R56 Ethics and Trust in the Investment Profession

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Version: 1.0

1. Introduction

To illustrate the importance of ethical behavior, the curriculum cites the example of an analyst's action at a financial services firm. The research department at the firm is responsible for making investment recommendations to clients after sound analysis and valuation of companies. An analyst in the research department misrepresents facts in his report with the objective of pleasing the management of the subject company. He hopes this would lead to financial benefits for his employer and himself. However, clients who act on the recommendation incur heavy losses and spread a negative word on several online forums about the firm. This eventually affects the reputation of the firm, forcing it to downsize and many employees lose their job. This example illustrates how one member's unethical actions have a spiraling effect on the firm and other employees for no fault of theirs.

The foundation of the investment management industry is trust; and ethical behavior is central to creating that trust. The top two attributes of an investment management firm are:

- Has transparent and open business practices.
- Has ethical business practices.

Ethical behavior is not just about adhering to the law, rules, and regulations. It is about identifying potential conflicts and acting righteously in situations where there are no stated rules.

2. Ethics

The word ethics comes from the Greek word "ethos" meaning character, guiding beliefs, or ideals. There are several definitions of ethics, all of which essentially convey the same meaning.

Ethics can be described as a set of moral principles and rules of conduct that provide guidance for our behavior. Examples of ethical principles include honesty, transparency, diligence, justice, being open about the costs involved in an investment, fairness, and respect for the rights of others.

Another definition of ethical conduct is behavior that balances one's own interest with the direct and indirect consequences of the behavior on others.

Instructor's Note:
The 'others' are often referred to as stakeholders, i.e. groups of people or individuals who are directly or indirectly impacted by a decision. Examples of stakeholders in decisions made by investment industry professionals include colleagues, clients, employers, the communities in which we live and work, the investment profession, trade associations, regulators, and other financial market participants.

Specific communities formally define the rules for acceptable and forbidden behavior into a written set of principles called the **code of conduct**. Professional associations, universities

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and companies often adopt a code of ethics and expect their members to adhere to those rules, at the very least. The members may choose to display higher standards of behavior than what is stipulated in the code of ethics. The code of ethics publicly communicates the established principles and expected behavior of its members.

Some communities may also expand on their code of ethics and adopt explicit rules or standards that identify specific behaviors required of community members. These **standards of conduct** serve as a benchmark of the minimally acceptable behavior expected from members of a community.

3. Ethics and Professionalism

A profession is an occupational community having specialized knowledge and skills; which adheres to ethical behavior; and is subject to some combination of licensed status and technical standards. Examples of professions include doctors, lawyers, actuaries, accountants, architects, etc.

The number of professions has increased over time due to rising demand from clients and individuals. A profession is different from craft guilds and trade bodies in two ways: unlike trade bodies, members of a profession are required to uphold high ethical standards and their mission is to serve society.

How Professions Establish Trust

The following characteristics help establish confidence and credibility in professionals and their organizations.

a) Professions normalize practitioner behavior by developing professional codes and standards.
b) Professions provide a service to society.
c) Professions are client focused: The major objective of codes and standards is to ensure that professionals always act in the best interest of the client and exercise a reasonable level of care, skill, and diligence with regard to providing them service.
d) Professions have high entry standards.
e) All members of a profession possess a body of expert knowledge.
f) Professions encourage and facilitate continuing education.
g) Professions monitor professional conduct to maintain integrity and reputation of an industry.
h) Professions are collegial and respect the rights, dignity, and autonomy of others.
i) Professions are recognized oversight bodies.
j) Professions encourage the engagement of members to develop expertise and ethics and to advance the profession.

Professions evolve over time as the requirements, technology, and standards change.

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Professionalism in Investment Management

Most countries require investment professionals to have some form of certification or licensing to practice. Due to regulatory coordination across borders and the emergence of technology, the investment management profession has become increasingly global.

Trust in Investment Management

Trust is a very important aspect in investment management. When market participants trust investment management professionals, it leads to smooth functioning and efficient capital markets, which in turn helps in the development of the economy.

CFA Institute as an Investment Management Professional Body

CFA Institute is the largest body for investment management professionals. The mission of CFA Institute is "to lead the investment profession globally, by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society." CFA Institute candidates and charterholders are required to meet the highest standards among those established by CFA Institute, regulators, or the employer. The CFA Institute Code and Standards aims at aligning the interests of firms and clients.

CFA charterholders and CFA Program candidates are required to "adhere to the Code and Standards and to annually sign a statement attesting to that continued adherence". Charterholders and candidates must "maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals".

4. Challenges to Ethical Conduct

Some of the challenges to ethical conduct include the following:

Overestimating one's morality: People often believe they are more ethical than they actually are. This overconfidence can sometimes lead to faulty decision-making. It is often seen that emotions cloud rational thinking, prompting one to make decisions that may not be the most ethical choice.

