

ETHICS IN FINANCE

CODE OF ETHICS & PROFESSIONAL CONDUCT

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CODE OF ETHICS & PROFESSIONAL CONDUCT

- Ethics in Finance?
- Code of Ethics in the finance industry?

WHERE?



CODES OF CONDUCT

- CFA Institute (Chartered Financial Analyst)
 - Code of Ethics & Professional Conduct
- CFP (Certified Financial Planner)
 - Code of Ethics & Professional Responsibility

CFA INSTITUTE

- Chartered Financial Analyst
- Code of Ethics
- Professional Code of Conduct
- CFA: Considered “Gold Standard” of finance ethics
- CFP: Standard for financial planning

Investment Professionals

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- Held to a higher standard of care
- Maintain a position of trust
- Fiduciary duty to clients & employers
- Hold a doctrine of fairness and impartiality
- Promotes the integrity of capital markets

- Old Prudent Man Rule
- New Prudent Investor Rule

CFA: Fundamental Investment Principles

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- **First principle:** Clients' interests come first
 - Investment professionals have a fiduciary obligation to their clients is elementary.
 - This principle means that their clients' interests come before all else, even their own portfolio.

CFA: Fundamental Investment Principles

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- **Second principle:** Independence and objectivity.
 - Investment professionals must avoid situations in which their judgment is subject to *undue influence*.
 - They must base their decisions, recommendations and investment actions on the *facts* of each situation.

CFA: Fundamental Investment Principles

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- **Third principle:** Avoid conflicts of interest
 - Investment managers should be free of any economic or personal encumbrances
 - or any other relationships that would give them an incentive to *skew their recommendations or actions*.

CFA: Fundamental Investment Principles

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- **Fourth principle:** Full and fair disclosure.
 - Clear communication between investment managers and clients is paramount
 - Key element in building trust with investors and allowing investors to make intelligent, well informed decisions.

CFA: Fundamental Investment Principles

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- **Fifth principle:** Fair dealing.
 - All clients in similar situations should be treated fairly, regardless of whether one client has more assets, pays more fees...
 - or is a golfing buddy.

CFA: Fundamental Investment Principles

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□ **Final principle**

- Reasonable care and prudent judgment.
- Standard of care for those who have a fiduciary responsibility of managing a client's investment portfolio.
- New Prudent Investor Rule vs. Old Prudent Man Rule

Old Prudent Man Rule

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□ Judge Putnam: 1830

The trustee shall conduct himself faithfully, and exercise sound discretion. He is to manage in terms of prudence, discretion, and intelligence, not in regard to speculation, but consider probable income and safety of capital.

Harvard v. Amory (trustee)

- Loyalty: free from conflicts of interest
- Prudence: care, skill, caution, safety of principle
- Impartiality: balance the interest of income beneficiaries and remainder beneficiaries
- No futures, options, margin, or “portfolio insurance”

New Prudent Investor Rule

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- Trustee *must* diversify
- Risk tolerance *must* be determined
- Prudence applies to *whole* portfolio, not just assets
- Trustee *must* minimize cost and expenses

New Prudent Investor Rule

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- A trustee that lacks expertise has *duty to delegate* specific responsibilities to experts in that field
- *Expert trustee* held to higher standard of care
- Fiduciary duty based on *all* facts and circumstances

Investment Professionals

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- Conflicts of Interest: disclosure is required (Regulation FD)
- Front Running: no buying ahead of client's trade
- Pump & Dump: no market manipulation allowed
- Investor Blogs: no hyping stocks, or manipulation

