Ethical Issues Facing the Financial Service Industry

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Abstract:
Financial intermediaries must keep to rules of law, industry standards and act ethically. Dealt with is ethical. What does it mean to act ethical in financial services? Law and industry standards are straightforward ethics an area for more interpretation. What is considered ethical in financial services? Ethics towards the customer, (investor or corporation looking for capital)? Ethics towards the employer/employee and ethics towards the society? This paper will try to look at the ethical aspects of the financial service industry towards stakeholders.The paper will cover standards of conduct in the industry and explore stakeholders view on current conduct as well as trends. The paper will cover a study of current behavior and standards and research the literature available the field. The outcome will cover the aspects of ethical behavior in financial services. What we have today and what is desired from stakeholders and not met by today's standards as well as ideas for improvement. The implications may lead to suggestions for the industry of how to deal with issues of loyalty and importance of firewalls between departments as well as a more elaborated code of conduct.

Keywords: Ethics. Misrepresentation. Integrity towards clients. Loyalty. Conflicts of interest. Material non-public information. Proprietory trading. Discretionary portfolio management. Global Investment Performance Standards (GIPS).

Introduction

As we all have read, there is an opinion that greed and unethical behavior by market participants is a culprit for financial crises and therefore it would be unwise to ignore the area of ethics and the requirements ethics put on market participants. Financial intermediaries must keep to rules of law, industry standards and act ethically. Dealing with ethics is not a sideline of the financial service industry but should be a part of its core. The question that arises is what is ethical and what is unethical? Are there any minimum requirements? Can certain intermediaries take ethics to a higher level? Law and industry standards are far from straightforward, ethics is an area for more interpretation.

1 Misrepresentation and Misconduct, Independence and Objectivity

A starting point is to examining the ethical aspects of the financial service industry towards stakeholders, uncovering standards of conduct in the industry and explore stakeholders view on current ethical conduct as well as trends.

The part will cover a study of current behavior and standards and research the literature available the field. The outcome will cover the aspects of ethical behavior in financial services. What we have today and what is desired from stakeholders and not met by today's standards as well as ideas for improvement.

The implications may lead to suggestions for the industry of how to deal with issues of loyalty and importance of firewalls between departments as well as a more elaborated code of conduct.

Participants in financial services must be true professionals and as a minimum requirement have knowledge about the law. The firms employing the professionals are responsible for compliance with legal requirement and industry specific regulations and best practices for the industry. (6)

1.1 Objectivity and independence

In investment analysis and recommendations it's important that the analyst is not on the "side" of the analyzed company but is being objective. Even worse would be to recommend customers to buy a security the analysts company wants to get rid of. "Federal, state and market regulators singled out three of the firms --

Citigroup's Salomon Smith Barney, Merrill Lynch and Credit Suisse First Boston -- and accused them of outright fraud in issuing bogus research." (11)

For example before the dotcom bubble burst in year 2000 Merill Lynch recommended investors to buy tech stock while they themselves was selling. In the end they were fined USD 100 million. (University of Wollongong)

If the analyst's employer do banking or advisory services to the company being analyzed it must be declared. Moreover analysis and investment banking decisions must have complete separation. If this is not functioning there is a real risk of mispresentation. (University of Wollongong)

Independence and objectivity means not being biased by personal relationships, personal benefits such as gifts or other forms of compensation. If an analyst has conflicts of interest it must be declared and should possibly disqualify the analyst to avoid any doubts of objectivity. (4)

Misconduct, is easier to describe and is attributed to fraud, deceit and dishonesty in all its forms. Reasons for misconduct can be greed, personal gain or desperation trying save ones job or jobs in the financial service provider's organization or to save the company. Every financial service company needs an independent compliance department as well as internal and external audit. (2012 Financial Services Industry Compliance Benchmark Study)

Obey the law. If more than one law applies and are in conflict or states the case differently. Comply with the strictest law, regulation or rule. If unethical or worse illegal activity is suspected, by a financial service provider or its employees, the company must discourage any such activity considered unethical and if it is violation of law, notify a competent authority or regulatory body. (2012 Financial Services Industry Compliance Benchmark Study)