Situational influences: These are external factors such as cultural, social, and environmental factors that influence one's thinking, behavior, and decision-making. Some of the common situational influences are:

- Money and prestige: Both money and prestige push people to act in their own self-interests and take actions that are less ethical. The promise of a large financial bonus or a promotion, can impact people's thinking ability and cause them to act in their own short-term interests and ignore the long-term consequences of their actions.
- Loyalty to employer, employee, and colleagues: Loyalty can have both positive and negative effects. For instance, some colleagues may encourage you to behave more ethically and enroll in the CFA Program to advance your career. On the other hand, colleagues who do not adhere to the Code and Standards may encourage you to simply act in accordance with the local law, even though it may fall short of ethical conduct.

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- Compliance culture: A strong compliance policy is important for ethical decision-making. However, processes focused solely on compliance, oversimplify decision-making and do not help the larger cause. Employees may adopt a "check the box" mentality and think in terms of "What *can* I do?" instead of "What *should* I do?"

5. Ethical vs. Legal Standards

Many times, there is a grey area between what is legally accepted and what is ethical. Acting in accordance with the law and acting ethically are not necessarily the same. There are four possible outcomes for any action from a legal and ethical perspective:

- Not legal and not ethical.
- Legal and ethical.
- Not legal but ethical: For example, civil disobedience or protesting peacefully against an issue may not be legal, but it is ethical. Another example of an illegal but ethical act is that of whistleblowing (Whistleblowing is raising the curtain off an illegal or corrupt activity).
- Legal but not ethical: Some countries do not have laws that prohibit trading while in possession of material nonpublic information. While this act of trading is legal from the local country's perspective, it is considered unethical by the CFA Institute and other investment professionals.

There are several reasons why laws are not sufficient to ensure ethical conduct among market participants:

- Laws and regulations are often created in response to existing market practices. A new law might address an existing ethical problem but create an opportunity for other unethical behavior in future.
- Laws can be interpreted differently. Market participants may choose to interpret the law to their advantage or delay compliance where there is no punitive action.
- Laws can vary across jurisdictions. This may encourage questionable practice to move to places that are less restrictive in nature.

Ethical conduct encourages us to:

- Go beyond what is legally required.
- Consider the impact on all stakeholders.
- Make good choices, even in the absence of clear laws and regulations.

6. Ethical Decision-Making Framework

Firms must strive to develop a strong ethical culture and encourage investment professionals to apply ethical decision-making skills every day; so much so that it becomes second nature. Working and operating in an environment that fosters integrity and accountability motivates its employees to do the right thing will go a long way in preventing unethical actions.

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Setting up an ethical framework:

- Helps in evaluating a situation from multiple perspectives after considering the larger picture in such a way that it benefits stakeholders in the long term. Often, the impact of a decision or all aspects of a situation is not clear in the short term and decisions taken in haste may harm stakeholders unintentionally.
- Helps decision makers justify actions to a broader group of stakeholders.

The following ethical decision-making framework is presented in the curriculum.

- **Identification phase**: Identify all the relevant facts and distinguish between facts and personal opinion, judgements, and biases. This includes information one has and what one would like to have.
  - Identify relevant facts such as details of the employer, information on an IPO or a deal, rules and regulations of the industry, etc.
  - Identify the stakeholders such as employer, market participants, clients, supervisor, investors, family, etc.
  - Identify relevant ethical principles for the situation. This may include loyalty to employer, clients' interests taking precedence before everything else, and maintaining the confidentiality of information etc.
  - Identify any potential conflicts of interest, or conflicts in your duties to employers/clients. Examples of potential conflict of interest include duties to one client versus other clients of the firm, financial rewards linked to the success of a deal versus duty to employer, and duty to supervisor versus the need to impress.
- **Consideration phase**: Seek guidance (preferably from someone outside the firm) to navigate through situational influences and personal biases that may affect decision-making.
  - Examples of situational influences include how much fees the firm will earn from a deal, how much bonus or compensation one expects to receive because of working on an IPO/deal, or associating one's self-worth to working on a prestigious account/deal.
  - Examples of where one could seek guidance include the firm's compliance department, peers, the CFA Institute Code and Standards, or a supervisor.
- **Decide and act**: Make a decision and act.
- **Reflect:** Once the decision is made, assess the decision to see if it had the desired outcome. If not, then analyze the reasons: were the stakeholders identified, was there any conflict of interest, were the ethical principles identified, did you seek guidance on how to deal with situational influences and personal behavioral biases?

Sometimes the information gathered is not sufficient to make a decision, in which case the process becomes iterative and you may seek additional guidance on how to gather more relevant information.

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Summary

LO.a: Explain ethics.

The word ethics is derived from the Greek word 'ethos,' which means character. Ethics means making good choices. Ethics includes a set of moral principles and rules of conduct that help us in our behavior.

LO.b: Describe the role of a code of ethics in defining a profession.

A profession is an occupational community having specialized knowledge and skills; which adheres to ethical behavior; and is subject to some combination of licensed status and technical standards

A profession is different from craft guilds and trade bodies in two ways, i.e. unlike trade bodies, members of professions are required to uphold high ethical standards and their mission is to serve society.

