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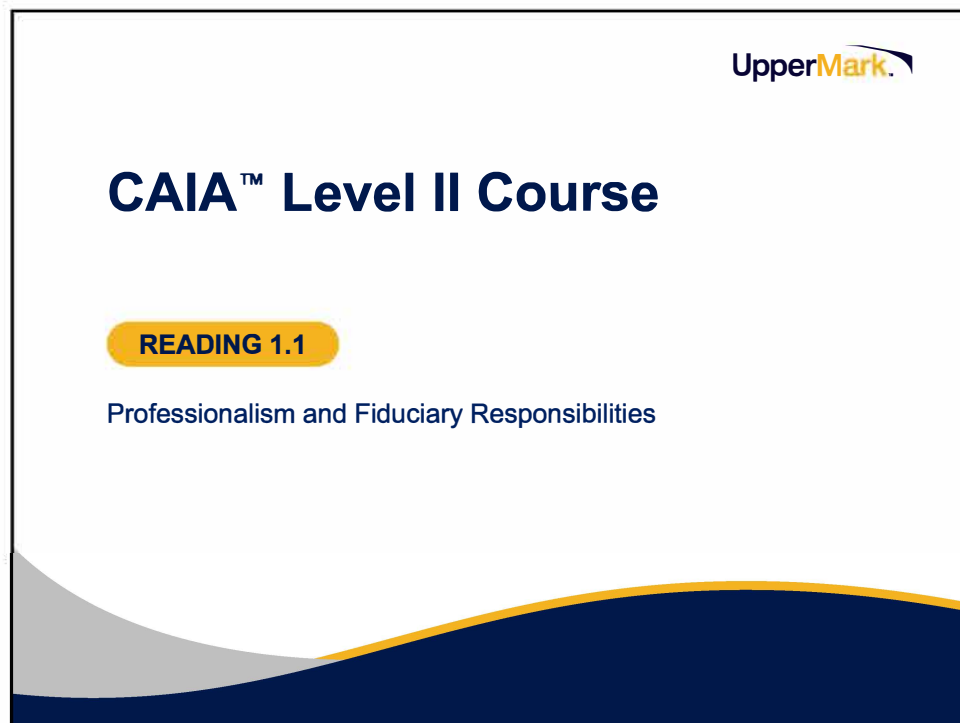
CAIA™ Level II Course

TOPIC 1

CAIA Ethical Principles

- 1.1 Professionalism and Fiduciary Responsibilities
- 1.2 Ethics

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READING 1.1

Professionalism and Fiduciary Responsibilities

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Investment Industry

- Ecosystem
 1. Participants – key components & resources; include institutions and agents (asset owners & managers, brokers, service providers; regulators; end savers).
 2. Technologies – factors in getting things done; derived from functions (e.g., regulation; investment theory) and implemented in processes (e.g., investment strategies).
 3. Markets – for securities and marketplaces for talent & services.
- Facets of purpose
 1. Fundamental purpose – contribute to society via increases in societal wealth & well-being (e.g., climate change; inequality).
 2. Intrinsic purpose – mobilize sourcing & allocation of capital to where needed.
 3. Core purpose – provide wealth & risk management to end savers.
 4. Collateral purpose – produce jobs, opportunities, & rewards for investment professionals & organizations. Not a primary purpose.

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Investment Industry Players

- Key player: **principal** (i.e., asset owner): individuals & legal entities (or allocators) typically manage investment funds.
- Multiple **agents** or intermediaries (the **value chain**) – provide services to and aim to create value for principal/client.
- **Stakeholders** – all participants with a stake in industry.

Asset owners – have traits of both principal & agent; accountable to end beneficiaries, investors, & savers; manage assets by building internal expertise or outsourcing.

Asset Owners	Agents	Wider Stakeholders
Pension funds	Asset managers	Governments
Endowments & foundations	Investment banks	Regulators
SWFs	Index providers	Standard setters
Insurance companies	Consultants/advisors	Investee entities
Mutual funds	Research providers	Co-investors
Outsourced CIOs	Data providers	Academics
Family offices		Civil society

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Qualifying Traits of Asset Owner/Allocator

- Traits –
 1. Work for beneficiaries (or savers or investors) as manager of assets in fiduciary capacity (upholding loyalty, prudence, & care) under delegated responsibility.
 2. Work with sponsoring entity (government, company, or nonprofit).
 3. Work within law & have implicit societal license to operate.
 4. Deliver mission-specific outcomes to beneficiaries & stakeholders (as payments or benefits).
 5. Use business models that combine governance budget (resources & processes) and risk budget (financial assets).
- Pension funds are largest group of qualifying asset owners.
 - SWFs, endowments, foundations, & OCIOs (agents of asset owners) fully qualify; other institutions (e.g., mutual funds) partly qualify.

Value Creation in Investment Industry

- Key purpose: provide & efficiently allocate capital for investment. Private markets are more successful at value creation.
 - However, less capital is provided for primary investments than for financial engineering or ownership transfers.
- Industry's two key activities –
 1. **Wealth & risk management** (most significant) – build portfolios to suit asset owners' risk budgets or tolerances, & manage risk (mostly point-in-time) with focus on relative risk (or tracking error risk).
 2. **Stewardship** – engage with management on best ways to generate sustainable long-term growth and manage risks & agency issues.
- ⇒ Industry earns higher value creation score for managing wealth & risk than for **capital allocation**.
 - Score is better if risk management is focused on through-time risk & absolute risk.