To mislead, make a false statement or leave out an important fact is misrepresentation. An example is when a financial service provider "guarantees" (not in writing, but by saying – "sure theoretically there is a risk but in reality..") a high risk free return when in fact there are risks involved with the investment. There been several such cases in the subprime crises. CDO or CMO was sold as virtually a no risk investment. Investors took loans to leverage their investment since it was 100% safe according to brokerage houses. Now these investors sit on the loan and worthless securities. A so-called safe investment did not just lead to the loss of invested capital, but further losses. (SVD 2010)

Cheating, stealing, lying deceiving are examples of non-accepted conduct (outside politics, that is). Financial service providers caught with miss-conduct may create a bad reputation for the whole industry. Any conduct even if legal, if it can reflect badly upon reputation, then it must be avoided.

1.2 Integrity of Financial Markets Participants

Insiders' trading is illegal, however rules vary between markets and jurisdictions. An insider is anyone with access to material non-public information. Professional participants must make sure rules are kept to keep trust and reputation intact. A lost reputation can destroy a financial market participant. Moreover the participants may not conduct market manipulation that is to buy and sell in a way to create an illusion that there is more interest in a security than the real interest. It's not just immoral but also illegal. The above illegal and unethical practices can help to make bubble larger and create a crisis in securities markets; therefore it is a major concern. (Bank for International Settlements)

1.3 Duties to Clients

It is needed for brokerages and investment banks to put their client first. First before their own self-interest or their companies interest. The client is paying for a service and has the right to loyalty. If the institution is investing clients' money they must act with prudence and be as careful as if the money was their own. Research however shows that people tend to be more reckless with other peoples money. This is also true with politicians spending taxpayers' money. The more detached from the source of funds the less prudent behavior. (2)

When giving advice, it’s necessary to be fair with the clients as well as while making investment analysis. An expert must understand the clients’ needs, knowledge and objectives in regards to risk and return. Investments must match the clients’ age and financial situation and fit with the clients other asset. An overall portfolio view is needed. There is even a EU directive (MIFID Markets in Financial Instruments Directive) covering the above. (9)

If a financial service provider is performing portfolio management or propitiatory trading in a clients’ portfolio, limits must be set up and the client must be informed about all risks and be made aware of the probability to lose money. The clients’ objectives and wants must be met. Any deviations from limits must be discussed with the client beforehand. Accurate and complete information of the portfolios performance and composition must be available at request at anytime. All client data are between the financial service provider and the client and must be kept confidential. A financial service provider should only break the confidentiality if the client so wishes, if it is ordered by a competent court of law or if it suspects illegal activities, such as insider trading, money laundry etc.

1.4 Employees Loyalty to Employer and Clients

To start with loyalty go two ways, it's a two way street and if co-workers do not trust or are not treated equitable, the employer can demand loyalty as much as it like to no avail.

Employees must be diligent, carful, thorough and without conflicts of interest. If giving advice it’s important that the advisory separates facts and opinion. Exercise diligence, independence and thoroughness. Documentation of investment analysis and advices given should be kept. It is also required that the communication is made simple making sure the client understands all implications and risks’.

Analysts’ cannot accept gifts, including entertainment from the corporations they are analyzing. Integrity and objectivity may be compromised. Accepting gifts from investment clients is okay, but the employer must be notified.

1.5 Conflicts of Interest

If issues can lead to conflicts of interest, the issues must be disclosed. A client transaction always has priority of investments in own book. Never front a client. To front a client is to buy first in the market in own book and then sell to client from inventory. If the advisor earns commission, compensation or other benefits from recommending a product, service or asset this fact is material and must be disclosed.

Conflicts of interest will occur if the same financial service provider, provide brokerage, analysis and investment banking services. Awareness is a must and analysis must be shielded from pressure from the investment banking division. Of course the investment banking division should have no say or input or be allowed disapprove or approve as well as make changes the analysis. A corporation issuing stock or bond may pay for a report or analysis. When the report is published it must be stated who financed it since it do create a conflict of interest and no investor is to believe that it’s an independent report created by someone without a vested interest in the corporation analyzed. One opportunity to make the conflict of interest less severe is to have the corporation pre-pay and after that have no say in recommendations, outcome and conclusions. Still analysts known to write friendly reports may attract more clients.

