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Ethical standards and financial law - Introduction.
Presentation outline

- Basic course information and conditions for receiving a credit
- Money and morality / Economics and ethics
- Useful theoretical approaches to study professional standards and rules of law (institutional economics and business ethics)
- From individual financial frauds to global financial crises – why ethics matter in the investment profession
- Ethics of an investment profession – psychological backgrounds
- Ethics of an investment profession – practical implementations
- Bibliography
BASIC COURSE INFORMATION
Course information and requirements

- Office hours: Monday, 12.00-13.00, r. 401
- Written end-term exam: mix of test & open questions, both theory and practical cases’ solutions
- Exam mostly based on lecture
Aims & scope of the lecture

- context, aims and significance of ethical and professional standards and legal regulations in the financial market, focus on investment environment
- review of regulations and standards of international scope as well as those applicable in Poland
- not a CFA paper preparation course
- practical orientation of the course
- understanding a big picture
Recommended readings

- English versions of Polish acts of law required for the course can be found at the Polish Financial Supervision Authority (KNF) webpage: http://www.knf.gov.pl
- Readings presented at the end of each lecture
- Optional, additional readings for students interested (in Polish, regarding Polish financial market context)
MONEY AND MORALITY / ECONOMICS AND ETHICS
„Money, make money; by honest means if you can; if not, by any means make money.”

Horace—*epistles*. I. 1. 65.
Financial market and morality – public perception

- big swindles in companies like Enron and WorldCom, fraud in the insurance company Skandia, role of analysts and investment bankers in dotcom bubble or rating agencies in a supreme crises and much more ...
- low public trust when financial market is in need of good trust
- ethical codes as restrictions to gain legitimacy
# Trust towards financial institutions

<table>
<thead>
<tr>
<th>Percent of Poles trusting:*</th>
<th></th>
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<tbody>
<tr>
<td>Polish financial institutions</td>
<td>22,1</td>
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<tr>
<td>foreign financial institutions</td>
<td>9,45</td>
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<tr>
<td>banks</td>
<td>43,23</td>
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<tr>
<td>stock market</td>
<td>4,87</td>
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<td>mutual funds</td>
<td>5,35</td>
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* according to Diagnoza Społeczna 2003
Amorality of the financial market – some explanations

- industry attracting people of a certain character / assimilation of the employees to the mentality
- abstract greed
- anonymity – feeling less responsibility towards people never met
- playing at the market – stock trading perceived as a (computer) game of brokers and traders
- actions of individuals seeming not having influence on the market
- spirit of neoclassical economics - staying away from moral concepts
Short story of money and morality

- trade based on mutual exchanges, firstly among the family group, later between tribes
- invention of money, increase of state administration power, taxes raising but also law enforcement
- money and law separated trade from friendship, transactions became more impersonal
- increase of trust in law, first securities (papers exchangeable for money); stock revolution – limited liability; issue of first bonds ...
- up to industrial revolution trade perceived as not a noble activity, greed was a sin, charging interest - usury was a sin
- Adam Smith: impersonal relations of own-interest seeking individuals due to an invisible hand of the market turn into common wellbeing
The ethics of the market

- mutual transactions based on self-interests, efficiently executed through price-mechanism
- „deux commerce” hypothesis of Enlightenment period
- problems of industrialisation and urbanisation (socialists and Marxism)
- revival of liberal thought in XX century and victory of capitalism
- questions of social justice of market’s goods distribution and its externalities
- moral assumptions that market is based on: trust, respect for private property and rule of law
- does market undermines the very social institutions upon which its existence depends?
- need of „reputational capital” in advanced market economies
Abandon all friendliness, you who enter? - ethics and economics

- modern mainstream economics behavioral assumptions - „homo oeconomicus” motivated solely on his profit maximization

- two origins of economics: ethics-related tradition going back to Aristotle (Smith!, Mill, Keynes) and „engineering” approach focused on logistic and technical issues (Petty, Ricardo, Cournot, Walras)

- Adam Smith as a Professor of Moral Philosophy and author of „The Theory of Moral Sentiments” – explanation of the seeming paradox
Revival of economics as a moral science

- „institutions matter”
- questioning neoclassical behavioral assumptions
- perceiving a need of ethics as a cure for „an agency problem”
- trust as a powerful tool to limit transaction costs
- popularity of „Corporate Governance”, „Corporate Social Responsibility”, „Social capital” and „Good Governance” – areas of interests combining economical outputs with norms and social relations
USEFUL THEORETICAL APPROACHES TO STUDY PROFESSIONAL STANDARDS AND RULES OF LAW
Professional standards and law regulations as institutions