Value Creation (cont.)

- Industry organizations share a mission in client-first delivery of wealth, and contribute to societal wealth & well-being in unique ways.
 - Purpose reflects 3 factors: people's passion, organization's competencies, and organizations success of profit & performance drivers.
 - Value created can also be mapped to the industry's employees.
- Key aspect of purpose & value creation comes from sustainable finance.
 - Brundtland report: **sustainability** meets present needs without compromising future generations' needs.
- Financial goals & broader goals (e.g., well-being) may overlap. Suggests 2 ways to create value –
 1. From financial outcome: investing for sustainability impact can lead to improved financial outcome.
 2. From impact: value creation that investment strategy generates on real-world issues (e.g., climate change).

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Value Creation (cont.)

- Asset owners' & managers' sustainability choices are based on **social-license principle**: rely on covenant from society to pursue financial goals; based on realizing socially-valued goals.
- Value models –
 - Shareholder value model – importance of financial returns.
 - Shared value model – companies should focus on maximizing shareholder value & their contribution to society.
 - Elkington (1994): "**triple bottom line**" concept – corporations should focus not only on economic value but also on environmental & social value they add.
 - Porter & Kramer (2011): company's competitiveness & community's health are mutually dependent.
 - Eccles & Youmans (2015): shareholder value should not be the objective but the outcome of firm's activities in line with objective to survive & grow.
 - Hart & Zingales (2017): support premise on shareholder value; but state directors have fiduciary duty to maximize shareholders' welfare (not value), which may include "pro-social aims."

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Value Creation (cont.)

➤ Different value models (cont.) –

- System-value model – places business within society & society within environment => investment industry affects & is affected by society & environment. Value creation should:
 1. Be activities used to create future wealth & well-being (fundamental purpose).
 2. Be judged through stakeholder lenses with subjectivity.
 3. Occur over extended periods, with progress assessed looking back and forward.

The diagram shows three stages of value creation models, connected by arrows from left to right:

- Shareholder Value:** A dark grey box labeled 'Business: Primacy of financial return' is centered within a light grey box labeled 'Society', which is itself within a white box labeled 'Environment'.
- Shared Value:** A dark grey box labeled 'Business' is centered within a light grey box labeled 'Society', which is itself within a white box labeled 'Environment'.
- System Value:** A dark grey box labeled 'Business' is centered within a light grey box labeled 'Society', which is itself within a white box labeled 'Environment'.

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Fiduciary Obligations

➤ Purpose of fiduciary duty: compel agents to adopt high standards of professional practice so clients are protected from abuse of power.

➤ Areas of fiduciary obligations –

1. Loyalty – place beneficiaries' interests first & avoid conflicts of interest.
2. Prudence and care
3. Diversification
4. Impartiality – no favoring a particular beneficiary.

➤ Challenges associated with areas of fiduciary obligations

1. No objective interpretation (of the obligations)
2. No static interpretation (not fixed in time)
3. No globally consistent interpretation
4. Financial interests first

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Fiduciary Obligations (cont.)

- Fiduciary duty is a codification of professionalism – applies to organizations & individuals, involves professional mindset and skill set, is the source of the industry's license to operate, and is evident in commitment to long-term value creation in ongoing client relationships.
- Operating with fiduciary and professional mindset – begins with understanding purpose and alignment to client, and is embedded in organization's key principles (e.g., culture, incentives, fee philosophy, diversity principles, etc.).

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Fiduciary Obligations (cont.)

- Values that support a true fiduciary & professional mindset –
 1. Ethical & professional behavior
 2. Partnership – with client; commitment to trust, empathy, & long-term relationships.
 3. Client first – know the client & understand their needs; then make decisions to meet those needs. Involves loyalty to the client and being purpose-driven.
 4. Transparency, integrity, & accountability
 5. Public responsibility & clean license to operate
 - Public responsibility captured in *social license compact* (society grants privileges to investment profession, which confirms will act responsibly). Investment profession's warranty involves certain behaviors –
 - i. Responsibility to society
 - ii. Accepted standards of fair practice
 - iii. Accepted body of knowledge & practice
 - iv. Processes for learning from experience
 - v. Standards for accreditation, codes of discipline, & sanctions, achieved via collective assurance

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Professionalism Skill Set

- Key areas –
 1. Adhere to "best practice" standard
 2. Continue to learn and grow their knowledge base
 3. Diligent, competent, & objective throughout investment process
 4. Judge risks broadly and avoid unnecessary risks
- Based on skills and abilities –

Skills	Technical	Soft	Leadership	T-Shaped
	<ul style="list-style-type: none"> • Solutions • Investment foundations • Finance • IT • Management science 	<ul style="list-style-type: none"> • Innovation • Collaboration • Relationship • Humility • Consultative/selling 	<ul style="list-style-type: none"> • Vision and mission • Ethical culture • Governance stakeholders • Crisis management • Comfortable globally 	<ul style="list-style-type: none"> • Situational fluency • Connects disciplines • Diverse perspectives • Network connections • System understanding
Abilities	Digital	Emotional	Creative	Systematic
	<ul style="list-style-type: none"> • Data science • Statistical intelligence 	<ul style="list-style-type: none"> • Emotional intelligence • Resilience 	<ul style="list-style-type: none"> • Creative intelligence • Idea ownership 	<ul style="list-style-type: none"> • Behavioral understanding • Inter-connections

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Culture and Industry Professionalism

- Role of culture – affects how people in a group think and behave; based on shared values and beliefs.
 - Is influenced by leaders (with each individual having leadership role), and embodies institutional memory.
- Culture influences organizations & contributes to achieving professionalism via 3 main channels/principles –
 1. Aligns values & beliefs, establishes expectations & trust, and reduces uncertainty.
 2. Focuses on factors that matter in all organizational situations.
 3. Captures power of strong communication and engagement in the organization and in client interactions.