Investment Professionals

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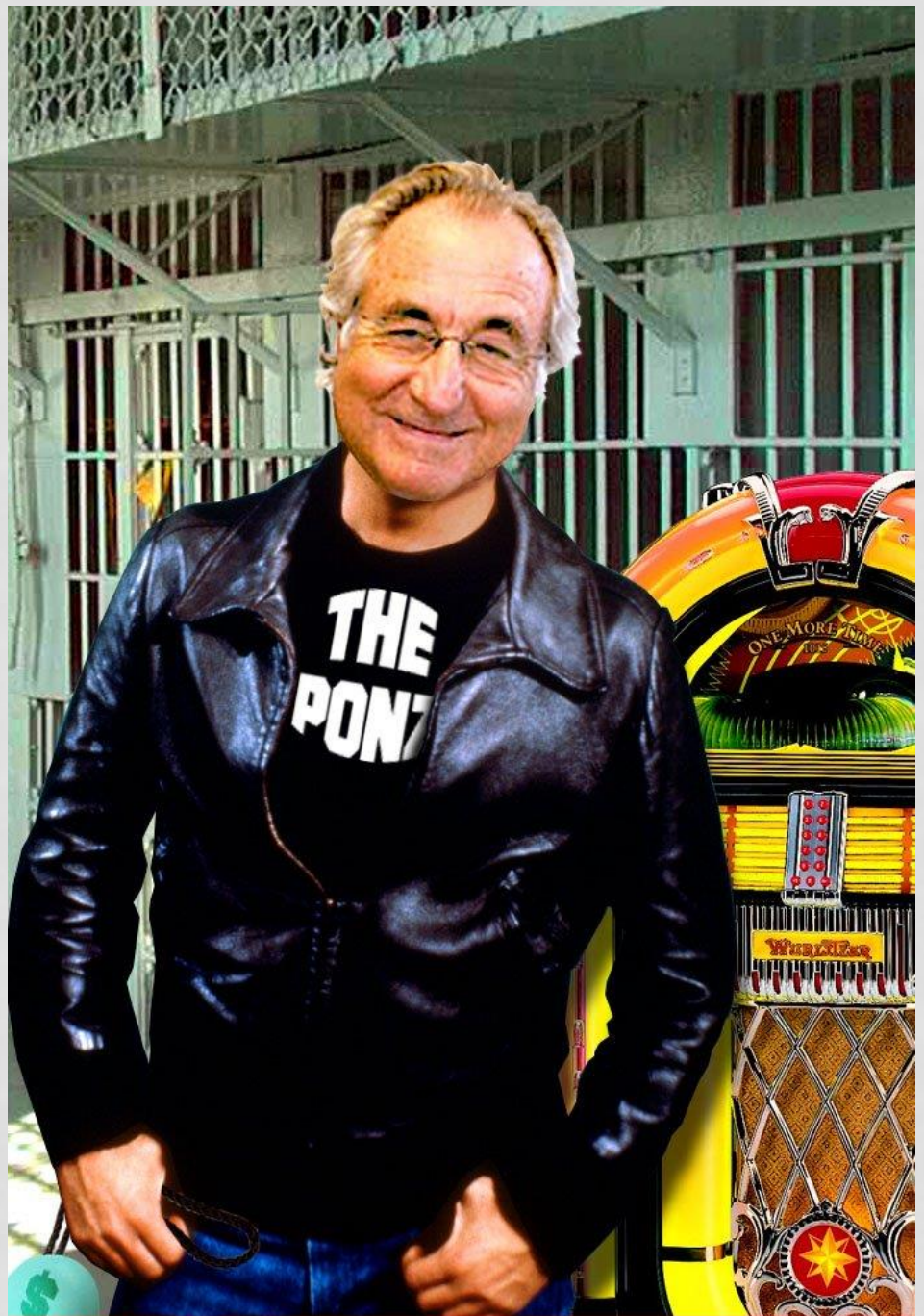
- IPO “hot” Issues: pro-rata sales of IPO’s to clients
- Friends & Family: identify beneficial relationships
- Material, non-public information: no trading allowed with the possession of this information
- Do not encourage others to violate law or standards

INVESTMENT FRAUD HASN'T CHANGED MUCH

Roaring 20's
Charles Ponzi

Roaring 2000's
Madoff

Maybe just more
sophisticated



CFA: ETHICAL CASE DECISION-MAKING FRAMEWORK

- What are the ethical principles involved?
- To whom is a duty owed?
- What are the important facts?
- Identify the options available.

