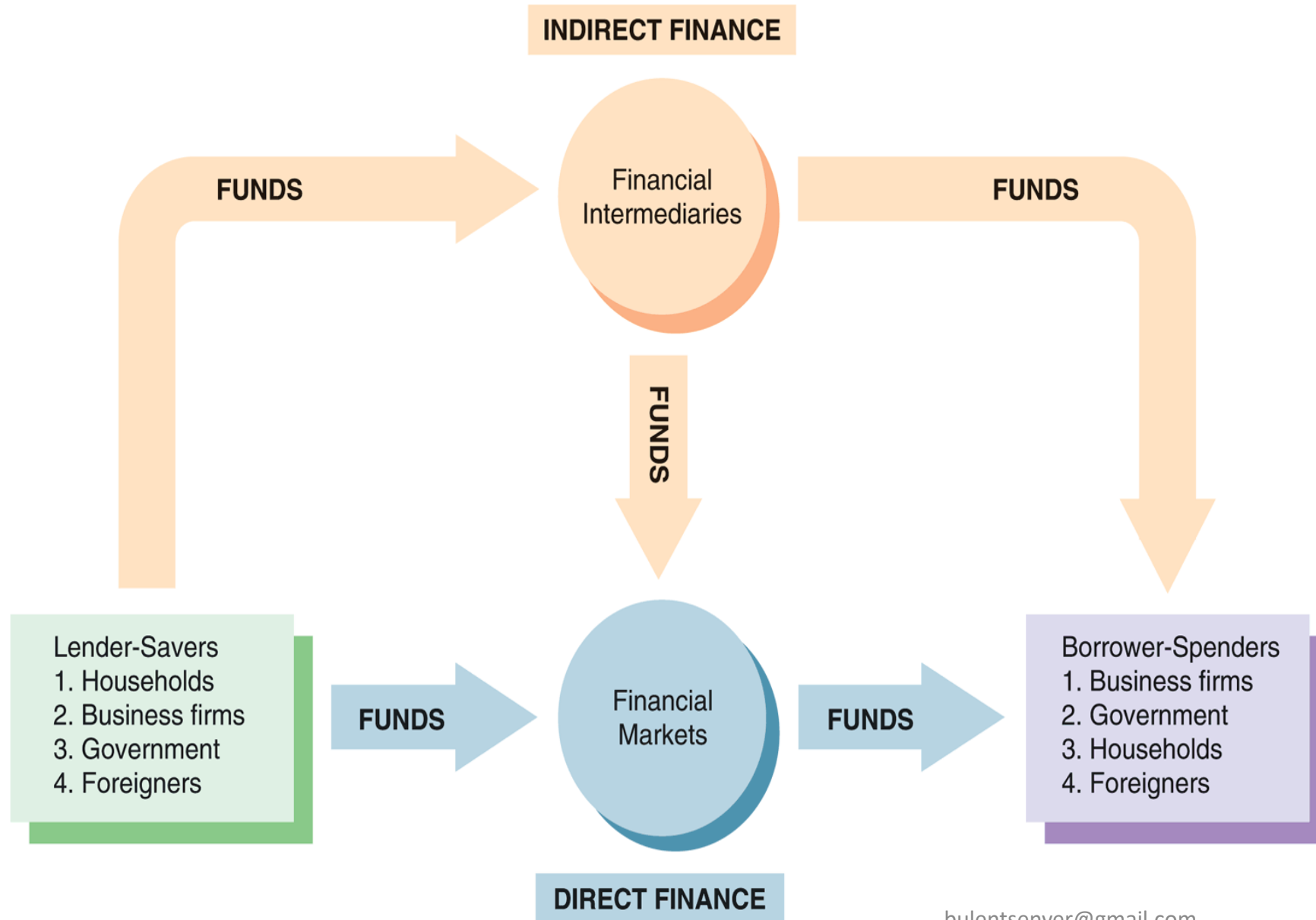


# Ethics In Financial Institutions & Financial Markets FEC - 594

Bülent Şenver

# Function of Financial Markets



# Comercial Banking



# Comercial Banking

Interest Earning **Assets**

Interest Bearing **Liabilities**

*LOANS*  
**IEA**



**Interest Income**



**Net  
Interest  
Income**

*DEPOSITS*  
**IBL**



**Interest Expense**

# Revenue Sources of Commercial

*Revenue 1*



*Revenue 2*



**+ Interest  
Income**

**+ Non Interest  
Income**

**Net  
Interest  
Income**

**Net  
Non Interest  
Income**

*Expense 1*



*Expense 2*



**- Interest  
Expense**

**- Non Interest  
Expense**

**Net Income Before Tax**

# Bank Intermediation Services

- **Intermediation:**

- 1. Denomination
- 2. Currency
- 3. Maturity
- 4. Interest Rate
- 5. Interest Sensitivity
- 6. Security Collateral