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Client-First Approach

- Putting the client first can only be guaranteed if there is only one client (and one product). Thus, in practice, the goal is to treat all clients fairly – challenging to operationalize (depends on organization's values).
- Putting clients first also involves how the value created is divided up.
 - Professional subject to fiduciary duty has a trade-off: forgo maximizing short-term profits for a relationship in which trust & respect can be monetized – e.g., with fair fees and rewards that reflect value delivered.
- Areas where the "right" choice is not always clear –
 1. Conflicts of interest (between organization and client and between clients)
 2. Trade-off between benefits and costs for different stakeholders
 3. Insufficient knowledge of the client (e.g., goals, context, and values)

Client-First Approach (cont.)

- When the right choice is not obvious, choice must be made within a well-ordered, transparent process with balanced rules and principles.
- Rather than trying to observe client-first behavior (challenging), observe culture – which may be evaluated with questions –
 1. Is there a well-managed capacity and capability to achieve client expectations?
 2. Is there a process & attitude to listen to clients and get their feedback?
 3. Is attention given to understanding & managing client risks?
 4. Do professionals understand professional & ethical practice and its boundaries and practical application?
 5. How does professional prioritize client, firm, & self and regard for societal interests?
 6. How does organization view principle of fair rewards, and can it show alignment with the principle?
 7. What are levels of trust between organization & clients?
- Exhibiting client-first principles also requires rejecting bad habits (e.g., overclaiming).

Trust in Client Relationships

- Trust is two-sided: is asset manager worthy of trust and is allocator willing to trust?
- For allocators, key situation that requires trust is dependency on asset manager when have long-term risk exposure. Significance of trust increases with investment's risk and duration.
- Trust is earned by asset managers who build credibility, communicate effectively, and exhibit professionalism.
 - Credibility is tangible; has objective features and can be divided into two parts: end investors need assurance –
 1. That professional/organization is accredited to provide services.
 2. Of value proposition, and validation that asset manager can add value, thus deserves to be trusted.
 - Communication is tangible when technology is effectively used.
 - Professionalism is tacit & subjective.

Trust

- Features of trust in the investment industry –
 1. Trust has value to allocator & asset manager (by enabling value creation to develop over time).
 2. Trust levels vary by geography & demography, can reflect cultural factors, and correlate with market experiences.
 3. Trust is a factor during entire investment life cycle; is more significant when interventions are needed.
 4. Trust can be helped by technology, but requires human involvement.
 5. Brand can support trust, but can compromise it if brand promise is not fulfilled.
 6. Information is essential.
 7. Innovation & use of technology can enhance trust.
- Widespread investment industry failings –
 1. Weakness in value proposition: value does not match fees charged
 2. Misalignments in values of asset management firms with their clients
 3. Communication with inadequate accuracy and honesty

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Value Produced by the Industry

- Industry can secure more or less value for itself and society.
 - **Misaligned industry** – not an issue in short term. In long term, high rewards at society's expense results in untrusted industry with smaller asset base; may not be sustainable.
 - **Professional industry** state is trusted, with clean license to operate (implies large asset base); sustainable.
- Costs of the **unnecessary industry** can be reduced by technology. But industry not driven by fiduciary culture does not get rewards associated with risk.

Greater Industry Benefit

Misaligned Industry Good for industry Bad for society	Professional Industry Good for industry Good for society
Absent Industry Bad for industry Bad for society	Unnecessary Industry Bad for industry Good for society