- institutions as rules of game, organizations as players (North)
- institutions – constraints created by people that shape social interactions and reduce uncertainty of exchange
- formal and informal institutions
- connected with mechanisms of rules enforcement - sanctions for rules breaking
- codes of ethics as self-regulation
Business ethics – two approaches

- Ethics – science dealing with morality, which is a set of norms stating what is good and evil
- Business ethics – applied ethics regarding business environment

- Consequential ethics - rightness of an action is determined by its consequences
- Deontological ethics – rules, obligations and duties based ethics
Stages of moral development (Kohlberg)

- **level I: pre-conventional (focus on direct consequences)**
  - stage 1 - obedience and punishment driven
  - stage 2 - self-interest driven

- **level II: conventional (focus on society’s conventions and expectations)**
  - stage 3 - interpersonal accord and conformity driven
  - stage 4 - authority and social order obedience driven

- **level III: post-conventional (focus of own principles of right and wrong)**
  - stage 5 - social contract driven
  - stage 6 - universal ethical principles driven
Ethical restrictions of choices at the financial market

- from professionals at the financial market we expect at least level II of moral development (adherence to rules of law, codes of ethics and social norms)
- restrictions of choices due to personal negative consequences of breaking social and group norms and law regulations
- restrictions of choices due to negative consequences of personal decisions at the market to communities or societies
FROM INDIVIDUAL FINANCIAL FRAUDS TO GLOBAL FINANCIAL CRISES – WHY ETHICS MATTER IN THE INVESTMENT PROFESSION
How an individual can cause a financial crisis – consequences of playing with derivatives

- Codelco and Metallgesellschaft AG, 1993/1994 (speculations including futures, loses of 200 million dollars and 1.3 billion dollars)
- Orange County, 1994 (bankruptcy due to lose of 1.6 billion dollars public money on leveraged derivatives)
- Barrings, 1995 (Nick Leeson’s nonauthorised transactions ended with loses of 800 million pounds and take-over of Barring Bank by ING)
- Sumitomo, 1996 (futures on copper, independent investment decisions of a dealer, final lose of 2.6 billion dollars)
Frauds at the financial markets

- insider trading
- creative accounting
- ponzi schemes
Insider Trading

- transactions in securities profiting from **inside information** (private information held by officers, directors or major stockholders that has not yet be divulged to the public)

- ambiguous definition (e.g. supplier deducing the firm’s near-term prospects from significant change in orders, job of security analysts to uncover such information)

- example of consequential and deontological analysis: *Is insider trading ethical?*
Creative/aggressive accounting

- practices that follow the letter of the rules of standard accounting practices, but deviate from the spirit of those rules, misinterpretations of the true income
- frauds ending in companies’ bankruptcy: Enron, WordCom, Conesco
- erosion of credibility of informational role of accounting
- problem which cannot be solved by rules of law solely, it needs following ethical standards by managers, auditors and company executives
Ponzi schemes

- Carlo Ponzi – role model, story of a famous Italian fauster and American postage stamps of early 1920
- idea of financial pyramid scheme
- examples: Bernard Madoff (21 billion dollars of losted victims investment, fooling both individual and institutional investors as well as authorities), Lech Grobelny’s Bezpieczna Kasa Oszczędności (Poland)

- investments of venture-capital funds in Internet companies
- fashion for .com and .net in the stock-markets
- disclosure of accounting scandals of some dot-coms (creative accounting)
- fall of NASDAQ in 2000
- panics in world stock-markets, lose of trust towards new technology companies, redundancies
- tangible results of securities’ speculations
Backgrounds of suprime crisis (2007-2010)

- over-tolerance of risk, bad risk management and unclear sophisticated financial operations
- decrease of requirements towards credit takers
- subprime credits for NINJA
- increase of prices (partly of speculative character) in real-estate market
- expansive fiscal policy and low interest rates
- trend towards debts’ selling and secularization, transfer of credit risk from banks to other financial markets sectors, camouflaged by rating agencies
- problems with collateralized dept obligations (CDO) and other derivatives connected with subprime market
- international repercussions of American market crisis due to financial market globalisation
Suprime crisis consequences

- Bear Stearns over-taken by JP Morgan Chase
- bankruptcy of Lehman Brothers and Washington Mutual
- Merrill Lynch over-taken by Bank of America
- problems of AIG
- problems at bank market of Island
- interventions of government eg. in France, Belgium, Holland, Spain, Hungary, Russia and Latvia
- problems of PIGS (Portugal, Ireland, Greece and Spain)
- erosion of trust in the interbank market and problems with liquidity
- discussion about role of regulations in the financial market
Globalisation of the financial market

