

---

## LEVEL 1: ETHICS

---

Reading 56 (1<sup>st</sup> out of 5): ETHICS AND TRUST

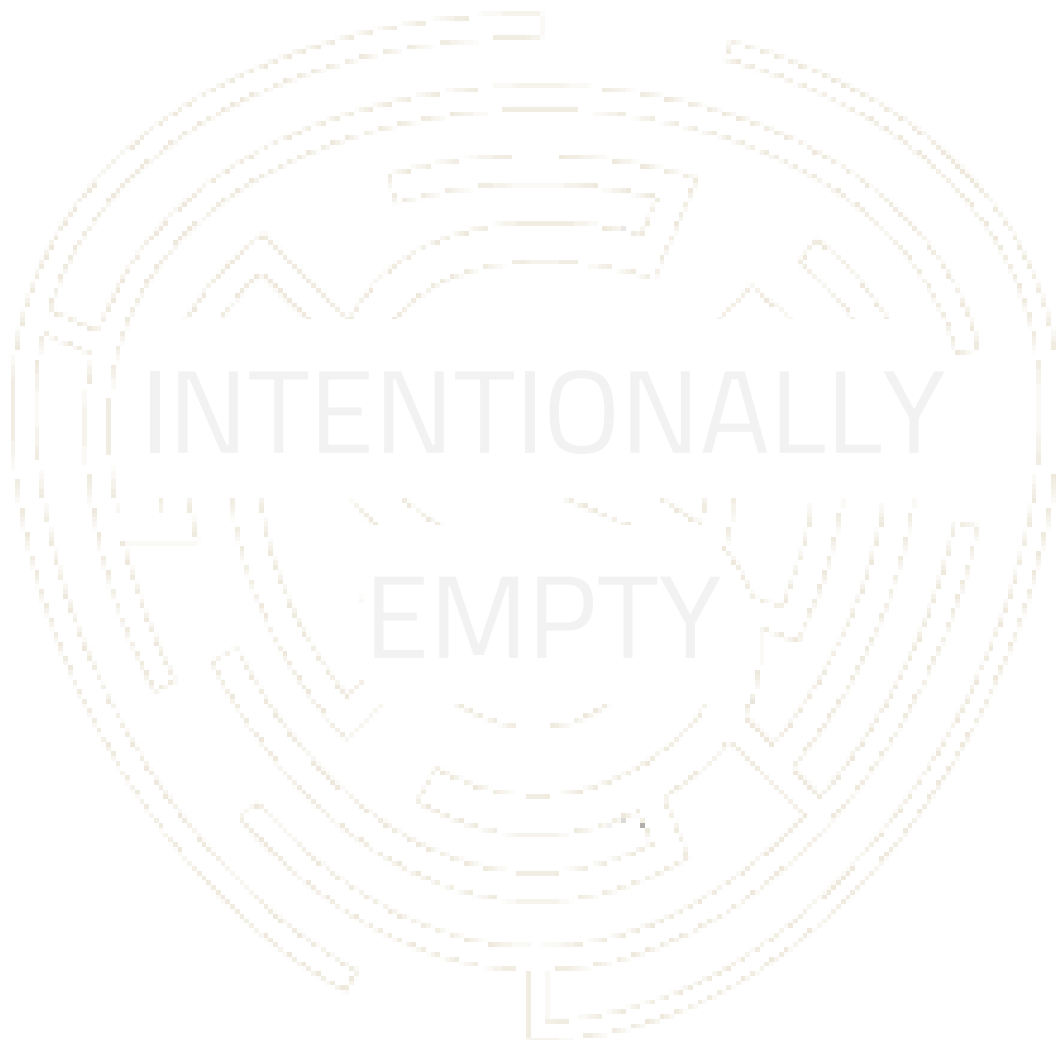
Difficulty:

**easy**

Benchmark Study Time:

**1h**

2022





**THIS E-BOOK:**

- ❖ is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- ❖ provides place for your own notes,
- ❖ helps you structure your study and revision time!

## How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep all important info for this Reading **in one place**.
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g., write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to [your study plan](#) and change the Reading's status to **green** :  
(it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

**NOTE:** While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.



## ETHICS AND TRUST

### Defining trust

**Trust** = when you believe – strongly! – that a person or an institution is reliable and trustworthy

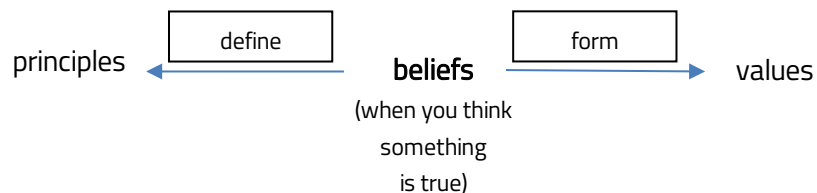
To earn investors' trust, investment managers should:

- ▶ have transparent business practices,
- ▶ act responsibly when there's an issue or a conflict to address,
- ▶ have ethical business practices.