Greater Societal Benefit

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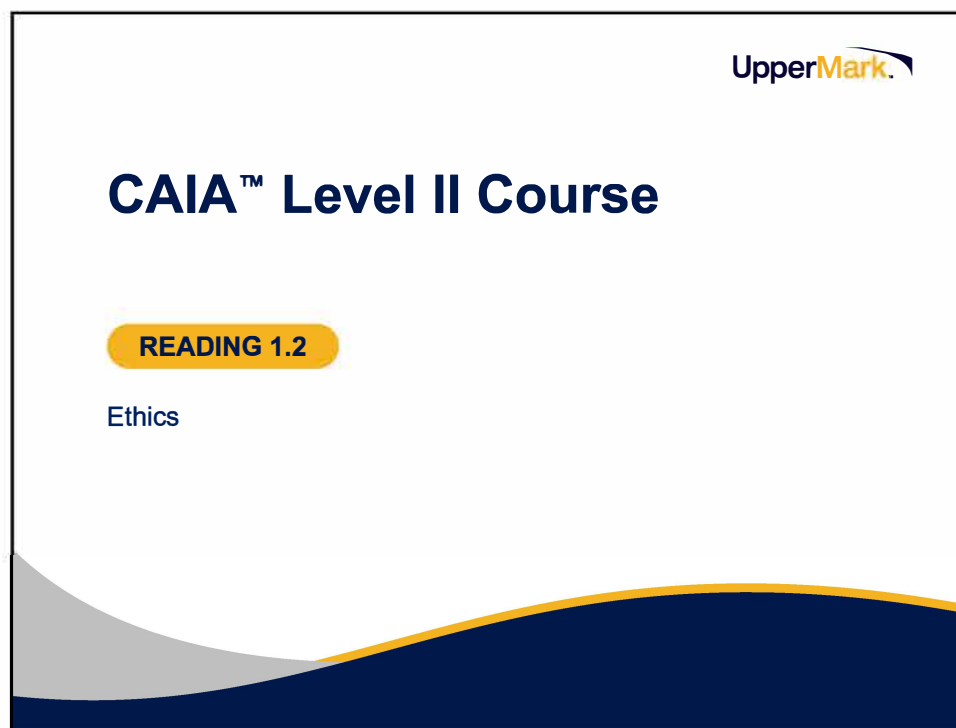
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Fiduciary & Professional Mindset

- Creates value for clients via –
 1. Values & behaviors aligned with fiduciary duty and focus on client interests
 2. Client relationships with trust & empathy; with transparent, accurate, & authentic communication.
 3. Working with holistic (or systemic) model and actions that relate to value creation relative to goals
 4. Adopting fair rewards given resources & outcomes involved
 5. Regard for public responsibility and adherence to clean social license
- Adds value since creates virtuous circle of positive forces –
 - **Portfolio** – benefits from skill & attention, making realizing performance goals more likely.
 - **Client** – benefits from best performance reinforced by trust in asset manager, making sustainable relationship more likely.
 - **Asset manager** – benefits from sustainable, successful client relationship, reinforcing fiduciary & professional culture.

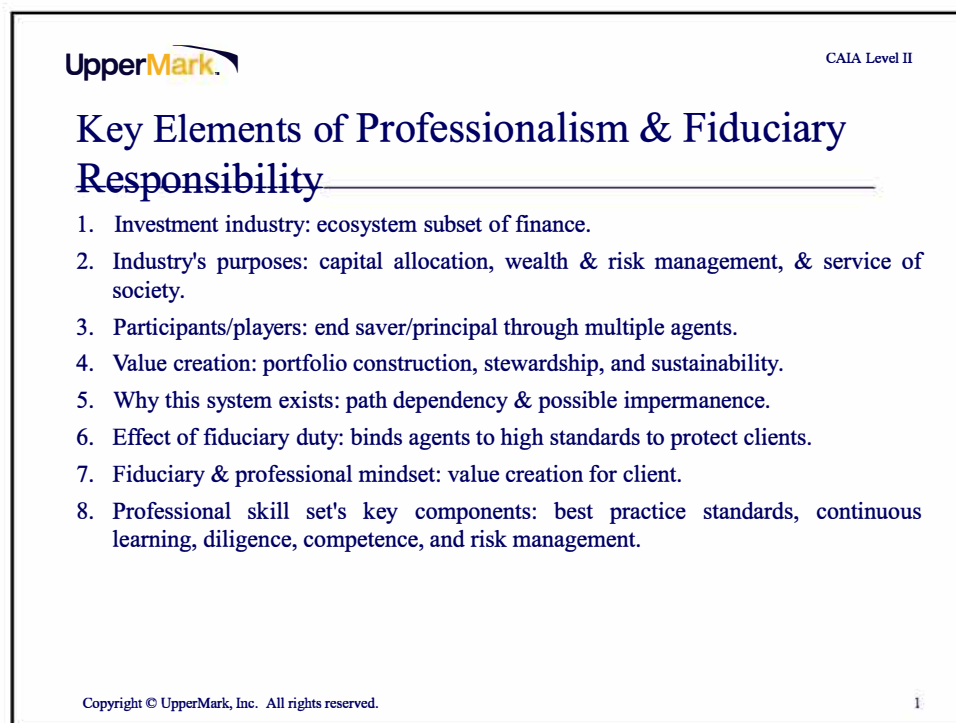
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The slide features the UpperMark logo in the top right corner. The main title 'CAIA™ Level II Course' is centered in a large, bold, dark blue font. Below it, 'READING 1.2' is highlighted in a yellow rounded rectangle. The word 'Ethics' is positioned below the reading title. At the bottom of the slide, there is a decorative graphic consisting of a dark blue wave shape with a yellow highlight on top, and a grey area on the left side.

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The slide features the UpperMark logo in the top left corner and 'CAIA Level II' in the top right corner. The main title 'Key Elements of Professionalism & Fiduciary Responsibility' is centered in a large, dark blue font. Below the title is a list of eight numbered points. At the bottom left, there is a copyright notice: 'Copyright © UpperMark, Inc. All rights reserved.' At the bottom right, there is a small number '1'.

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Key Elements of Professionalism & Fiduciary Responsibility

1. Investment industry: ecosystem subset of finance.
2. Industry's purposes: capital allocation, wealth & risk management, & service of society.
3. Participants/players: end saver/principal through multiple agents.
4. Value creation: portfolio construction, stewardship, and sustainability.
5. Why this system exists: path dependency & possible impermanence.
6. Effect of fiduciary duty: binds agents to high standards to protect clients.
7. Fiduciary & professional mindset: value creation for client.
8. Professional skill set's key components: best practice standards, continuous learning, diligence, competence, and risk management.