- **Related Risks:**

- 1. Concentration R
- 2. Foreign Exchange Position
- 3. Liquidity R
- 4. Net Interest Income R
- 5. Sensitivity Gap R
- 6. Recoverability

# Needs of Bank Customers

## Needs:

- 1. Savings need
- 2. Borrowing need
- 3. Investment need
- 4. Security need
- 5. Trading need
- 6. Payment need
- 7. Advice & consulting need

## Products:

- 1. Term Deposits
- 2. Loans
- 3. Mutual Funds, CD, MBS, ABS
- 4. Insurance products
- 5. Buy & sell CM products
- 6. Credit Card, ATM, EFT, SWIFT
- 7. Asset management, investment banking

# Financial Intermediaries

## Types of Banks

- Commercial Banks
- Investment Banks
- Merchant Banks
- Islamic Banks (participation banks)
- Development Banks
- Off Shore Banks
- Special Purpose Banks



# Financial Intermediaries

## Non Bank Financial Institutions

- Factoring
- Forfeiting
- Leasing
- Insurance
- Pension Funds
- Brokerage Houses
- Consumer Finance
- Islamic Finance
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- Real Estate Property Funds

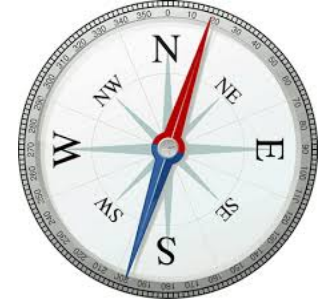
# Overview of Ethics in Finance

- Finance concerns **Other People's Money** (OPM)
- Other People's Money (OPM) invites **misconduct**
- Billions of financial transactions take place every day with a high level of **integrity**
- Placing our assets in the hands of other people requires immense trust
- **Trust** is essential in finance
- **Finance is impossible without Ethics**

# Overview of Ethics in Finance

- Ethical misconduct is not always a matter of **bad people** doing **bad things**,
- But often of **good people** who **stumble unwittingly** into **wrongdoing**