- volume of global financial transactions versus transactions involving goods and services
- global finance players as transnational, factual centres of economic power
- financial engineering instruments generating huge profits and huge risk for financial stability of global economy
- globalisation as a factor responsible for spreading crises in world economy and for transferring crises from the sfera of finance to the word of real economy
- problem of global crisis of trust towards financial institutions and states as supervisors of law and social norms
Why ethics matter in the investment profession? - summary

- increase of investors confidence in financial markets
- more efficient and transparent operation of the market
- enhancement of public trust in markets allowing development of markets
- especially important because of the last crisis in the investment industry, revealing accounting frauds and manipulations connected both with heavy financial losses and stained reputations, leading to organizations’ collapses, highlighted unethical actions in area of governance, investment ratings, financial products packaging and distribution and outright investment fraud
- more and more important as finance develops as more and more sophisticated and interconnected global industry, with new complex financial instruments appearing
- regard for market sustainability – individual actions especially regarding risk management and product development may cause crises and have impact on other regions and countries
- where ethics is missing, eg. due to short-sightness and disregard to outcomes, stringer law regulations have to be introduced, which are constrains to operational environment of investment professionals
ETHICS OF AN INVESTMENT PROFESSION – PSYCHOLOGICAL BACKGROUND
Ethics of a profession

- a profession as a group performing activity especially important for the public interest
- autonomy to execute the profession, under the condition of realising public interest
- self-creation of moral **norms** and **standards** (in form of codes of professional ethics) and safeguarding that members follow them
- professional association empowered to use sanctions for rules breaking
Psychology of ethics

- ethics as constraint or motivation – empirical results of „ultimatum game”
- different reasons to behave ethical:
  - I follow the company rule so I will not be punished
  - Doing so will pay off some later day
  - My colleagues will approve of me because I acted professionally
  - I have to do it, because it is in the law
  - It is in interest of my company members and the society at large
  - Doing so I adhere to universal principles with which I agree, I would not do it if I did not agree with it
Process of ethical decision making

1. identifying an ethical dilemma
2. judging what is ethical
3. intending to act ethically
4. acting ethically
Perception of ethical issues

- moral intensity
  - magnitude of consequences
  - social consensus
  - probability of effect
  - temporal immediacy
  - proximity
  - concentration of effect
- moral framing
Individual factors influencing ethical behavior

- personality traits: machiavellianism versus integrity
- psychological locus of control
- moral imagination
- biases and stereotypes – role of attributes
- decision heuristics
- cognitive dissonance reduction
- rationalization and moral disengagement
- shame and guilt
Social factors influencing ethical behavior

- social influence:
  - coersion
  - manipulation
  - persuasion
  - facilitation

- group conformity
- group polarisation effect
- groupthink
- role of leadership / whistle blowing
ETHICS OF AN INVESTMENT PROFESSION – PRACTICAL IMPLEMENTATIONS
Financial market players – investment environment

- pension funds and insurance companies
- bankers (deposits and loans)
- investment bankers
- mutual funds, hedge funds and other investment companies
- brokers and other securities’ trade intermediaries
- corporations (issuers of stocks and bonds)
- public sector (issuer of bonds)
Rights of participants of the financial market

1. security of transactions
2. free entrance and exit
3. equal chances of taking part in transactions
4. confidentiality of transactions
5. protection of property rights
6. right to be informed in order to ensure an honest transaction

possible contradictions: 4 & 6, 1 & 2, 1 & 3
Problem of agency connected with intermediation at the financial market

- client as a principal, intermediary as agent:
  - hidden action
  - hidden information
  - uncertainty
- obligation to respect property rights of principal
- obligation to carry on agreement
- role of trust:
  - trust in intermediary’s knowledge, skills and efficiency
  - trust in intermediary’s intentions
  - trust in intermediary’s values (honesty, sincerity, loyalty)
Regulations of the US securities markets – how rules of law and self-regulations coexist

Government regulations:

- two major laws: Securities Act of 1933 (requirement of full disclosure) and Securities Exchange Act of 1934 (establishing the Securities and Exchange Commission – SEC)
- other, except for SEC, regulatory agencies, eg. Commodity Futures Trading Commission (CFTC) and Federal Reserve (FED)
- state laws (blue sky laws)
- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Self-Regulation:

- self-regulation of secondary exchanges and OTC markets (e.g. Financial Industry Regulatory Authority – FINRA)
- CFA Institute Code of Ethics and Standards of Professional Conduct – listing e.g. responsibilities towards the profession, the employer, clients and the public (global organization of USA and Canada origin)
CFA Institute Code and Standards: characteristics to be ensured = reasons to study

- representative of high standards of professional conduct;
- relevant to the changing nature of the investment profession;
- globally applicable;
- sufficiently comprehensive, practical and specific;
- enforceable, and
- testable for the CFA Program
Bibliography (I)

Bibliography (II)


Bibliography in Polish