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Key Elements of Professionalism & Fiduciary Responsibility

9. Role of culture: alignment of values & beliefs, focus on significant things, & engagement.
10. Put client first: treat all clients fairly.
11. Make "right" choice: navigate conflicts of interest, trade-off between stakeholders' benefits & costs; and address client's insufficient knowledge.
12. Exhibit client-first approach, role of trust in client relationship and investment outcome, and how above elements compare to current system.
13. How professional & fiduciary mindset adds value to clients, etc.; and why organizations should foster a culture of professionalism.

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Key Takeaways from Previous Reading

- Understanding professionalism requires understanding investment industry – need deeper thinking and broader context than most explored.
- Consider professionalism via organizational purpose & vision; consider goals, motivations, and boundaries. Industry not reflected on this sufficiently.
- Professionalism best codified via balanced use of principles with rules & policies.
- Clarity on organizational purpose & ideals of professionalism improve outcomes.

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8 Ethical Principles

Professionalism: Doing the right things

1. Ethical & professional behavior – Create outcomes that reflect well on the firm and show concern for stakeholders.
2. Partnership – Serve as peer & partner. Partnership is commitment to trust, empathy, and strong relationships.
3. Client-first mindset – Know client, understand needs, and meet the needs. Entails loyalty to client & being purpose-driven.
4. High standards of conduct: Transparency, integrity, & accountability

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8 Ethical Principles (cont.)

Professionalism: Doing things right

5. High standards of practice – based on evidence & rigorous thinking, consistent with theory & best practices.
6. Professional work – Continued engagement with client context. Need expertise in holistic understanding of risk.
7. Continued learning – Includes self-learning and self-improving.
8. Collaboration – Peer review, diversity of knowledge, critical thinking, and different perspectives improve accuracy and insight of advice.

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The Principles' Foundational Ideas and Concepts

- **Investment ecosystem** – Better term than "investment industry".
- **Purpose & vision** – includes fundamental purpose of contributing to society (via increases to societal wealth and well-being).
- **Professionalism and professional conduct** – competencies, values, etc. Captured flexibly in principles & guardrails; explicitly in rules.
- **Ethics and values**
 - **Values** – individual beliefs that motivate people to act in some way.
 - **Ethics** – set of moral principles that guide thinking and action. Include honesty, fairness, diligence, and care & respect.
- **Regulation** – and culture of integrity & ethical principles.
- **National & cultural differences** – establish principles, etc. that promote ethical principles globally.
- **Importance of trust** – in the system & participants.

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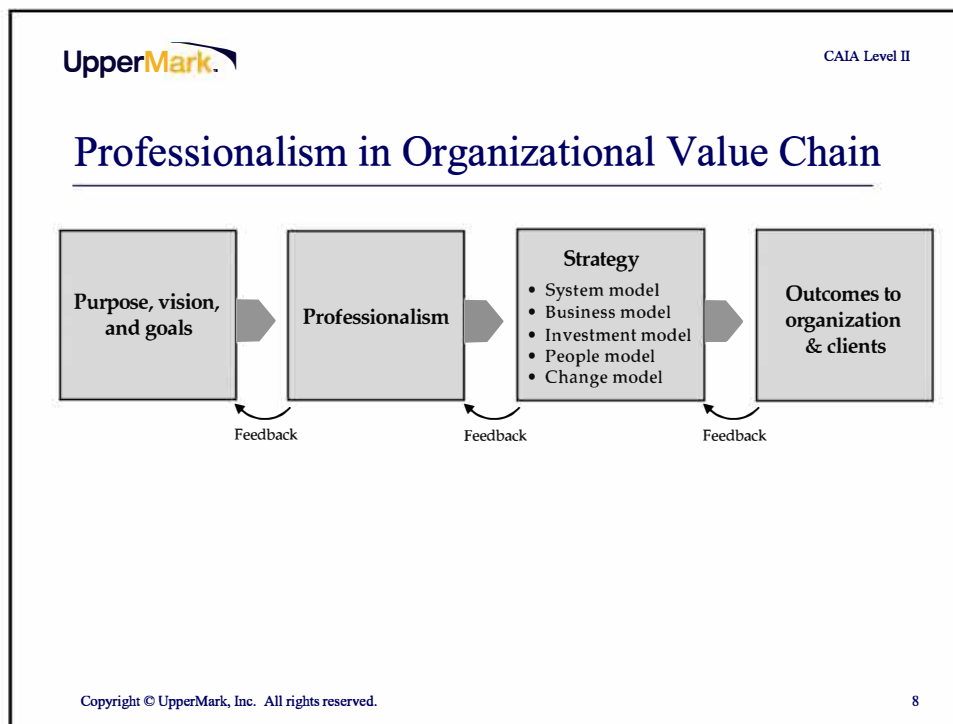
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Value Creation Equation

