slow to catch up with market innovations.
        iii. Activities that occur in different jurisdictions can be complicated by inconsistencies in legal obligations in different countries.
        iv. Situations may arise in which no applicable law exists or the existing law is inconclusive.
        v. The effectiveness of laws and regulations depends on how market participants interpret and comply with them.

Benefits of Ethical Conduct and Consequences of Unethical Conduct

1. Introduction
    a. Unethical behavior can have significant consequences for the financial system and the economy, potentially financial crises that affect economic development and society's welfare.
    b. Ethical behavior ensures stability of the financial system and complements existing legal obligations, professional standards of conduct, and organizational policies and procedures.
2. Benefits of Ethical Conduct
    a. The liquidity, profitability, and efficiency of markets and economies are rooted in trust. Trust increases confidence and participation in financial markets, which affects efficiency.
    b. This, in turn, improves equity and debt funding, which decreases the cost of capital for companies and governments requiring capital. This also improves the efficiency and profitability of companies.
    c. Lack of trust in financial systems can lead consumers to use financial systems less, which increases job insecurity. Conversely, increases in trust increase job security, achievement, compensation, and reputation
3. Consequences of Unethical Conduct
    a. Consequences of unethical behavior include failure to achieve goals on behalf of a client or employer, negative effects on the entire investment industry through decreased participation, and loss of trust in the integrity of financial markets and the investment profession.
    b. Consequences for Industry and Economy:
        i. Unethical behavior leads to decreased participation, which in turn can lead to the cost of capital increasing, decreases in efficiency and profitability, and economic downturn.
        ii. Shocks within individual companies can also lead to shocks in interrelated companies and the economy as a whole. (Think of the effect of a financial institution's solvency.)
    c. Consequences for Clients:
        i. Unethical behavior leads to clients suffering losses financially and emotionally.
        ii. Improper financial advice and investment can lead to clients being exposed to excessive risk, ownership of unsuitable assets, lack of diversification, and unjust transaction/management costs.
        iii. Ultimately, clients lose wealth and income.
    d. Consequences for Employers:
        i. Unethical behavior on the part of an employee can lead to firm-wide negative effects on current and future clients, loss of reputation and company value, legal liabilities and increased scrutiny by regulators, and increased administrative and analytical costs.

        ii. Negatively impacted reputation can result in a loss in company profits and a loss of shareholder value. Firms can also be held legally accountable for losses sustained by clients and can lose licenses / be required to pay fines.
    e. Consequences for Individuals:
        i. Consequences for individuals who engage in unethical behavior include legal, professional, personal, and economic consequences. (Employer punishment, legal prosecution by government and individuals, fines, loss of employment, imprisonment, inability to advance career, loss of reputation and income.)

Framework for Ethical Decision Making

1. Identify the ethical issues and relveant 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 judgement.
6. Identify and evaluate alternative actions.
7. Seek additional guidance.
8. Act and review the outcome.