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Research
Spotlight

Ethics 101 for Investment Professionals

Callan Chairman and CEO Ron Peyton has long argued that implementing high ethical standards in the investment industry is not only the right thing to do, but also the best way to build a sustainable business. The recent introduction of new rules from the Department of Labor on the role of fiduciaries is a timely reminder of the importance of these standards. In this paper he outlines his thoughts on how to create, instill, and maintain ethical standards for investment professionals. His advice: the right culture creates the best environment to maintain these standards. Firms should develop ethical guidelines that are based on principles, not rules, since the former offer better guidance for employees across the organization.

This paper highlights what I have found to be practical resources, tools, and examples for keeping high ethical standards at the forefront of thought and behavior in our industry and with my fellow associates. I am passionate about the subject because research and my own experience show that the more ethics are promoted in a firm's daily culture, the more associates are "reminded" to conduct themselves with high moral standards and not rationalize anything less. In addition, ethically minded associates help create firm cultures more likely to do the right thing for clients, their fellow associates, and other stakeholders.

Ron Peyton serves as Chairman of the CFA Institute Asset Manager Code of Professional Conduct Advisory Committee.

"If associates have a mission and vision of doing something good for society over just financial incentives, they are more likely to make good moral and ethical decisions."

Ron Peyton, Callan's Chairman and CEO

Regrettably, all financial occupations receive a poor ethical rating from the public. (A recent survey from the CFA Institute conducted in partnership with the public relations firm Edelman on the perception of various industries found that financial services ranked near the bottom when judged on trust, for instance.) I won't speculate whether this perception is warranted or how it came about. There is not much the industry can do about it in the short run. What we can do is strive to be the best example of ethical behavior we can be by promoting ethics to our young associates and keeping ethical practices at the forefront of all decision-making and execution. (By the way, that same CFA Institute survey found that institutional investors said the most important attribute they wanted to see in the firms they worked with was that they act in an ethical manner.)

Tips from Ethical Mindfulness

Rationalizations: Beware of how easy it is to rationalize your own self-interest, setting a mental trap that can endanger your reputation and even your career.

The Race for Success: Don't become too caught up in the race for success—some of the traits of highly motivated individuals, like focus and intensity, can lead to ethical blindness.

The Slippery Slope: Keep in mind that the "slippery slope" is real: Seemingly innocent actions can ultimately lead to big problems one small step at a time.

Client Doubt: Never give your clients reason to doubt your integrity. If a client comes to doubt you, it will be the client's point of view, not your own, that determines whether you lose business and perhaps become the subject of a complaint.

The Family Test: Ask yourself whether you would be doing and saying exactly the same thing if your mother were the client, or someone else for whom you care deeply.

The perception and validation of ethical standards in investment professionals builds client trust in an advisor. If you think about it, the fundamental conclusion for all manager research is the development of trust for the people, philosophy, processes, and performance promise of an investment management firm. In the early 1970s, Callan's first manager research analyst was Ann Kingsland, a business education major who admitted she did not always follow the finer investment points of the many manager presentations she endured. What she did have was an uncanny ability to judge honesty and character. Ann would perceptively conclude if managers cared more about making money for themselves or for their clients. That conclusion is still the bottom line for all manager research and relationships of trust.

The best ethics primer for young professionals (and old ones too!) that I have ever read is the CFA Institute's *Ethical Mindfulness: A Guide for New Financial Services Professionals* by Donald C. Langevoort.[1] It is a brief, practical, and interesting read; it is very relevant to our industry with great examples on how gray-area ethical issues can arise and how to handle them. The best advice from this paper is to contemplate and address potential ethical scenarios before facing real-life situations. This may be the only way to avoid being caught flat-footed and realizing that the ethical line had already been crossed on the subtle slippery slope to impropriety. And as Warren Buffet has said, "It takes 20 years to build a reputation and five minutes to ruin it." There is also an excellent short reading list in the paper for those who want to study further.

From my experience, the acid test for ethical behavior towards a client is that the fee for a service should reasonably compensate the firm for every aspect of doing the best job it can for the client. In other words, the fee takes care of the self-interest part of the relationship. The bottom line for ethical behavior requires that every other consideration or action in the relationship be for the best interests of the client, and that no other advantage for the firm or any associate be sought at the client's disadvantage.

1 CFA Institute's *Ethical Mindfulness: A Guide for New Financial Services Professionals*

Most firms have a rules-based ethics policy. These statements can be very detailed and run scores of pages. Rules-based policies are necessary for regulatory and legal compliance issues but, in my opinion, and in the opinion of others I have collaborated with over the years,[2] are not as effective for the "ethical mindfulness" of non-compliance and non-legal professionals, the vast majority of associates.