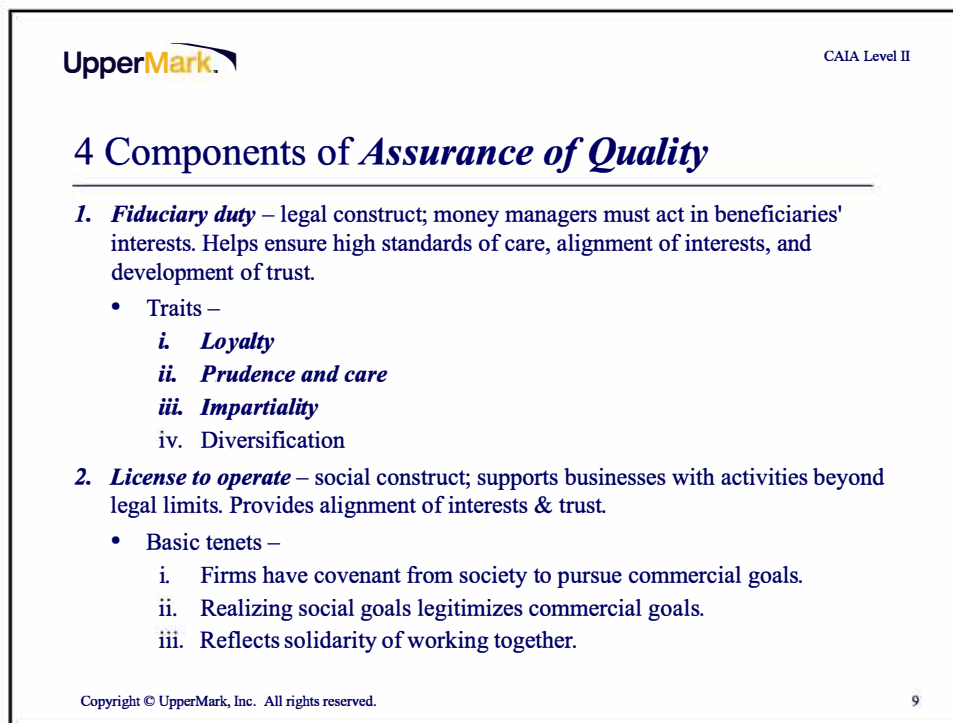
Purpose	Professionalism	Assurance	Value			
<ul style="list-style-type: none"> • Vision & values <ul style="list-style-type: none"> ➤ Why we exist ➤ How we create value • Fiduciary duty • Stakeholder map <ul style="list-style-type: none"> ➤ Interconnectivity 	+	<ul style="list-style-type: none"> • Values <ul style="list-style-type: none"> ➤ Ethics • Competency <ul style="list-style-type: none"> ➤ Standards ➤ Knowledge & skill • Accountability 	+	<ul style="list-style-type: none"> • Fiduciary duty • License to operate • Trust & reputation • Track record <ul style="list-style-type: none"> ➤ Standards ➤ Credentials 	=	<ul style="list-style-type: none"> • Experiences • Outcomes <ul style="list-style-type: none"> ➤ Influenced via trust & perceptions vs expectations

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4 Components of *Assurance of Quality* (cont.)

3. *Trust* model

- Vital features of trust –
 - i. 2-sided: trust-willingness from end investor and trustworthiness from provider.
 - ii. Value to end investor giving trust & to provider receiving it.
 - iii. Grows slowly, but can quickly erode.
 - iv. Importance grows as risk and duration increase.
 - v. For end investor, value relates to perceptions of outcome relative to expectations.
- "Trust capital" (i.e., size & robustness) is affected by fact that trust –
 - i. Is key in entire savings life cycle; more significant at times.
 - ii. Is enhanced by reputation.
 - iii. Depends on quantity & quality of communication.
 - iv. Helped by technology, but needs personal touch.
 - v. Can enhance brand; can diminish it if promise is unfulfilled.
 - vi. Levels vary by geography & demography, and correlate with market experiences.

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4 Components of *Assurance of Quality* (cont.)

3. *Trust* model (cont.)

Trust Willingness	Trust Worthiness		Trust Willingness + Trust Worthiness Trust Capital & Trust Domain
Attributes of saver/investor that gives their trust	Attributes of provider/manager that receives trust	Trust	Built by assessing the benefits of exchange in a trust relationship, including the experience of giving trust.
Trust Capital	Trust Domain	Trust worthiness	Assessed by considering Professionalism & Assurance.
Context of the expectations in the trust relationship given rational and relational choice factors	Context of the domain over which trust is conferred; notably, term, risk, complexity, & difficulty.	Professionalism	Competency (subject matter knowledge + listening + problem-solving skills) + Values (ethics & customer care); a "soft" assessment (i.e., subjective aspects)
		Assurance	License to operate (incl. credentials) + Experience + Track record (value for money); a "hard" assessment (i.e., mostly objective)
		Brand	Approximate indicator of trustworthiness. Helpful as a timesaver, but not all organizations follow through on brand promises.

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4 Components of Assurance of Quality (cont.)

4. Conflict-of-interest model

- Interests conflict with duty to act in client's best interests; compromises ability to be objective and professional.
- Examples –
 - Financial incentives
 - Commitments to other clients or areas of responsibility
 - Personal relationships or interests that may be incentives
 - Gifts
- Patterns – some conflicts:
 - Are avoidable (e.g., commissions).
 - May be managed.
 - May affect clients in positive & negative ways.
 - May be subjective or abstract.
- Complex situations (e.g., managing many clients) may result in unavoidable conflicts.
- Effects of conflicts may be mitigated by transparency, integrity, and responsible practices; and by governance & culture.

