The UK Society of Investment Professionals

UKSIP is a member society of AIMR®

FSA Discussion Paper 18

'An Ethical Framework for financial services'

Response by the UK Society of Investment Professionals

About UKSIP

The UK Society of Investment Professionals ("UKSIP") is a professional body whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. It currently has over 4,000 members, who work or have an interest in the UK financial services industry. UKSIP is the second largest member society worldwide of the Association for Investment Management and Research (AIMR®), and the largest in Europe. AIMR is a global non-profit organisation of more than 67,000 investment professionals, and is best known as the organisation that develops and administers the Chartered Financial Analyst (CFA®) Program.

UKSIP also oversees the Investment Management Certificate ("IMC"), the benchmark qualification for those working in investment management in the UK and currently held by over 12,500 investment professionals. UKSIP members who successfully completed UKSIP's former Associate examination can use the designation ASIP.

About this response

The development and maintenance of high professional standards is both a pre-requisite for ethical conduct and core to membership requirements of AIMR and UKSIP. This will continue to be the case, irrespective of whether the FSA introduces its own "ethical" expectations of investment professionals. The reason for this is that AIMR's members adhere to the high principles set out in the organization's *Code of Ethics* and *Standards of Professional Conduct*. High ethical standards of conduct – quite rightly – are a set of values to which most people and businesses aspire to reach. There is no finite height barrier to such values, a factor which can strengthen their moral force. Ethics mandated by regulators would almost certainly be regarded as a matter of compliance; the grade must be met but not necessarily exceeded. This would not be an ideal approach to ethical considerations.

Analysis of the Discussion Paper

1. UKSIP welcomes the opportunity to offer views about Discussion Paper 18 from the Financial Services Authority (FSA) ‘An ethical framework for financial services’. It strongly supports the principles-based approach to regulation adopted by FSA for the UK. UKSIP agrees that, to the extent that the sector conducts its business in line with the overall standards and principles in the higher level sections of the Handbook, the feeling of progressive regulatory restriction referred to in the Introduction (page 4, third paragraph) should be avoided. To some extent it a matter for FSA to show, through its supervision and enforcement policy, the importance that it attaches to the higher level principles on which its detailed Rules are based making it clear to firms that their reputation will be damaged if the principles are not adhered to both in spirit and in practice. Discussion Paper 18 is, of course, part of this process. But it is also a matter for the financial services industry, both individuals and firms, to found their business dealings on a firm ethical basis. FSA does not presume to be the sole conscience of the financial services sector in the UK; as the Discussion Paper notes (page 5, top of page), it sees itself as part of the collective conscience. UKSIP sees professional bodies, including itself, as playing complementary roles.

2. UKSIP agrees with FSA’s analysis in Sections 2 and 3 (‘Why ethics matter’ and ‘Where ethics and regulation meet’). Ethics matter in their own right, but they also bring business benefits. From the regulator’s viewpoint, an ethical firm could represent less of a risk to the achievement of its regulatory objectives, reducing crime and providing better consumer protection. This might justify the FSA adopting a lighter regulatory touch in its dealings with that firm; this could be seen by the firm as a further incentive for ethical behaviour. UKSIP’s understanding is that FSA has the capability to identify firms where ethical practice is not a major priority. FSA needs to get the message across that operations not founded on strong ethical practices and demonstrating business process expertise are likely to incur a heavier regulatory burden.

3. It is now almost universally acknowledged that conflicts of interest are inherent within certain organisational structures such as integrated investment houses. Clearly high standard of ethics at the corporate level (see paragraph 6 below) - and robust standards of professional conduct at all levels - are essential if such conflicts are to be managed effectively. The regulatory role should make a contribution, particularly given the authorities’ responsibility for allowing the present market structure to be created and for its on-going regulation.

4. The Myners Report also raised a series of ethical concerns related to the constructive relationship between pension fund trustees and investment managers. This is, of course, the subject of the FSA’s Consultative Paper 176, to which UKSIP has submitted a detailed response.