### Defining ethics and ethics studies

**ethics** (from Greek *ethos*, i.e., *character*) = set of moral principles and rules that guide our conduct

**moral/ethical principles** = beliefs that juxtapose the good, acceptable, and thus obligatory with the bad, unacceptable, and thus forbidden



Countries often regulate the investment industry. Differences in regulations may result in **varying beliefs and values when it comes to the investment industry.**

**ethics studies** = aim at studying:

- ▶ good vs bad behavior,
- ▶ making good vs bad choices,
- ▶ consequences of the choices,
- ▶ personal character.



HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## More on ethics and ethical conduct

Many think that ETHICAL CONDUCT is the equivalent of following relevant laws and rules. However, often there will be no established laws or rules to appropriately regulate a situation. ETHICAL CONDUCT stems from the ability to identify potential ethical issues and come up with ethical solutions.

ASK: What **SHOULD** I do? NOT JUST: What *can* I do?

Our decisions and actions *always* impact other people. In the context of the investment industry, these are other stakeholders like colleagues (other employees), clients (investors), our employer, other financial market participants, and in fact the whole financial industry and investment profession. Our decisions may be **either beneficial or harmful** to other stakeholders.

**true ethics** >> making good choices even in the absence of appropriate rules or laws

**good ethical judgment** >> critical ingredient for good choices and appropriate conduct

**ethical action in an investment environment** >> beneficial to the client and conforming to his or her ethical expectations, e.g., informing the client about the risks associated with an investment

## Code of ethics

**code of ethics** = provides general guidance and publicly communicates the established principles and expected behavior

code of ethics = general guide

**code of ethics** = what we **SHOULD** share though sometimes fail to! + a means to discipline us

## Standards of conduct

**standards of conduct** = more explicit rules that explain the code of ethics in more detail and help to interpret its principles by providing benchmarks for minimally acceptable behavior



standards of conduct = detailed rules

Organizations make sure that the code of ethics and standards of conduct (if applied) are clearly displayed and easily available to members. Members are usually asked to commit to the code and standards in writing.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Violations

**violation** = lack of adherence to the code of ethics and standards of conduct established by the organization

### Threats behind violations:

- ✦ can be harmful to the organization in many different aspects
- ✦ can damage the reputation, both externally and internally
- ✦ reduce trust!

### In the wake of a violation:

- ✦ investigation of the violation
- ✦ corrective actions (also to investigate possible violations), repair, damages
- ✦ disciplinary regulations and/or actions against the violator (incl. revoked membership in the community)

## CFA Institute Code of Ethics and Standards of Professional Conduct

CFA Institute is an organization like many others. Its **principles, values, and expectations are stated in the Code of Ethics and Standards of Professional Conduct (Code and Standards)**. Each year, CFA members and candidates submit their Professional Conduct Statement where they reaffirm their commitment to adhere to the Code and Standards and disclose any conduct that may violate the Code and Standards.

To protect against any possible violations, CFA Institute has its disciplinary process established. **Disciplinary actions against the violator include:** private reprimand, suspension from the CFA Program, suspension of membership, revocation of the right to use CFA designation, etc.

**CFA Institute Code and Standards** >> principle-based standards, meaning they apply to all CFA members and candidates at all times

CFA candidate: You must also adhere to  
the Code and Standards!





HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Occupation vs profession

**occupation** = doing a job that helps you earn your living

**profession** = practicing occupation at the highest level possible, where devotion and true efforts – also to create ethical standards for the profession – are present

Profession is:

- ✦ based on specialized knowledge and skills
- ✦ based on service to others
- ✦ practiced by members who share a common code of ethics and agree to adhere to it

## Challenges to ethical conduct

- ✦ overconfidence in one's own ethical behavior
- ✦ underestimation of situational influences
- ✦ concentration on long-term consequences related to self-interest rather than short-term negative outcomes

There are many different challenges to ethical conduct that may **affect our conduct and lead to faulty decision-making**. As psychological studies explain, we tend to believe in the morality of our own behavior and overlook the impact of various situational influences such as social pressure or challenged behavior in the presence of other people. In the face of self-interest and the lure of profit, we are more likely to shift our brains from long-term to short-term consequences (e.g., individual bonus or promotion). All this may induce unethical behavior even in people who think of themselves as ethical.