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4 Components of Assurance of Quality (cont.)

4. Conflict-of-interest model (cont.)

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    graph LR
      subgraph Row1 [Avoidable Conflicts]
        A1[Avoidable conflicts  
• E.g., financial incentives like commissions] --> I1[Possible impacts  
• Bad judgements and actions]
        I1 --> R1[Responses  
• Avoidance  
• Transparency  
• Management]
      end
      subgraph Row2 [Unavoidable Conflicts]
        A2[Unavoidable conflicts  
• E.g., managing multiple clients fairly] --> I2[Possible impacts  
• Net positive and net negative consequences]
        I2 --> R2[Responses  
• Ethical framework  
• Transparency  
• Management]
      end
  
```

Unavoidable conflicts of interest	In complex business situations with multiple clients, overlapping interests create unavoidable conflicts of interest.
Management of trade-offs	To decide on a mix of trade-offs between interests, need an ethical framework to capture principles of fairness of action.
Mitigations to conflicts of interest	Effects of conflicts may be mitigated by transparency integrity, and responsible practices; and by governance and culture at the organization level.

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Principle 1: Ethical and Professional Behavior

1. Act ethically
2. Act professionally with integrity and respect (includes aiming for highest standard of conduct)
3. Be concerned for well-being
4. Voice concerns
5. Take personal responsibility (includes considering wider society)
6. Show responsibility to stakeholders
7. Encourage others to act ethically
8. Act with *moral courage*

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Principles 2 & 3

Principle 2: Partnership

1. Know your client
2. Communicate timely and accurately
3. Embrace opportunities for co-creation and collaboration
4. Operate with alignment of interests
5. Seek alignment of values

Principle 3: Client-first mindset

1. Operate with a client-first mindset
2. Support governance and culture
3. Manage conflicts within multiple products
4. Avoid conflicts of interest

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Principles 4 & 5

Principle 4: High standards of conduct: transparency, integrity, & accountability

1. Be transparent and set goals
2. Disclose errors
3. Disclose costs
4. Act with *integrity*
5. Take *accountability*
6. Support and promote ethical cultural values

Principle 5: High standards of practice

1. Clearly define standards of practice
2. Clearly define competencies and body of knowledge
3. Seek professional accreditation
4. Operate within an ethical framework
5. Work within an appropriate reward system
6. Be adaptable and responsive

Principles 6 & 7

Principle 6: Professional work

1. Comply with applicable local laws
2. Show professional work
3. Ensure appropriate risk assumptions and models
4. Operate within an ethical judgment framework
5. Ensure sufficient documentation
6. Behave with diligence and professionalism under stress

Principle 7: Continued learning

1. Embrace humility and curiosity as key attitudes
2. Pursue continuous education
3. Apply growth mindset principles
4. Understand the impact of technology
5. Undertake adjacent learning

Principle 8: Collaboration

1. Value to diversity, teamwork, and collaboration
2. Use peer review of work
3. Seek peer review in ethics code
4. Support the investment ecosystem
5. Support the professional community

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Ethical Misconduct at MF Global

- Commodities brokerage – large European sovereign debt investments. When debt crisis worsened, could not cover losses or margin obligations.
- October 2011: filed bankruptcy with ~\$1.6b shortfall in customer accounts.
- What went wrong?
 1. Failed to uphold fiduciary duties & engage in ethical conduct.
 2. Lack of risk management, with very large investment and risk exposure.
 3. CEO/chair ignored CRO's warnings and replaced him. CEO asked board to increase risk exposure; threatened to leave if permission not given.
 4. Illegally used customer funds to maintain liquidity.

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Ethical Misconduct at MF Global (cont.)

- Ethical violations -
 1. Principle 3 (Client-First Mindset) – due to weak governance and CEO promoting excessive risk-taking.
 2. Employees violated Principle 1 (Ethical & Prof. Behavior) – by not voicing concerns or taking responsibility for losses.
 3. Principle 4 (High Standards of Conduct) – by failing to disclose losses, be accountable, and act with integrity.
 4. Principle 6 (Professional Work) – by not segregating customer accounts.
- In review
 - CEO's excessive risk-taking.
 - CEO removed CRO & pressured board to support high-risk trades.
 - CEO authorized illegal use of customer funds to cover losses.
 - Due to poor governance, CEO could promote improper culture, replace employees, and conduct illegal transactions.

Ethical Misconduct at Archegos Capital Management

- Family office; founded in 2013 by Hwang. Operated like HF with high leverage and derivatives (e.g., TRSs). Several counterparties; concealed total exposure.
- 2021: large losses, resulting in margin calls and forced sales.
 - Large ViacomCBS position. After ViacomCBS's major stock price increase & \$3b secondary share sale, its share price fell > 20% in one day, then declined further (~60% peak-to-trough).
 - Could not meet margin calls. Positions continued to fall; led to counterparty losses.
- Lied about positions and credit metrics – inflated \$1.5b portfolio to \$36b.

Ethical Misconduct at Archegos Capital (cont.)

