
Ethics and Financial Markets: The Role of the Analyst (a summary)

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Published 2013 by the Research Foundation of CFA Institute
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The ethical issues financial analysts face today are no different from the ethical issues financial advisers, fund managers, and analysts have faced over the decades and centuries that financial markets have existed. A review of the history of ethics in investment markets, as well as the literature related to that history and the profession, points to two conclusions: (1) History does repeat itself, and (2) when analysts depart from three simple questions (Does this violate the law? Is this honest? What if I were on the other side?), complex issues are resolved through a thicket of codes, laws, and regulations that encourage further interpretations and exceptions and cloud judgment.

This historical perspective is designed to bring about the introspection that prevents repetition of the same ethical missteps and permits progress through ethical practices and the resulting enhancement of professional reputation.

The Long Journey from Hammurabi to 1929

Ethics in the marketplace is not a new concept. In fact, fraud has been and always will be with us. The Code of Hammurabi covered everything from adultery to business trade, with the basic goal of the code being to impose harm on the perpetrator equal to the harm done to the customer/client. Imagine the same principle applied to investment advisers whose clients experienced collapsed investment portfolios: If you lose their money, you lose yours too.

It is clear from the Bible that fraud was afoot because we find this warning in Leviticus 25:14: “And if thou sell ought unto thy neighbor, or buyest ought of thy neighbor’s hand, ye shall not oppress one another” (from the King James Version of the Bible). The modern translation would be that selling short is wrong if you have inside information that earnings for the company’s stock are going to go down.

In the roughly 1,400 years between that warning and the time of the prophet Ezekiel, there was apparently not much improvement. Ezekiel warned: “The people of the land have used oppression, and exercised robbery, and have vexed the poor and needy: Yea, they have oppressed the stranger wrongfully” (King James Version of the Bible, Ezekiel 22:29). Oppression is translated as fraud, and apparently, it was a problem during the eras when we did not even

have running water. Strangers were taken advantage of by those trying to sell, sell, sell. Market sophistication changes, but the problem of taking advantage of others is too often still at the root of all collapsed investments.

About 2,000 years after Ezekiel, investors faced the great tulip market bubble of 1636, which is the earliest documented bubble in a market. When the tulip was developed, people were enamored by it. They began buying tulips, fields of tulips, and developing tulips. When tulips were no longer available, they began buying tulip bulbs because they would have a tulip at some time in the future. When there were no bulbs left, they created a market for tulip bulb futures.

Eventually, investors realized that those who sold the futures could not possibly deliver bulbs for all those futures that had been sold, and the market collapsed. The story of the world's first market bubble is eerily similar to each bubble since then. At the time, investors could have purchased 24 tons of wheat (tangible goods) for the cost of one tulip bulb future. The event thus illustrates how the drive to succeed in a bull market clouds judgment and compromises honesty.

The institution we call "Wall Street" was born in 1792 through the Buttonwood Agreement by an association of brokers, which eventually developed into the New York Stock & Exchange Board and then into the New York Stock Exchange (NYSE). The first scandal to take banks down was the Duer and Malcomb land scandal, resulting in public outrage and cries for morality in the marketplace.

1863–1913: The New York Stock Exchange Grows and Then Panics—Hearings Result. The 1863–1913 time period was an era that witnessed expansive investment in the country's infrastructure (railroads), followed by the Panic of 1873. The panic resulted from investors' realization that the speculative investments in railroads, this era's equivalent of the tulip bulb, were worthless. Investors had been taken in by the railroad expansion, and overbuilding resulted; think real estate speculation. Advisers, however, continued to tout railroad investments long after it was clear that tracks and facilities had been overbuilt. The result was the sale of junk-quality bonds.

When the railroad bubble burst, more than 100 railroads declared bankruptcy. Public outrage over the event resulted in a change in political parties in the subsequent federal elections. A lasting result was a "general distrust" of Wall Street among investors as well as bank customers.

The states subsequently attempted regulation because of the perception that the federal government lacked the authority to regulate financial markets. The first significant state securities law was passed in Kansas in 1911. It was an antifraud statute that resulted in similar laws in other states, referred to as "blue sky laws" because they were designed to prevent swindlers who were so bold that they "would sell building lots in the blue sky."