Source: CFA Ethics Training Online course

CFA: CASE ETHICAL ANALYSIS

- Are there any conflicts of interest?
- How are the conflicts being managed?
- Are there any situational issues at work?
- How apply the Code & Standards?

Source: CFA Ethics Training Online course

CFA INSTITUTE CODES

- Preamble
- The Code of Ethics
- Standards of Professional Conduct
- Standards of Practice Handbook (CFA, 2010)
 - New version July 2014

CFA INSTITUTE CODES

The Code of Ethics and Standards of Professional Conduct ("Code and Standards") are the ethical benchmark for investment professionals around the globe, regardless of job title, cultural differences, or local laws. (CFA Institute, <http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx>)

- Voluntary Standards
- Check your mutual fund or portfolio manager
- We are teaching this to finance student at UCCS

CFA CODE OF ETHICS

1. Act with integrity, competence, diligence
2. Place the integrity of the profession and the interests of clients above your own interests
3. Exercise reasonable care & professional judgment
4. Demonstrate ethical practice & professionalism
5. Promote capital market integrity
6. Maintain & improve professional competence

STANDARD OF PROFESSIONAL CONDUCT

I. Professionalism

A. Knowledge of the Law

- Understand & comply with applicable laws
- Comply with the more strict standard
- Disassociate from violations and violators

B. Independence and Objectivity

- Use reasonable care and judgment
- Not offer, solicit, gift, bribes, or anything that skews objectivity

C. Misrepresentation

- Do not lie about investments or performance

D. Misconduct

- No dishonesty, fraud, deceit

STANDARD OF PROFESSIONAL CONDUCT

II. Integrity of Capital Markets

A. Material Nonpublic Information

- Don't use it
- Don't cause others to use

B. Market Manipulation

- Do not distort prices, or trading volume
- Do not mislead investors

STANDARD OF PROFESSIONAL CONDUCT

III. Duties to Clients

A. Loyalty, Prudence, and Care

- Act in benefit of the client
- Exercise prudent judgment

B. Fair Dealing

- No special treatment of friends & family
- No special treatment of large clients

C. Suitability

- Reasonable inquiry to clients needs
- Is it suitable for the client?

D. Performance Presentation

- Fair, accurate, complete

E. Preservation of Confidentiality

- No sharing of client details

STANDARD OF PROFESSIONAL CONDUCT

IV. Duties to Employers

A. Loyalty

- Act in the benefit of employer
- Provide the best of talent, skills, and abilities
- Do not steal client information, financial models, trade secrets

B. Additional Compensation

- Do not accept compensation/gifts that compete with employer
- Written consent required to compete

C. Responsibility of Supervisors

- Detect and prevent violations by anyone under your supervision

STANDARD OF PROFESSIONAL CONDUCT

V. Investment Analysis, Recommendations, & Actions

A. Diligence & Reasonable Basis

1. Exercise due diligence & independence
2. Have a reasonable basis for recommendations

B. Communication with Clients & Prospective Clients

1. Disclose format and principles of investment process
2. Use reasonable judgment identifying investment factors
3. Distinguish facts from opinion

C. Record Retention

- Maintain appropriate records to support investment analysis & recommendations
- IPS – Investment Policy Statement

STANDARD OF PROFESSIONAL CONDUCT

VI. Conflict of Interests

A. Disclosure of Conflicts

- Requires full and fair disclosure of matters that would impair independence and objectivity
- Prominent, plain language, relevant information

B. Priority of Transactions

- Clients, then employers, have priority in transactions, over personal or beneficial to member

C. Referral Fees

- Must disclose referral fees, compensation, or benefit from referring product or services

STANDARD OF PROFESSIONAL CONDUCT

VII. Responsibilities of CFA members

A. Conduct as Member

- Do not compromise integrity of the CFA designation
- No cheating on CFA exams

B. Reference to CFA Institute, Designation or Program

- Do not misrepresent or exaggerate the CFA designation
- Do not imply greater performance or ability

CFA INSTITUTE CODES

- Voluntary Standards
- Designed for finance & investment professionals
- Read: CFA Standards of Practice Handbook (online, 220 pp)
www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n2.1
- NEW! CFA Professional Development Online (6hrs, 7CE)
www.cfainstitute.org/learning/products/onlinelearning/Pages/62901.aspx
- NEW! Standards of Practice Handbook Online exam
www.cfainstitute.org/learning/products/onlinelearning 67 questions, 1 CE)

CFA INSTITUTE CODES

Now, imagine if more firms practiced these codes?