Principles-based ethics policies are much more practical for daily guidance. If a professional follows the basic principles of ethical behavior, she will be able to make most decisions correctly without having to consult the policy manual. Consider the Ten Commandments. "Thou shalt not steal" is pretty hard to get around even with a good lawyer! And it wasn't until the Pharisees introduced what was essentially a rules-based ethics policy, writing hundreds of guidelines on how to obey the Ten Commandments, that people found ways around the basic principles. We see that hair-splitting behavior too often today.

Another principles-based ethics policy is the CFA Institute's Asset Manager Code of Professional Conduct (AMC). The AMC principles are easy to remember and serve as a ready reminder for ethical behavior. Research has shown that people tend to behave more ethically when they are regularly reminded to do so (Dan Ariely, Honor Code Experiment, MIT 2007: Those who signed an honor code before the experiment cheated much less than those who did not. The conclusion was that being reminded of moral issues is a key to encouraging ethical behavior).

Over 1,300 investment management firms have adopted the AMC principles in addition to their own rules-based codes of ethics. Adoption of the AMC for a large firm is not a trivial process, in many cases taking the firm's legal and compliance groups over a year to confirm alignment of the code with the firm's own policies, operations, and business practices. Investment managers know that if they adopt the AMC they must be able to demonstrate their compliance with it to clients and regulators. This should give fund sponsors more confidence in their documentation as they complete their own due diligence on managers that have adopted the code.

Six Key Principles for Asset Managers
(applied to all areas of firm operations)

Managers have the following responsibilities to their clients. They must:

1. Act in a professional and ethical manner at all times.
2. Act for the benefit of clients.
3. Act with independence and objectivity.
4. Act with skill, competence, and diligence.
5. Communicate with clients in a timely and accurate manner.
6. Uphold the applicable rules governing capital markets.

— CFA Institute's Asset Manager Code of Conduct

The new Department of Labor Fiduciary Rule accomplishes the same "reminder" for ethical behavior, with potentially severe legal consequences. While the Fiduciary Rule and associated clarifications cover hundreds of pages, the key for compliance is to remember the primary "commandment" of being a fiduciary: To act prudently only in the best interests of the client.

2 For instance, Brian Golob, Global General Counsel and Chief Compliance Officer of Russell Investments, and I have discussed this matter often.

I would also warn that new regulatory standards and the resulting perception of wrongdoing are often set retroactively; investment professionals who abide by the simple principles I have outlined will always be ahead of the curve.

A long time ago, when most consultants' fees were payable in brokerage commissions, Callan established the principle of brokerage recapture. If a client's directed brokerage exceeded the agreed-upon cash fee, we refunded the difference each year to our client rather than keep the money. We felt this was the right thing to do, and resulting industry practices and regulatory actions certainly proved us right. For an example of the wrong thing to do, consider the time when custody fees came under pressure in client negotiations. Some institutions made up the difference with high-margin securities lending practices and disadvantageous foreign exchange practices. These efforts eventually created many legal and regulatory headaches for the institutions as clients and regulators discovered the true nature of the risks and costs. I cite these two examples to illustrate how dramatically industry "best practices" can change over time and how important it is to fully disclose and explain how a firm makes its money. It is always better to focus on best outcomes than whatever happen to be the "best practices" of the day.[3]

Callan's Values

- Keeping client interests paramount
- Exercising independent thought
- Demanding quality and integrity in everything we do
- Honoring every commitment
- Pursuing innovation that matters
- Leading through practical research and education
- Collaborating and showing collegial respect
- Encouraging each associate's success

"Cultures that condone rule violations are more likely to be dishonest. Dishonesty is enabled by rationalization which makes lying seem less dishonest," wrote Simon Gächter of the University of Nottingham and Jonathan Schulz of Yale University.[4] Firm cultures are a creature of senior management. Culture is a composite of the firm's mission, vision, strategic plan, values, financial incentives, and client relationships, and the result of many leadership decisions over time. Continually educating and committing associates to a morally sound firm culture creates the ethical environment. If associates have a mission and vision of doing something good for society beyond financial incentives, they are more likely to make good moral and ethical decisions. For instance, at Callan we know that we are helping people to retire with some financial dignity or enabling the grant-making of an endowment or foundation for a critical social cause.