1920s: From Ponzi Schemes to Investment Trusts. Charles Ponzi left both his mark and his name in the financial markets with his use of arbitrage via the pricing disparity in stamps between Spain and the United States. But the 1920s was still a period of tremendous market growth fueled by shares in investment trusts—a form of auction-rate securities, the same types of securities that investment banks would sell to clients nearly 100 years later.

By 1927, the NYSE saw what the Kansas legislature had already seen: The information investors had was neither forthright nor forthcoming. The NYSE responded to the need for better disclosure in stock offerings by imposing filing requirements on its members before they would be permitted to list securities for sale on the exchange.

Nonetheless, the leveraged market structure became more leveraged with each additional offering of investment trusts. The initial purchases had to continue to show investors that the demand for these trust securities continued. When the stock market crashed in 1929, investors who had bought into the “safe” investment trusts were left with worthless investments. Those who had lent money to the investment banks were left with worthless collateral and debtors lacking not only cash but also assets. The Dow dropped 89% by 1932.

Securities Regulation: 1933 and 1934 Legislation

The post-1929 congressional hearings on the market crash examined the activities of investment firms as well as the analysts who had touted the investment trust instruments as being safe. The Pecora hearings of 1932 represented a turning point in market regulations and was a time when the public was riveted by the disclosures and testimony before the Senate Banking Committee. Ferdinand Pecora was chief counsel to the United States Senate Committee on Banking and Currency during its investigation after the market crash.

By the time of the Pecora hearings, the market was nearing its bottom, 89%. Pecora’s focus on the ethical and moral character of the businesses and professionals on Wall Street resulted in the market’s most substantial reforms in its history.

The results of the conduct of the investment industry during the bull market, the resulting 1929 crash, and the revelations in congressional hearings about the conduct of banks, investment professionals, and company executives were the Banking Act of 1933 (the Glass–Steagall Act) and the Securities Act of 1933 (for the regulation of primary offerings), which was then followed by the Securities Exchange Act of 1934 (for regulation of the secondary markets) and the creation of the Securities and Exchange Commission.

1934–1959: Investment Market Reforms—Voluntary Action and Professional Ethics

The 1934–59 era was one of introspection for some members of the profession because of the impact the hearings had on the public’s perception of analysts and their trust in markets. In addition, there was unprecedented volatility in the markets following the 1929 crash. It was as if perceptive analysts took the lessons of the Pecora hearings and embraced an Edgar Allan Poe resolve of “never more.”

In 1925, a group of Chicago investment analysts began meeting for lunch to discuss the issues facing their profession. Slowly, national professional groups developed, along with ethical standards and the perceived need for entrance requirements, a code of ethics, and disciplinary procedures for members. By 1947, the city-based groups had decided to form a multinational organization (the United States and Canada were first to be included) to advance their mission of improving standards and ethics within the industry. The national group that resulted was the Financial Analysts Federation (FAF).

1959–1974: Professional Entrance Requirements and Soft Dollars Begin

In 1959 the FAF created the Institute of Chartered Financial Analysts (ICFA) and charged it with developing and keeping current a body of knowledge that would help members understand the issues in the industry. The ICFA was also given the responsibility of developing a rigorous examination (roughly 10% of which focused on ethical issues) that would be required for members to use the CFA designation following their names.

As the FAF was proceeding with its efforts to increase both ethics and professionalism in investment markets, the structure of the market itself was creating different types of ethical issues. One particular issue emerged that remains with the investment industry today—soft dollars. The practice of paying “soft dollars” began in the 1950s, when the investment brokers and traders operated under fixed, nonnegotiable commission rates, which were probably too high.

Even as this seemingly free offer of research took hold, an ethical issue gnawed at fund managers: Were they compromising their fiduciary duties to their beneficiaries by accepting the free research?

1975: May Day and Soft Dollars Expand

In 1975, Congress amended the 1934 Securities Exchange Act to deregulate commission rates on Wall Street. May Day 1975 (as this move was called because of the date of the change) meant that the NYSE price controls were eliminated to ease the soft dollar tension. The unintended consequence of the deregulation, however, was that ethical issues became more acute because pricing differentials

still included the formerly unpriced research services. The soft dollar concept was now institutionalized because the commissions and research services were bundled together. Changes in federal law did, however, address the ethical concerns for fund managers with regard to the issue of fiduciary duty should they opt to pay a higher commission rate because of the research benefits.