2 Integrity of Capital Markets

2.1 Material Non-Public Information

Information is non-public until it has been disclosed to the general public, through press releases etc. Informing a selected group of people, like current investors or analysts is not considered making information public. Anyone that is **anyone** having access to non-public information that can influence the value of a financial asset when made public or as time passes may not exploit or make others to profit on such private material information. It is difficult to determine what constitutes of materiality. Aspects considered; the reliability of the information, the type of information, the source of information.

If the source is considered less trustworthy it is more unlikely that the information can be considered material compared to a sure source such as an insider. The more difficult it is to see how the information affects the price on an asset, the less likely it can be considered material. It is normal for stock market analysts to draw substantial deductions from public and non-material inside information received from the corporations top management while studying a company.

An example; insiders in a company knowing that the annual report will be better or worse than analysts expect have material non-public information and may not act on that information to make money or avoid losses. A rumor on the internet claiming that a certain company will earn more or less than expected cannot normally be considered material. Reliability is general low.

The specificity of the information, the extent of its difference from public information, its nature and its reliability are key factors in determining whether a particular piece of information fits the definition of material.

2.2 Firewalls

The idea is to in some extent separate departments with access to insider information such as the corporate finance and investment-banking department with analytics, trading, sales and brokerage. Physical separation, different buildings or even location is a safety solution worth considering. People who do not meet do not communicate as much and the risk of leakage of sensitive information is if not eliminated at least minimized. Avoid career paths going from analytics, brokerage and trading to and from corporate finance. Also storage of sensitive information must be considered, such as access to databases etc.

When communicating in between departments is needed, it must be supervised and overseen. The question is by whom. That by the way summarizes the main problem of self-regulation. It is important that employees are restricted from trading, either by law or by employment contract. Also the financial intermediary must monitor and follow up on employees trading as well as trading in own book, proprietary trading. One solution is that employees make their (and their families) trading records available to the employer.

2.3 Proprietary trading

If a firm has access to any form of material non-public information it can choose to cease trading involved instruments. However that might not be the appropriate action if the firm acts as a market maker or have other good reasons, like maintaining liquidity, to continue its operations as normal not to disclose material non-public information. Crucial is that the intermediary acts passively and only to market orders from clients and traders avoiding taking position benefitting from the material non-public information.

2.4 Arbitrage trading

Arbitrage trading must be avoided since it is active, not reactive like on customers demand nor is it passive. This in itself increases the risk of illegal activity. For this reason all arbitrage trading must be stopped involving instruments on the company's "watch-list".

2.5 Market Manipulation

Market manipulation is an illegal activity with the aim of misleading market participant. It means participating in undertakings that distort prices and/or trading volumes. Market manipulation includes buying and selling the same security to increase the traded volume. An other example is the practice of spreading false information misleading other market participants to undertake transactions they would otherwise not undertake. Transactions that artificially distort prices or volume to give the impression of activity or price movement in a financial instrument are not allowed. Moreover "cornering" the market is not allowed when it leads to influencing prices on derivatives derived from the underlying asset.
(10)

3 Duties to Clients

When transactions are carried out for a clients purpose the intermediary for example a broker must do what they can to protect the clients interest above its own interests. i.e. carry out the transaction in the best possible way given the current knowledge, market situation as well as other circumstances. Caution and discretion is also something a client has the right to expect. In advisory pre-transaction or discretionary trading risk and return must reflect the client's needs and wishes. Any limits or guidelines set by the clients must be strictly observed and an overall portfolio view is required. An intermediary cannot look at each trade as an isolated event.