One of Callan's values, "keeping client interests paramount," is the driver of another value, "honoring every commitment." These values may seem trivial at first—everyone does this, right? However, this is not the case when one reflects on the full ramifications. How many times have we been tempted to abandon a social commitment because we were offered a better opportunity? How many times are we

3 Written Statement of Brian Golob, Global General Counsel and Chief Compliance Officer, Russell Investments, to ERISA Advisory Council, United States Department of Labor, Hearing on "Outsourcing Employee Benefit Plan Services," June 18, 2014.

4 Gächter, Schulz, *Nature* 531, March 24, 2016 (London, Nature Publishing Group) 496–499.

tempted to short-cut a complex client problem with an off-the-shelf solution? We discuss our values with our associates so they will appreciate the nuances and not be tempted to rationalize dishonest or just plain lazy behavior.

Callan is fortunate because most of our associates have direct contact with clients. This results in a real empathy that encourages behavior for the sole benefit of the client even at the expense of the firm. I have witnessed this empathy over the years and felt it strongly in my own client relationships. Some professionals aren't so fortunate to develop this empathy from direct client contact. Isolated traders, who often don't know the client, can be driven by other motivational factors to trade for the firm or their own competitive interests. Having witnessed many mishaps with traders, I see the problem as a bigger management and cultural issue for the organization rather than traders gone rogue.

Honoring our commitments means doing what we promise to do even if it is personally inconvenient or costs the firm money. When dealing with clients, it is always helpful to think about the good we are doing for them and not the burden they may place on us. All clients have unexpected situations: the loss of a key staff member; a public hearing where they need someone to stand up for them; unfavorable media attention; the need for a special report or to redo an old one. I have seen my associates drop weekend plans and spend far more time with a client than anticipated to honor our commitment of support within our existing retainer arrangement.

Thankfully, most firms in our industry share a vision of doing good things for their clients and society with the necessary values and culture for good ethical behavior. I remember the first formal set of values that I had ever seen at Brinson Partners in the early 1980s. They were inscribed in bronze and hung on the wall of the reception area. They made quite an impression. My favorites were "Execution supersedes intention" and "There are no higher ethical values than truth, honesty, and professionalism." Brinson Partners was acquired a long time ago, but hopefully its values lived on.

Certainly people will make mistakes, but hopefully the mistakes are ones of execution rather than amoral intent. Meanwhile it is important to keep promoting, discussing, and practicing ethical principles with our associates. If we spend time thinking about the principles over the rules, remembering to focus on the beneficial outcomes rather than what happen to be industry best practices at the time, we will get it right most of the time. Best practices change and the judgment of the marketplace can be retroactive and harsh.

In closing, I will leave you with one last great ethical principle: Ed Callan always said, "If there is any question at all about doing something, don't do it."

About the Author

Ronald D. Peyton is Chairman and Chief Executive Officer for Callan Associates Inc., an employee-owned firm whose mission is: “Collaborating with each client to build tailored and lasting investment solutions.”

Ron provides firm-wide oversight by conferring with associates and clients to improve communications, process, and service quality. He regularly meets with senior industry professionals and actively engages in industry and community events to advocate for the institutional investment industry. Ron is Chairman of Callan’s Management Committee and the Emerging and Minority, Women, or Disabled-owned Managers Committee. He is Chairman of Callan’s Board of Directors and a shareholder of the firm.

He serves on the Board of the United Way of the Bay Area, for which he is the Development Committee Chair. He also serves as Chairman of CFA Institute Asset Manager Code of Professional Conduct Advisory Committee, and is a member of the Strategic Advisory Committee for the CFA Society San Francisco. Ron serves as “Counselor” for the Indiana University Kelley School of Business Dean’s Council. He is also an advocate for the Vista Center for the Blind and Visually Impaired, which Callan has supported for more than 20 years.

Prior to joining Callan in 1974, in addition to other financial responsibilities, Ron worked with Marathon Oil Company’s pension investments while serving as an officer in the U.S. Army Reserve. Ron earned an MBA degree in Finance and a BS degree in Accounting at Indiana University.

If you have any questions or comments, please email institute@callan.com.

About Callan

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are uniquely backed by proprietary research, exclusive data, ongoing education and decision support. Today, Callan advises on more than $2 trillion in total assets, which makes us among the largest independently owned investment consulting firms in the U.S. We use a client-focused consulting model to serve public and private pension plan sponsors, endowments, foundations, operating funds, smaller investment consulting firms, investment managers, and financial intermediaries. For more information, please visit www.callan.com.

About the Callan Institute

The Callan Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys, and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

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