5. Section 4 (‘How problems arise’) suggests four reasons for unethical behaviour. The first two (the pressure of short term gain and the risk/reward pay-off) are related to dysfunctional incentive structures. These can operate at both the level of the firm – most notably, through remuneration and bonus arrangements – and at an industry level, where,

for example, commission-based payment for advice creates conflicts of interest which, on occasion, has been challenging for the financial services sector to manage adequately. The remaining two – basically misunderstandings of a firm's own actions - in the broader ethical and regulatory contexts – should be addressed by the existing regulatory regime.

6. Section 5 is headed 'What could firms do?' UKSIP feels that this heading is misleading in that the section seems unclear as to whether it is addressing individual ethics or those of the firm. The two are obviously linked. A firm is a collection of individuals, but its ethical tone is set at the top and can incorporate inherited practices and modes of thought. At the highest level, Boards of Directors should follow the principles laid down in the Turnbull Report, including its guidance about matters of corporate social responsibility and the effective management of their risks. Management is also responsible for setting and actively implementing the practices and ethical tone of the business. In those firms where a high standard of ethical behaviour is set and rewarded by management, the culture is aligned at all levels and becomes second nature to individual members of staff. In those organisations where management does not have a clear ethical policy or one that is actively pursued, it may be much more difficult for individual members of staff to achieve the highest possible standard of ethical conduct, because of a hostile culture. UKSIP therefore believes that it is important to be clear about the separate issues raised by ethics in relation to the firm and in relation to the individual, while recognising that they are inter-related.

7. The questions on page 13 could be thought provoking if answered honestly, although it is unclear whether their focus is on individual actions or on the firm's procedures. UKSIP does not feel that the practical examples included are particularly helpful. In most cases the 'correct' ethical answer is obvious, but the assumption is that the person concerned works for a firm where ethical behaviour is penalised. The examples do not address the sort of grey area where there is no obviously correct course of action. An interesting article on bribery in the 'Financial Times' (Michael Peel, 'High ideals and murky realities', 27th January 2003) concludes with the remark of a Lagos checkpoint officer whose request for money has been turned down: "We work for you: do you want security?". In particular contexts – in this case, a country where the police are paid less than a subsistence wage, and even that frequently many months in arrears – the ethical issue is often more blurred than the Discussion Paper's practical examples would have us believe.

The role of the professional bodies

8. UKSIP has already observed (paragraph 1, above) that professional bodies, like FSA, are part of the collective conscience of the industry. Professional bodies have a vital role to fulfil in raising ethical standards, both through codes of ethics and standards of professional conduct, through their more general role in professional education and training, and, indeed, through advocacy. This paper being an example of the latter.

9. As FSA is likely to be aware, AIMR has a Code of Ethics and Standards of Professional Conduct, a copy of which is attached. These are by no means merely aspirational. AIMR members – and Regular UKSIP members – must annually attest that they have and will continue to abide by the Code and Standards, and failure to do so will result in loss of membership. The Code of Ethics lays down high level principles and is followed by

five specific Standards of Professional Conduct covering relationships with – and responsibilities to – the profession, the employer, clients and prospects, and the investing public. The Code and Standards are backed up by a 300-page Standards of Practice Handbook with commentary and interpretations and are an integral part of the CFA examination syllabus. A breach of the relevant standards is subject to disciplinary procedure.

10. The focus of the professional bodies' ethical codes is on individual rather than on corporate behaviour. Guidelines for corporate codes are readily available, and attached, as an appendix, is an amended version of the section on establishing and sustaining an effective code from the joint NAPF/Institute of Business Ethics publication 'Engaging for success' (NAPF, 2001). Qualified professionals frequently hold senior posts and are thus able to influence their firm's culture and ethical standards. AIMR's Standards of Professional Conduct specifically refer to the responsibilities of supervisors (Standard III, E: "Members with supervisory responsibility, authority, or the ability to influence the conduct of others shall exercise reasonable supervision over those subject to their supervision or authority to prevent any violation of applicable statutes, regulations, or provisions of the Code and Standards"). AIMR has also issued non-binding Guidelines and Standards directed at firms to supplement those for its individual members. For example, in response to concerns about independence of much investment research, AIMR issued draft Research Objectivity Standards for comment in July 2002. In November 2002 it released Trade Management Guidelines on 'best execution' and on 31 December 2002 published ten New Year resolutions directed at all market participants. On 23 January 2003 an open letter from Tom Bowman, AIMR's Chief Executive Officer and President, to the leaders of the investment community was published as a paid editorial in the 'Financial Times', calling on them to make 2003 the Year of the Investor.