All clients must be treated fair. The intermediary cannot give advantages to certain clients at the expense of other clients. Fair treatment does however not imply equal treatment. A large important client may receive better service, lower commission and other benefits that do not directly impact other clients negatively. Different clients can therefore receive a different level of service but its not allowed to give a negative influence on other clients. If the intermediary provides different service levels these levels must be clearly stated. However fair treatment do include same advice in investment proposals i.e. if the intermediary recommend a particular stock it should be recommend to all investor that fits the investment profile. Information must be disclosed to all clients at the approximate same time, giving all clients a chance to act on the disclosed information. Disclosing information to only a few clients (selective disclosure) or to some clients earlier and to other clients later is discriminatory; it's unfair and not allowed. (10)

Primary and secondary offerings should be offered to all clients suitable for the investment. Minimum block size however is okay. The intermediary is not allowed to use their knowledge and industry membership position to take advantage of the clients. If an investment advice changes from a for example "buy" to sell the intermediary must pay great attention disclosing the information to all holders at the same time. (9)

A system to assure compliance to the rules above in regards to fair treatment must be in place. Also a system of grievance must be available fair and easy to use for clients thinking that their rights been violated.

3.1 Precautions

The number of people within an organization that know non-public material information as well as any other proprietary information including results from analysis before made public, should be kept to a minimum. Timeliness; must be kept meaning that the time from decision to make an investment recommendation until the recommendation takes place must be kept to a minimum. Often a report will be lengthy and take time to prepare and publish. In that case make a short brief summarized version to publish in advance. The danger is sitting on good information too long making it possible for "insiders" to act. Anyone having any aforementioned knowledge about an investment recommendation about to be published, may not act, discuss or disclose this information to anyone prematurely.

Best practices include reviews or auditing, to assure that no client received unfair dealings compared to other clients. In the case of advisory relationships it is important to wait and start advising first when the clients wants and needs are thoroughly understood in regards to risk, return investment horizon, objectives as well as financial constraints.

In private discretionary portfolio management, which is common in private wealth management. The financial service provider must manage the portfolio according to the mandate, which is according the objectives and constraints (limits) of the portfolio. The mandate should be written and made very clear. Any deviations must pre pre-approved by the investor. The approval must be recorded. When disclosing periodical performance reports the reporting must be unbiased, easy to understand, accurate, complete, timely and using fair principles of valuation. Fair valuation in most cases means mark to market. If using time series data to compare to historical values, the historical data must also be fair, complete and accurate. Using past data in market communication as a "guarantee" or even indication for future development is highly unethical. Lastly if the intermediary changes valuation methods, data sources, methodology in reporting, it must have a good reason for it and disclose it fully and accurately.

Clients and former clients must be able to trust full confidentiality with the exception of court orders obviously. Law requires other exceptions, if the client conducts illegal activities, and disclosure. Also the tax-law and tax authorities may have the right to receive information. In short law covers confidentiality. If not covered by law; assume that it is in the client's interest to disclose as little information about the client as possible. For sure never share customer data with any other organization without the customers explicit permission.

4 Obligations towards Employers

One thing to remember is that loyalty goes two ways. Recently there been several scandals involving employees overstepping their mandate. To mention a few; Nick Leeson, Bearings Bank, 1995, the bank bankrupted. Jérôme Kerviel of Société Générale, made in 2006-2008 a loss of €4.9 billion. Kweku Adoboli from USB made a loss of €2.3 billion. They all have one thing in common; they broke the rules. The issue at hand is why and if the institutions culture, remuneration etc. have anything to do with it. (12)

Employees must be loyal to their employer and obey the rules and their mandate and use the skills, knowledge and capabilities for the benefit of the employer. An employer must keep confidential information safe not to case damage to their employer. The examples of the rogue traders above show the importance sticking to ones mandate following rules and procedures. Only if rules and procedures violate local regulations or law of the jurisdiction, only then non-compliance and disclosure is expected. Employees must not copy or steal the customer database prior to seeking a new engagement. Moreover the employee must not discuss changing jobs to a competitor with clients. However after starting working for a new employer these former clients can be contacted unless the contact information comes from the former employer. A non-compete clause in an employment contracts is often null and void under European law. Whistle blowing is a difficult area, but generally accepted under law if the employer conducts illegal or unethical endeavor. If an employee receives any kind of benefit from a third party it must ne discussed and approved by the employer. This is important and crucial to avoid any conflict if interest or suspicion of conflict of interest. Disclosing any benefit-received form a third party is a minimum requirement.