# Ethical Compass



Wrong  
Incorrect

Fair  
Just

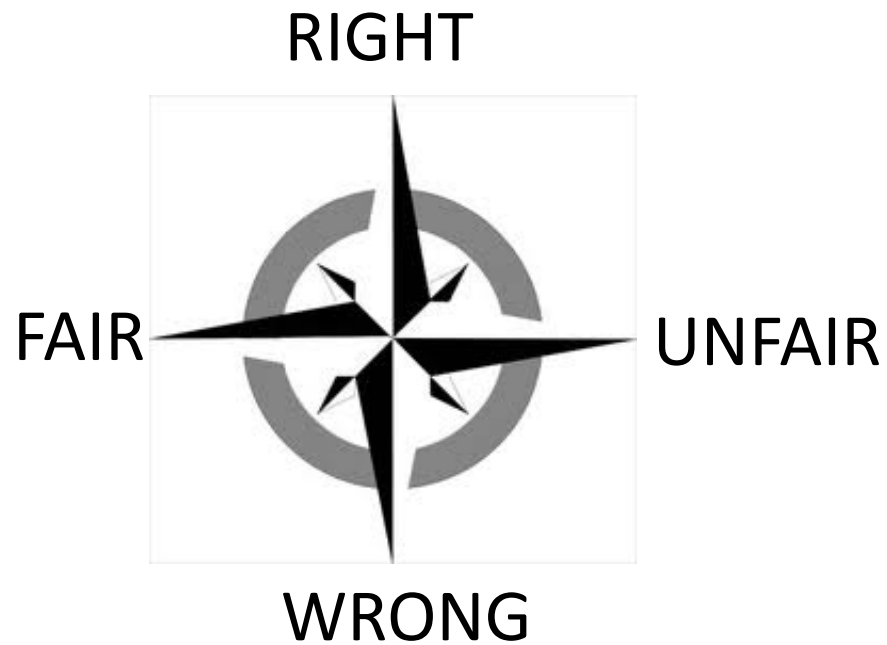


Unfair  
Unjust

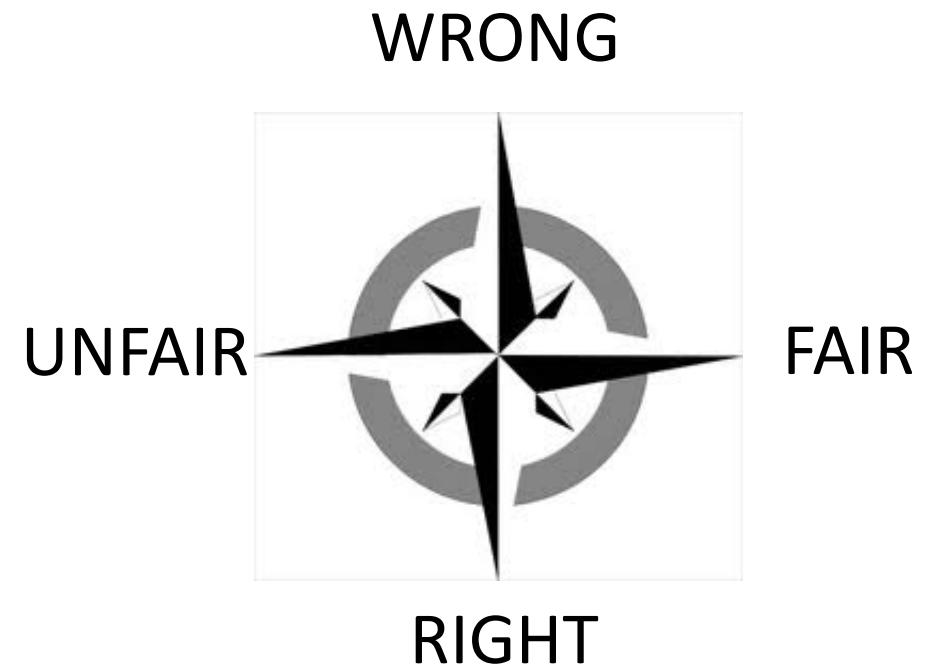
Correct  
Right

# Whose Compass?

## The Bank's



## The Customer's



# Causes of Wrongdoing

- **Pressure and culture**
- Strong organizational pressures to do things which are unethical or illegal (just do it!)
- Unethical behaviour can also be fostered by the culture of an organization. (not a conscious act, more a reflex)
- **Organisational factors**
- Wrongdoing also occurs in large organisations when responsibility is diffused among many individuals and no one person is «really» responsible.
- Wrongdoing can be attributed only to the organization as a whole.
- Innovation

# Causes of Wrongdoing

- **Innovation**

- Innovation creates new situations in which the rules for proper conduct, as well as for safe practice, are uncertain and slow to develop.
- New situations sometimes involve a change of incentives and a shift of risk and responsibility.(mortgage loans from originate-to-hold model to originate-to-sell model)
- Innovation is inherently complex and opaque and the dangers are difficult to perceive.
- Innovation is subject to a classic collective action problem in which no one individual can affect an outcome that can be avoided only if everyone cooperates. (As long as the music is playing, you've got to get up and dance)

# Excuses for Unethical Behaviour (Wrongdoing)

- Everybody else is doing it
- It's not that big of a deal
- It's necessary (the end justifies the means)
- It's not going to hurt anyone
- It's for the benefit of the company
- I deserve it
- It's legal
- Nobody will see, Nobody will know



# Core Values of Companies

- **Accenture**

1. Stewardship
2. The Best People
3. Client Value Creation
4. One Global Network
5. Respect for the Individual
6. Integrity

- **Adidas**

7. Performance: Sport is the foundation for all we do and executional excellence is a core value of our Group.
8. Passion: Passion is at the heart of our company. We are continuously moving forward, innovating, and improving.
9. Integrity: We are honest, open, ethical, and fair. People trust us to adhere to our word.
10. Diversity: We know it takes people with different ideas, strengths, interests, and cultural backgrounds to make our company succeed. We encourage healthy debate and differences of opinion.

