

## Chapter 11

### *Ethics in Finance*

#### **CHAPTER SUMMARY**

Ethical issues in finance are important because they bear on our financial well-being. Ethical misconduct, whether it be by individuals acting alone or by financial institutions, has the potential to rob people of their life savings. Because so much money is involved in financial dealings, there must be well-developed and effective safeguards in place to ensure personal and organizational ethics. Although the law governs much financial activity, strong emphasis must be placed on the integrity of finance professionals and on ethical leadership in our financial institutions. Some of the principles in finance ethics are common to other aspects of business, especially the duties of fiduciaries and fairness in sales practices and securities markets. However, such activities as insider trading and hostile takeovers raise unique issues that require special consideration. Insider trading is prohibited because it involves trading of information not publicly available or breaching a fiduciary duty by misappropriating confidential information. Hostile takeovers are problematic because of the conflicting interests and fiduciary duties that exist among the various parties involved.

#### **CHAPTER OBJECTIVES**

- 11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients
- 11.2: Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices
- 11.3: Summarize the two main arguments against insider trading and the challenges in applying these theories to its prevention and prosecution
- 11.4: Analyze the ethical issues raised by various hostile takeover tactics and what they suggest about the rights and fiduciary duties of officers and directors

#### **SUGGESTED DISCUSSION PROMPTS**

1. How does the field of finance provide intrinsic motivation for deception?
2. Is it unethical for a financial broker to generate commissions in a way that neither helps nor harms her client?
3. How does one tell when legitimate transactions become a case of “churning”?
4. What does it mean for financial markets to be “fair”?
5. What ethical rules does insider trading involve breaking?

## ASSESSMENT FOR IN-CLASS USE

### *Multiple Choice Questions*

Choose the BEST possible answer for each of the following.

1. Financial dealings most fundamentally require the value of \_\_\_\_\_.
  - A. freedom
  - B. time
  - C. trust
  - D. competence

Correct Answer: C

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

2. Financial service people are most fundamentally in the business of selling \_\_\_\_\_.
  - A. savings
  - B. investments
  - C. stocks
  - D. bonds

Correct Answer: B

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

3. Deception is an ever-present danger in financial selling mostly because \_\_\_\_\_.
  - A. the customer has to rely on the seller for all of the relevant information
  - B. financial salespeople often do not know very much about the securities they sell
  - C. there are not many laws that regulate financial services
  - D. no one ever has all the information at a given time

Correct Answer: A

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

4. A financial broker may be tempted to “churn” because by doing so he can \_\_\_\_\_.
- A. sell more shares
  - B. artificially inflate yields
  - C. get more customers
  - D. earn additional commissions

Correct Answer: D

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

5. Due to the wide variety of financial products available, it is incumbent on the broker to help the customer select those that are \_\_\_\_\_.
- A. suitable
  - B. liquid
  - C. cheapest
  - D. least risky

Correct Answer: A

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

6. Doing business in the financial markets most fundamentally presupposes that \_\_\_\_\_ will be respected.
- A. power
  - B. fairness
  - C. freedom
  - D. ideas

Correct Answer: B

11.2: Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices

Topic/Concept: Financial Markets

Difficulty Level: Moderate

Skill Level: Analyze

7. Efficiency in financial markets means that \_\_\_\_\_.

- A. social well-being will be maximized
- B. all investments will keep their value
- C. overall yields will increase
- D. fairness will always be maintained

Correct Answer: C

11.2: Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices

Topic/Concept: Financial Markets

Difficulty Level: Moderate

Skill Level: Evaluate

8. If people in financial markets have unequal access to information, \_\_\_\_\_.
- A. it is always unfair
  - B. this can happen in spite of their expertise
  - C. it should not impact their ability to make good decisions
  - D. a law has probably been broken

Correct Answer: B

11.2: Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices

Topic/Concept: Financial Markets

Difficulty Level: Moderate

Skill Level: Evaluate

9. Agreements reached in financial trading are generally considered fair as long as \_\_\_\_\_.
- A. everyone profits from the exchange
  - B. all traders involved are professionals
  - C. everyone has the same information
  - D. they are reached through good-faith bargaining

Correct Answer: D

11.3: Summarize the two main arguments against insider trading and the challenges in applying these theories to its prevention and prosecution

Topic/Concept: Insider Trading

Difficulty Level: Easy

Skill Level: Understanding

10. Takeover offers must now be accompanied by enough time so that \_\_\_\_\_.
- A. shareholders have opportunity to consider the offer carefully
  - B. consumers can decide whether to buy stock in the company
  - C. abusive tender offers can be rescinded by government action
  - D. there can be an orderly transition of control

Correct Answer: A

11.4: Analyze the ethical issues raised by various hostile takeover tactics and what they suggest about the rights and fiduciary duties of officers and directors

Topic/Concept: Hostile Takeovers

Difficulty Level: Moderate

Skill Level: Analyze

### *Essay Questions*

1. Explain why in the context of finance it is so important that customers be empowered to make rational choices.

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

2. Describe an example of the kind of transaction that a financial advisor might make that does not benefit the client.

11.1: Explain the three basic forms of ethical misconduct when selling financial products and services, and the responsibilities brokers have to their clients

Topic/Concept: Financial Services

Difficulty Level: Easy

Skill Level: Understanding

3. Describe how the ideal of fairness plays out in the financial markets.

11.2: Assess the significance of the three main elements of fairness in financial markets and the ethical issues introduced by new financial instruments and practices

Topic/Concept: Financial Markets

Difficulty Level: Moderate

Skill Level: Evaluate