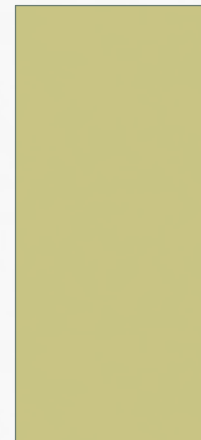


YOUR INSTITUTION'S CODES

- In regard to your own profession, how well do you practice similar standards?
- What part of the code is in your “daily diet”?
- What part would you want to commit to today?

ETHICS IN FINANCE

DO NOT LIE, CHEAT, STEAL



APPLICATION OF THE CODE

- Several quiz questions follow concerning the application of the **CFA Standards of Practice Handbook**

APPLICATION OF THE CODE

- Bradley Ames, a well-known and respected analyst, follows the computer industry. In the course of his research, he finds that a small, relatively unknown company whose shares are traded over the counter has just signed significant contracts with some of the companies he follows.
- After a considerable amount of investigation, Ames decides to write a research report on the small company and recommend purchase of its shares.
- While the report is being reviewed by the company for factual accuracy, Ames schedules a luncheon with several of his best clients to discuss the company.
- At the luncheon, he mentions the purchase recommendation scheduled to be sent early the following week to all the firm's clients.

APPLICATION OF THE CODE

- Is there any violation of the codes?
- What violation would you cite?

APPLICATION OF THE CODE

Comments:

Ames has violated Standard III(B) by disseminating the purchase recommendation to the clients with whom he has lunch a week before the recommendation is sent to all clients.

APPLICATION OF THE CODE

- Dominic Morris works for a small regional securities firm. His work consists of corporate finance activities and investing for institutional clients. Arena, Ltd., is planning to go public.
- The partners have secured rights to buy an arena football league franchise and are planning to use the funds from the issue to complete the purchase.
- Because arena football is the current rage, Morris believes he has a hot issue on his hands. He has quietly negotiated some options for himself for helping convince Arena to do the financing through his securities firm.
- When he seeks expressions of interest, the institutional buyers oversubscribe the issue. Morris, assuming that the institutions have the financial clout to drive the stock up, then fills all orders (including his own) and decreases the institutional blocks.

APPLICATION OF THE CODE

- Is there any violation of the codes?
- What violation would you cite?

APPLICATION OF THE CODE

Comment:

Morris has violated Standard III(B) by not treating all customers fairly. He should not have taken any shares himself and should have prorated the shares offered among all clients.

In addition, he should have disclosed to his firm and to his clients that he received options as part of the deal [see Standard VI(A)–Disclosure of Conflicts].

APPLICATION OF THE CODE

- Michael Allen works for a brokerage firm and is responsible for an underwriting of securities. A company official gives Allen information indicating that the financial statements Allen filed with the regulator overstate the issuer's earnings. Allen seeks the advice of the brokerage firm's general counsel, who states that it would be difficult for the regulator to prove that Allen has been involved in any wrongdoing.

APPLICATION OF THE CODE

- Is there any violation of the codes?
- What violation would you cite?

APPLICATION OF THE CODE

Comment:

Although it is recommended that members seek the advice of legal counsel, the reliance on such advice *does not absolve* a member from the requirement to comply with the law or regulation.