- What went wrong? – Obtained more leverage by not disclosing holdings to counterparties. Led to sizeable holdings; and manipulated prices. Lacked governance & independent risk management.
- Ethical violations -
 1. Principle 1 (Ethical & Prof. Behavior) & Principle 4 (High Standards of Conduct)
 2. Principle 5 (High Standards of Practice) & Principle 6 (Prof. Work)
- In review
 - Highly-leveraged positions with several banks and deceived counterparties. Thus held large positions in a few companies; some likely resulted in manipulated inflated prices.
 - Collapse triggered by ViacomCBS's 20% 1-day decline, and inability to meet margin calls and forced unwindings.
 - Counterparties lost ~\$10b.
 - 2024: Hwang sentenced to 18 years for fraud & market manipulation.

Ethical Misconduct at Bear Stearns

- 2 HFs: High-Grade Structured Credit (HGSC) and HGSC Enhanced Leveraged
- Invested in MBSs & CDOs. Lost > \$2b due to collapse of subprime markets, and liquidity issues and excessive leverage. Onset of company's downfall.
- What went wrong?
 - Investors told subprime mortgages were < 10% of fund assets, but were ~60%.
 - Portfolio managers knew of large losses before first reported in April 2007 (obscured by hedges). Downplayed troubles; falsely claimed were adding to personal investments (when withdrawing & shorting subprime mortgages).
 - June: HFs lost nearly all capital and unable to meet margin calls & redemption requests. Collapse due to poor risk management and excessive leverage. Investors ill-informed & unaware of true risk due to misleading communication and lack of transparency and integrity.

Ethical Misconduct at Bear Stearns (cont.)

- Ethical violations -
 1. Principle 1 (Ethical & Prof. Behavior) – due to withholding information and withdrawing personal assets while soliciting new money.
 2. Principle 3 (Client-First Mindset) & Principle 4 (High Standards of Conduct)
- In review
 - Excessive exposure to subprimes; did not disclose investment size to clients.
 - As performance declined, portfolio managers withdrew personal capital while soliciting new capital.
 - Due to high leverage & illiquid market, HFs could not meet redemption requests & margin calls. 2007: HFs collapsed.

Ethical Misconduct at New York State (NYS) Common Retirement Fund (CRF)

- Financial firms and intermediaries paid bribes, political contributions, & kickbacks to public officials responsible for CRF in exchange for allocation of its investments.
 - 2003-2006: Hevesi (NYS Comptroller, CRF's trustee) participated in pay-to-play with placement agents; accepted ~\$1m in gifts, etc. for influencing CRF's investments.
 - Morris (Hevesi's political adviser) also involved; received kickbacks for directing investments to financial firms.
- In 2010, Hevesi pled guilty to felony corruption and Morris to securities fraud. Both sentenced to prison and fined. Financial firms involved did not admit misconduct; paid penalties to SEC & NYS.
- After this, NYS banned use of placement agents & lobbyists by NYSCRF; increased disclosure requirements and created an independent oversight process.
 - SEC limited political contributions by investors working with public pensions.

Ethical Misconduct at NYSCRF (cont.)

- What went wrong? – Governance concentrated power; enabled self-interest. Lack of adequate oversight, checks & balances, and restrictions on donations also issues. Both Hevesi and financial firms existed ethics failures.
- Ethical failures –
 1. Hevesi, Morris, and related parties violated Principle 1 (Ethical and Prof. Behavior) – due to unethical conduct, lack of integrity, and disregard for stakeholders.
 2. H & M violated Principle 3 (Client-First Mindset) – by placing their interests above CRF's.
 3. H & M violated Principle 6 (Prof. Work) – due to lack of objective decision-making.
- In review
 - Hevesi abused position with pay-to-play; got gifts to direct pension assets.
 - CRF's weak governance concentrated power and lacked oversight.
 - Political contributions not adequately limited.
 - Hevesi & others eventually sentenced.

Ethical Misconduct at CalPERS

- Bribery involving Buenrostro (CEO) and Villalobos (former board member; later placement agent for PE funds).
 - Villa. bribed Buen. to influence CalPERS's investment decisions for Villa.'s clients. Buen. created disclosure letters falsely claiming CalPERS had approved investment decisions.
 - After leaving CalPERS, Buen. was hired by Villa. at placement agent firm.
- CalPERS later reformed its governance – e.g., enhanced transparency & oversight of investment decisions, stricter regulations on & disclosure requirements for use of placement agents, and limits on gifts to board members and staff.
- What went wrong? – Buen. gave Villa. CalPERS's confidential information, and accepted benefits in exchange for influencing CalPERS's decision-making. After leaving CalPERS, was hired by Villa.

Ethical Misconduct at CalPERS (cont.)

- Ethical violations by Buenrostro –
 1. Principle 1 (Ethical and Prof. Behavior) – by taking bribes, thus failing to act ethically or show responsibility to stakeholders.
 2. Principle 3 (Client-First Mindset) – by creating conflict of interest and not supporting strong governance.
 3. Principle 5 (High Standards of Practice) – by not operating in ethical framework or appropriate rewards system.
- In review
 - Buen. abused position by producing false documents & accepting bribes to influence CalPERS's investment decisions.
 - After CalPERS, Buen. joined Villa.'s placement agency & continued to try to influence CalPERS's investment staff.
 - 2014: Buen. sentenced to 4.5 yrs for corruption. Villa. died by suicide before trial for fraud and bribery.
 - CalPERS made many governance policy changes.