1980–1990: Public Distrust from Analyst Practices

The 1980s was a decade of headline ethical lapses, including the Dirks and Boesky insider-trading cases as well as the Milken junk bond issues. These cases captured the public's attention because fictional Gordon Gekko's mantra of "greed is good" fueled backlash about investment markets.¹ The perception of an unfair playing field or asymmetrical dissemination of information to movers and shakers or by analysts to lucky clients perpetuated a public unease about the profession.

1991–2002: The Dot-Com Bubble and Collapse, and the Global Settlement

Throughout the 1990s, soft dollar arrangements went largely undisclosed and/or misunderstood by fund beneficiaries, even as academics, the media, and regulators were raising questions about the lack of transparency, their real cost, and the independence of the research being furnished through the arrangements.

In 1992, the *Wall Street Journal*, reporting on the realities of investment banking operations, indicated that the so-called Chinese wall (said to separate the analyst/research side of the brokerage house and the investment banking and trading side of the house) was imaginary. Some analysts were told to avoid negative statements about clients of the firm. In addition, analysts were expected to do more than simply offer favorable ratings. Analysts were told to "pound the table" to sell the stocks that they had rated favorably. As the popular business press continued its investigative reporting on actual analyst practices, academic studies began to appear with the same conclusion: There was an inherent bias between investment bankers and analysts.

As the many-faceted debate over soft dollars and independence continued, the market was building a bubble. The confidence of a bull market in evolving technology resulted in initial public offerings (IPOs) and stock offerings by companies that had not yet shown any earnings but that had been blessed with favorable ratings from analysts housed at the investment banking firms that were

¹The quote from the movie *Wall Street* (1987) was actually taken from a May 1986 commencement address Ivan Boesky gave at Berkeley in which he said, "Greed is all right.... Greed is healthy. You can be greedy and still feel good about yourself." As quoted in Christopher R. Brauchli, "From the Wool-Sack," *Colorado Lawyer* (August 2002):43.

leading the IPOs. Then-chairman of the SEC Arthur Levitt publicly expressed concern about the role of analysts in touting stocks their firms were offering.

When the bubble burst, in tandem with the Enron, Tyco, and other ethical collapses, the SEC promulgated Regulation Fair Disclosure (hereafter, Regulation FD). The regulation was designed to curb the practice of disclosing pertinent information to a select set of analysts and investors. Believed to be a tool for firms to influence institutional investors and curry favor with superstar analysts, selective disclosure had long been criticized as a scourge plaguing information dissemination.

The end result of the dot-com bubble was what is known as the “global settlement,” which resulted in the following changes in the profession:

- Analyst compensation cannot be tied to specific investment banking transactions.
- Analysts’ personal trading is restricted in securities of companies they are following for their firms.
- Analysts cannot offer favorable research in exchange for business for their firms.
- Investment banking review of analysts’ research reports is restricted.
- Quiet periods have been designated for the issuance of research reports.

2002–2007: The Real Estate/Mortgage Bubble

The same critical question that arose following the end of market runs in the other eras arose in 2002–2007: How was so much that was so obvious neither discussed nor disclosed for so long? The simple answer to the question is that many were aware, particularly those who were analysts, but they suppressed their concerns rather than disclosing them publicly. In fact, the documentation of concerns among analysts and others involved in the sales and evaluation of these securities during this era was greater than the documentation found from previous financial collapses, including even the modern Enron and dot-com eras.

2008–2012: The Financial Crisis and Reforms, Expert Networks, Pension Crises, Municipal Bankruptcies, and Insider Trading

The 2008–12 period was an era of regulatory reform. The Dodd–Frank Wall Street Reform and Consumer Protection Act was passed in 2010 and created the Financial Stability Oversight Council (FSOC) to monitor the financial health of financial institutions. Dodd–Frank brought to analysts the same types of changes that Sarbanes–Oxley had imposed on accountants and auditors in 2007.

As those reforms proceeded, new issues involving analysts emerged. This period was full of news articles on insider-trading arrests and resulting “perp walks” because of the so-called expert networks and their interconnections with research firms and hedge funds.

The Common Ethical Threads of the Ethical Eras

This review of investment market eras shows us that history repeats and that the ethical issues that affect investment markets have not changed and are not yet resolved with clear standards. The issues of soft dollars, insider trading, conflicts of interest, and unprofessional conduct remain with us.

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The complete literature review, which contains 94 annotated citations on the relevant research, can be found at <http://www.cfapubs.org/toc/rflr/2013/8/1>.

Use your smartphone to scan the QR code to go straight to the webpage.