**situational influences** = external factors, such as environmental or cultural elements, that shape our thinking, decision making, and behavior

### SITUATIONAL INFLUENCES: POSITIVE VS NEGATIVE IMPACT

e.g., money or prestige (key situational influences in the investment industry)	
POSITIVE IMPACT	NEGATIVE IMPACT
participation in the CFA Program to certify your knowledge and devotion while in the profession associated with money and prestige	compromising your behavior and decisions while seeking personal benefits such as individual bonus or promotion
e.g., presence of other people	
POSITIVE IMPACT	NEGATIVE IMPACT
loyalty to the employer and colleagues	lack of action or compromised course of action



HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Importance of ethical conduct in the investment industry

Because of the nature of the client relationship, differences in knowledge and access to information, and the nature of investment products and services, ethical conduct and trust are particularly important in the investment industry.

WHY?

- ▶ CLIENT RELATIONSHIP: clients are entrusting their assets for care and **safekeeping** >> the clients need to know that their assets are safe
- ▶ KNOWLEDGE AND INFORMATION: investment professionals have **specialized** knowledge (that the clients often lack) and broader access to information >> the clients need to trust that the professionals they hire won't take advantage of them but will serve their benefits
- ▶ PRODUCTS AND SERVICES: investment product and services are usually **intangible** >> the clients need to know that the information they get about their intangible investments is accurate and complete

MOREOVER:

- ▶ clients are attracted to companies with **trustworthy reputations** >> e.g., if the client trusts that the company will act according to the client's expectations, the client is more willing to take risk
- ▶ ethical conduct of **all market participants** >> means broader participation in the markets, protection of clients' interests, opportunities for investment professionals and companies
- ▶ **globalization** of finance >> without trust global transactions are less likely to occur

The harmful impact of unethical conduct? Destroys trust!

- ▶ investors >> less willing to accept risk >> demand higher returns / invest elsewhere / not invest at all
- ▶ borrowers >> higher cost of seeking capital, inability to meet their goals, reduction in: jobs, growth, innovation

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Ethical vs legal standards

- ▶ stakeholders may have different ethical expectations
- ▶ laws and regulations codify what gives better outcomes for society and stakeholders, e.g., regulations on risk disclosures
- ▶ lack of adherence >> investigations, file charges, disciplinary sanctions, monetary penalties, time in jail, etc.

### Types of conduct:

- ▶ legal but unethical (in some jurisdictions, e.g., trading while in possession of material nonpublic information or whistleblowing)
- ▶ ethical but illegal (in some jurisdictions, e.g., civil disobedience or peaceful protests)
- ▶ both ethical and legal



### Increased regulations? Way to go?

Generally, the law is not the best way to deal with unethical conduct because it:

- ▶ often reflects market practices,
- ▶ takes time to react,
- ▶ varies across jurisdictions,
- ▶ will never be able to account for all possibly problematic situations,
- ▶ is rule-based and subject to interpretation.



HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Framework for ethical decision making

A good decision-making framework is meant to:

- ▶ evaluate a decision from different perspectives,
- ▶ identify important issues,
- ▶ help make wise decisions,
- ▶ limit unintended consequences.

ALSO:

- ▶ it exercises good judgment and decision-making skills
- ▶ there should be a correlation between the company's ethical code and decision-making framework
- ▶ the process is often iterative and can be approached in a different order

## FRAMEWORK FOR ETHICAL DECISION MAKING

1. **Identify:** relevant facts, stakeholders, 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? why not?

### ! RECOMMENDED MUST-READ SECTION !

Your Level 1 CFA Exam Curriculum, Reading 56 (Ethics & Trust):

Example 5, **Applying an Ethical Decision-Making Framework I** + commentary





HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, etc.



## Summarizing key concepts:

### ☐ Defining trust

**My summary:**

### ☐ Defining ethics and ethics studies

**My summary:**

### ☐ Code of ethics

**My summary:**

### ☐ Standards of conduct

**My summary:**



☐ Violations

**My summary:**

☐ CFA Institute Code of Ethics and Standards of Professional Conduct

**My summary:**

☐ Occupation vs profession

**My summary:**

☐ Challenges to ethical conduct

**My summary:**



☐ Importance of ethical conduct in the investment industry

**My summary:**

☐ Ethical vs legal standards

**My summary:**

☐ Framework for ethical decision making

**My summary:**



## Keeping myself accountable:

**TABLE 1 | STUDY**

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.



Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25' + 5')													
date		date		date		date		date		date		date	
25'		25'		25'		25'		25'		25'		25'	
5'		5'		5'		5'		5'		5'		5'	
25'		25'		25'		25'		25'		25'		25'	
5'		5'		5'		5'		5'		5'		5'	
25'		25'		25'		25'		25'		25'		25'	
5'		5'		5'		5'		5'		5'		5'	
25'		25'		25'		25'		25'		25'		25'	
5'		5'		5'		5'		5'		5'		5'	

**TABLE 2 | REVIEW**

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions**.

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	