4.1 Compliance

Back office, middle office or internal audit need to assure that they are determined to uncover and thwart violations of valid regulations, rules, code of ethical conduct and of course violations of the law. Relentless control and audit is needed. Systems and procedures need to be established and formalized. Managers should refuse responsibility unless a framework is agreed and integrated. The supervisor must decline supervision responsibilities if such procedures have not been laid down. The rules must be written and easy to understand. Use a simple expressive language. The importance is understandability and usefulness not linguistically snobbery. The rules can refer to details and should indicate where to find the details if needed. Disclosing the code of ethics to clients is a marketing tool to create awareness of the ethical high ground claimed by the company, keeping in mind that it is also in the best interest of the clients. (10)

4.2 Investment Analysis

Analysis must be independent from corporate finance. Analysis must be able to write an unfavorable recommendation about a company without regret or threats of lost business. Analysis must be thorough and backed by facts and investigation. The analyses must disclose the method of analysis and how they choose portfolio constituents. A clear distinction must be made between hard fact and opinion. Looking into the future estimating net income, dividend pay-out ratio etc. is opinion since its not fact yet. Methodology of analysis must be kept for future scrutinization. All records must be archived within the firm for the future. The records do not belong to the analyst. (9)

4.3 Conflict of Interest

Conflict of interest should if possible be avoided. If that is not possible conflict of interest that may impact objectivity must be disclosed fully as well as clearly communicated. Then the client can make an informed choice if to use the financial intermediary or not. Knowing if the financial service provider has reasons to be biased is crucial information. Common conflicts of interest is about underwriting securities with the left hand and recommending them with the right hand. The investment banking, corporates finance department is the culprit for many conflict of interest issues. An analyst benefits from disclosing their own portfolio, making sure that clients do not think they just recommend what they just bought. Somewhat harder to deal with is compensation. Full disclosure of compensation is sensitive. Still clients do benefit knowing how the representative is paid. Pay for referrals, incentives, commissions, and performance criteria short as well as long-term. Client's transactions must have priority over other transactions like transactions in own portfolio. Accounts belonging to family members are not allowed any preferential treatment and should be treated just as any other account. Private placements create similar conflicts as IPO's. Employees should not take part of any transactions that can be perceived as gifts or may impair judgment in future deals. It happens that IPO's give a good short-term return and for that reason alone employees of financial intermediaries being responsible for the IPO should not be allowed to take part. Firstly it means taking opportunities away from clients. Secondly it may lead to over-promoting the stock after the IPO.

5 Global Investment Performance Standards (GIPS)

GIPS covers the following areas; calculation methodology, composite construction, disclosures, input data, private equity, real estate, presentation and reporting. (5)

The aim of GIPS is to point out and bam common misleading practises including choosing no representative accounts for performance measurements. i.e. selecting the best performing accounts disclosing information such as up to 55% return in investment. Best practise includes avoiding giving the impression that the best accounts are average accounts. Survivorship bias includes displaying historical performance, only showing the "survivors" that is excluding underperforming accounts closed down over time. An other way to manipulate is to set the time period in a way benefitting our performance. Time periods should be standardized making comparison easy and comprehensive. (5)

The goals of GIPS are to create a standardized approach suitable for most financial intermediaries.

GIPS aim at establishing a standardised industry wide approach for investment firms to follow in calculating and reporting their historical investment results to prospective clients. Keep in mind that GIPS is not law and it is not binding. Moreover only asset managers can be GIPS compliant. It is not available for online discount brokerages etc. If a firm want to comply the whole form must comply it is not open for a product or a single composite. (5)

Composites should be representative and consists of aggregated discretionary portfolios of similar strategy or possibly objective. To make unbiased composites the composites must be created prior to known results assuring that the form is not picking out only the best preforming portfolios. (5)

6 Conclusion

To conclude non-compliance to best practices and the highest level of ethics is dangerous and may lead to large losses including bankruptcy. The GIPS standard provides a good comprehensive framework which de-facto has become industry standard. The main issue is not to make the rules stricter but assure adherence and compliance to the standards developed. Internal and external audit and a compliance department/compliance officer are needed to avoid fraud and other unwanted unethical behavior.

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