LO.c: Describe professions and how they establish trust;

LO.e: explain professionalism in investment management;

The common characteristics that help establishing the confidence and credibility in professionals and their organizations include the following:

k) Professions normalize practitioner behavior;
l) Professions provide a service to society;
m) Professions have high entry standards;
n) All members of a profession possess a body of expert knowledge;
o) Professions encourage and facilitate continuing education;
p) Professions monitor professional conduct to maintain integrity and reputation of an industry;
q) Professions are collegial and respect the rights, dignity, and autonomy of others;
r) Professions are recognized oversight bodies;
s) Professions encourage the engagement of members;

Professions evolve over time as the requirements, technology, and standards change. Trust is the key in investment management and the trust is established by acting with care, due diligence, and judgment for clients. Investment management profession combined with ethical corporate governance plays a vital role in the growth and development of the capital market.

LO.d: Describe the need for high ethical standards in investment management.

Investment management profession combined with ethical corporate governance plays a vital role in the growth and development of the capital market. When market participants have trust in the investment management professionals, it leads to efficient capital market and smooth functioning which in turn helps in the development of the economy.

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LO.f: identify challenges to ethical behavior;

Some of the challenges to ethical conduct include the following:

Overestimating one's morality: People believe they are more ethical than they actually are. This overconfidence in themselves can sometimes lead to faulty decision-making.

Situational influences: These are external factors such as cultural, social, and environmental factors that influence one's thinking, behavior, and decision-making. Some of the common situational influences are:

- Money and prestige:
- Loyalty to employer, employee, and colleagues:
- Compliance culture:

LO.g: Compare and contrast ethical standards with legal standards.

Legal and ethical conduct is not always the same.

Laws are not always the best mechanism to reduce unethical behavior because:

- Legal standards are often created to address past ethical failings. They do not provide direction for an ever changing and increasingly complex world.
- Laws are often rule-based.
- Laws will vary across countries.

Ethical conduct goes beyond legal standards.

LO.h: Describe and apply a framework for ethical decision-making.

A framework for ethical decision-making can help people look at and assess a decision from different perspectives. This enables them to make good decisions, and to limit unplanned consequences.

A general ethical decision-making framework has the following four steps.

1. Identify: Relevant facts, stakeholders and duties owed, ethical principles, conflicts of interest.
2. Consider: Situational influences, additional guidance, alternative actions.
3. Decide and act.
4. Reflect: Was the outcome as anticipated? Why or why not?

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Practice Questions

1. Which of the following statements is *most likely* correct?
   A. Ethics can be described as a set of moral principles that provide guidance for our behavior.
   B. Ethical conduct is behavior that balances one's own interest with only the direct consequences of the behavior on others.
   C. Professional associations adopt a code of ethics to protect their own professional community.

2. Which one of the following is *least likely* a reason for a profession to establish a code of ethics?
   A. A code of ethics serves as an aid in decision-making.
   B. A code of ethics helps instill confidence among clients and prospective clients.
   C. A code of ethics helps ensure that members of the profession will follow the law.

3. Which of the following is *least likely* a challenge faced by professionals to display ethical behavior?
   A. People tend to believe they are more ethical than they actually are.
   B. People tend to underestimate their own morality.
   C. People tend to underestimate the impact of situational influences.

4. Which of the following statements is *least likely* accurate? Trust is particularly important in the investment profession because:
   A. investment professionals have specialized knowledge and access to information is asymmetrical.
   B. products and services in the investment industry tend to be intangible.
   C. returns cannot be guaranteed for most types of investments.

5. Which of the following is *least likely* a reason for laws being insufficient to ensure ethical conduct among market participants?
   A. Laws can be interpreted differently.
   B. Laws are largely the same across jurisdictions.
   C. Passing a law takes significant time.

6. Which of the following statements about ethical decision framework is/are *most likely* accurate?
   - **Statement 1**: An ethical decision framework helps decision makers justify actions to stakeholders.
   - **Statement 2**: Too many choices can at best lead to inaction.
   - **Statement 3:** An ethical decision framework serves as a tool for investment

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professionals to choose the best possible alternative.

A. Statement 1 and 3.
B. Statement 3 only.
C. Statement 1, 2, and 3.

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Solutions

1. A is correct. Statement B is incorrect because ethical conduct is behavior that balances one's own interest with the direct and indirect consequences of the behavior on others. Statement C is incorrect.

2. C is correct. The code of ethics cannot ensure that members of the profession will follow the law. Statements A and B are true.

3. B is correct. Challenges faced by professionals to display ethical behavior include: 1) overestimating one's morality and 2) underestimating the effect of situational influences.

4. C is correct. Statement A and B are valid reasons for trust being important in the investment profession. C does not represent a reason for why trust is particularly important in the investment industry.

5. B is correct. Laws can vary across jurisdictions. This may encourage questionable practice to move to places that are less restrictive in nature. Statements A and C are valid reasons for why the law alone might be insufficient to ensure ethical behavior.

6. C is correct. All three statements regarding ethical decision frameworks are correct.

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