Allen should report this situation to his supervisor, seek an independent legal opinion, and determine whether the regulator should be notified of the error. [see Standard I(A)-Knowledge of the Law]

APPLICATION OF THE CODE

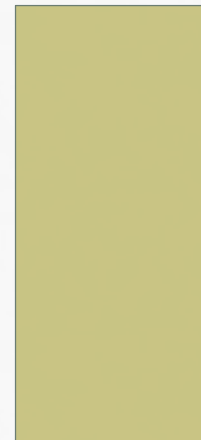
- Ethical issues are normal. Anticipate them in finance.
- Be more conscious to notice and act on ethical issues before they become problems
- Be aware of and address negative situational influences
- Apply the Ethical Decision-Making Framework

APPLICATION OF THE CODE

- Live and breathe the fundamental ethical principles
- Know your duties
- Gather relevant facts in cases
- Manage conflicts of interest early
- Grow comfortable discussing ethical issues with colleagues and management

ETHICS IN FINANCE

DO NOT LIE, CHEAT, STEAL



CFP ASSOCIATION

- Certified Financial Planner (CFP)
 1. Code of Ethics
 2. Rules of Conduct
 3. Practice Standards
- CFP Board's Rules of Conduct, Practice Standards, and Disciplinary Rules

www.cfp.net/for-cfp-professionals/professional-standards-enforcement/standards-of-professional-conduct/code-of-ethics-professional-responsibility#sthash.THfynFKv.dpuf

CFP ASSOCIATION

- **Code of Ethics & Professional Responsibility**
- **Principle 1 – Integrity**
- **Principle 2 – Objectivity**
- **Principle 3 – Competence**
- **Principle 4 – Fairness**
- **Principle 5 – Confidentiality**
- **Principle 6 – Professionalism**
- **Principle 7 – Diligence**

CFP ASSOCIATION

- **Principle 1 – Integrity:** Provide professional services with integrity.
- Integrity demands honesty and candor which must not be subordinated to personal gain and advantage.
- Certificants are placed in positions of trust by clients, and the ultimate source of that trust is the certificant's personal integrity.
- Allowance can be made for innocent error and legitimate differences of opinion, but integrity cannot co-exist with deceit or subordination of one's principles.

CFP ASSOCIATION

- **Principle 2 – Objectivity:** Provide professional services objectively.
- Objectivity requires intellectual honesty and impartiality.
- Regardless of the particular service rendered or the capacity in which a certificant functions, certificants should protect the integrity of their work, maintain objectivity and avoid subordination of their judgment.

CFP ASSOCIATION

- **Principle 3 – Competence:** Maintain the knowledge and skill necessary to provide professional services competently.
- Competence means attaining and maintaining an adequate level of knowledge and skill, and application of that knowledge and skill in providing services to clients.
- Competence also includes the wisdom to recognize the limitations of that knowledge and when consultation with other professionals is appropriate or referral to other professionals necessary. Certificants make a continuing commitment to learning and professional improvement.

CFP ASSOCIATION

- **Principle 4 – Fairness:** Be fair and reasonable in all professional relationships. Disclose conflicts of interest.
- Fairness requires impartiality, intellectual honesty and disclosure of material conflicts of interest.
- It involves a subordination of one's own feelings, prejudices and desires so as to achieve a proper balance of conflicting interests.
- Fairness is treating others in the same fashion that you would want to be treated.

CFP ASSOCIATION

- **Principle 5 – Confidentiality:** Protect the confidentiality of all client information.
- Confidentiality means ensuring that information is accessible only to those authorized to have access.
- A relationship of trust and confidence with the client can only be built upon the understanding that the client's information will remain confidential.

CFP ASSOCIATION

- **Principle 6 – Professionalism:** Act in a manner that demonstrates exemplary professional conduct.
- Professionalism requires behaving with dignity and courtesy to clients, fellow professionals, and others in business-related activities.
- Certificants cooperate with fellow certificants to enhance and maintain the profession's public image and improve the quality of services.

CFP ASSOCIATION

- **Principle 7 – Diligence:** Provide professional services diligently.
- Diligence is the provision of services in a reasonably prompt and thorough manner, including the proper planning for, and supervision of, the rendering of professional services.

CFP ASSOCIATION

- CFP Board's Rules of Conduct, Practice Standards, and Disciplinary Rules

www.cfp.net/for-cfp-professionals/professional-standards-enforcement/standards-of-professional-conduct/code-of-ethics-professional-responsibility#sthash.THfynFKv.dpuf

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