11. UKSIP notes the FSA's potential interest in running workshops on ethical issues. It is, of course, quite feasible to brief staff on matters such as "whistle blowing", whether this be done by the Regulator, professional bodies or, indeed, firms themselves. UKSIP would suggest that the prime objective for any such workshops must be to influence a firm's culture at the highest level.

Conclusion

12. The work of the professional bodies in raising professional standards through their qualifications, examinations and continuing development programmes also plays an important part in raising ethical standards. Competent, well qualified practitioners are better placed to identify, analyse and handle ethical issues. They are also likely to have greater confidence in their position when challenging practices in their firms - or in the industry generally - that they consider unethical. Professional education and training has in itself an important ethical dimension. UKSIP's own IMC is currently the main threshold competence examination in the UK for investment managers, while the CFA is the world's leading top-level professional investment qualification. As previously explained, the imposition of an ethical overlay as a matter of regulatory compliance – in UKSIP's view – would do little, in reality, to further raise standards. Its introduction might certainly encourage investors to believe more strongly that their savings were being managed less well than they had previously believed. It is, of course, right that the financial services industry is well managed and effectively regulated; UKSIP's belief is

that it is at least as well managed as businesses in the broader economic context and that it is also well regulated. Bearing these factors in mind, UKSIP welcomes the opportunity to provide input to the FSA on ethical considerations and would be happy to discuss the professional bodies’ role in raising ethical standards with the FSA.

Appendix

Extract from “Engaging for Success”

Ethical concerns

a) Does the company have a mission or vision statement that includes core values (such as trust, integrity, etc)?
b) Has the company a code of business ethics/conduct?
c) Is it endorsed by the CEO/chairman and board?
d) Is there a person designated in the company to deal with ethical matters?
e) Is the code made available to all employees and,, to suppliers, customers, contractors, partners, subsidiaries?
f) Is compliance monitored and are breaches properly dealt with?
g) Are employees rewarded for raising ethical concerns? (eg helpline/suggestion scheme)
h) Are ethical dilemmas included in company training programmes?
i) How is the code reviewed and amended?
j) When was the code last reviewed?
k) Is the code given and explained to all new employees?
l) Does the company have investments, joint ventures or partnerships in places where there is an actual or potential threat of conflict?
m) Does the company have investments, joint ventures or partnerships in countries with widely acknowledged non democratic governments or where the media are subject to censorship?

Establishing and sustaining an effective code

A corporate code, whether it covers social, environmental or ethical issues – or all three – is likely to be more effective where:

a) It is sufficiently flexible to adapt to changing business circumstances, particularly corporate expansion
b) It is perceived as a benchmark code for other companies in the sector
c) It takes account of the interests of a wide range of stakeholders
d) It has been compiled in broad consultation with employees and others and has been subjected, in draft, to their comments
e) Having been adopted by the board, it has been provided to all staff and is made available, to other relevant stakeholders
f) It has been the subject of specific overt director-level endorsement and has been actively presented to staff by management
g) A “blame free” procedure exists for feedback and constructive criticism on the content and working of the code
h) The impact on daily business activities is evaluated
i) Its impact and relevance are subject to a relevant audit/compliance process
j) Its aspirational aspects are incorporated into corporate strategy
k) It fosters a continuous search for improvement
l) It is referred to in the Annual Report
m) It is incorporated in corporate training programmes
SRI – without a formal code

If the company does not have a formal code or similar document, does it give guidance to staff on how to deal with any of the following ethical issues:

- Bribery and other unconventional payments?
- Competitive practices?
- Conflicts of interest?
- Gifts and entertainment?
- Insider dealing?
- Political activity?
- Health and safety issues?
- Harassment (race, gender, mental, physical?)
- Equal opportunities?
- Diversity, disability and the disadvantaged?
- Discrimination?
- Substance abuse?
- Use of corporate assets?
- Prompt payments?
- Charitable and community support?