# Core Values of Companies

- **Adobe**

- 11. Genuine.
- 12. Exceptional.
- 13. Innovative.
- 14. Involved.

- **American Express**

- 15. Customer Commitment
- 16. Quality
- 17. Integrity
- 18. Teamwork
- 19. Respect for People
- 20. Good Citizenship
- 21. A Will to Win
- 22. Personal Accountability

# Core Values of Companies

- **Barnes & Noble Booksellers**

23. Customer Service

24. Quality

25. Empathy

26. Respect

27. Integrity

28. Responsibility

29. Teamwork

- **Ben and Jerry's Ice-Cream**

30. We strive to minimize our negative impact on the environment.

31. We strive to show a deep respect for human beings inside and outside our company and for the communities in which they live.

32. We seek and support nonviolent ways to achieve peace and justice. We believe government resources are more productively used in meeting human needs than in building and maintaining weapons systems.

33. We strive to create economic opportunities for those who have been denied them and to advance new models of economic justice that are sustainable and replicable.

34. We support sustainable and safe methods of food production that reduce environmental degradation, maintain the productivity of the land over time, and support the economic viability of family farms and rural communities.

-

# Core Values of Companies

- **Bulid-A-Bear**

- 35. Reach
- 36. Learn
- 37. Di-bear-sity
- 38. Colla-bear-ate
- 39. Give
- 40. Cele-bear-ate

- **Coca-Cola**

- 41. Leadership: The courage to shape a better future
- 42. Collaboration: Leverage collective genius
- 43. Integrity: Be real
- 44. Accountability: If it is to be, it's up to me
- 45. Passion: Committed in heart and mind
- 46. Diversity: As inclusive as our brands
- 47. Quality: What we do, we do well

# Core Values of Companies

- **Facebook**

- 48. Focus on impact
- 49. Move fast
- 50. Be bold
- 51. Be open
- 52. Build social value

- **Four Seasons Hotels & Resorts**

- 53. Supporting Sustainability
- 54. Building Communities
- 55. Advancing Cancer Research

# Core Values of Companies

- **Genentech**

56. Passion means we use our drive and commitment to energize, engage and inspire others.

57. Courage means we are entrepreneurial and thus take risks, reach beyond boundaries and experiment.

58. Integrity means we are consistently open, honest, ethical and genuine.

- 

- **Google**

59. Focus on the user and all else will follow.

60. It's best to do one thing really, really well.

61. Fast is better than slow.

62. Democracy on the web works.

63. You don't need to be at your desk to need an answer.

64. You can make money without doing evil.

65. There's always more information out there.

66. The need for information crosses all borders.

67. You can be serious without a suit.

68. Great just isn't good enough.

# Core Values of Companies

- **H&M**

- 69. We believe in people
- 70. We are one team
- 71. Straightforward and open-minded
- 72. Keep it simple
- 73. Entrepreneurial spirit
- 74. Constant improvement
- 75. Cost-consciousness

- **The Honest Company**

- 76. Create a Culture of Honesty
- 77. Make Beauty
- 78. Outperform
- 79. Service Matters
- 80. Sustain Life
- 81. Be Accessible
- 82. Pay it Forward
- 83. Fun!

# Core Values of Companies

- **IKEA**

- 84. Humbleness and willpower.
- 85. Leadership by example.
- 86. Daring to be different.
- 87. Togetherness and enthusiasm.
- 88. Cost-consciousness.
- 89. Constant desire for renewal.
- 90. Accept and delegate responsibility.

- **Kellogg's**

- 91. Integrity
- 92. Accountability
- 93. Passion
- 94. Humility
- 95. Simplicity
- 96. A focus on success



# Core Values of Companies

- **Nike**

- 97. It is our nature to innovate.
- 98. Nike is a company.
- 99. Nike is a brand.
- 100. Simplify and go.
- 101. The consumer decides.
- 102. Be a sponge.
- 103. Evolve immediately.
- 104. Do the right thing.
- 105. Master the fundamentals.
- 106. We are on the offense – always.
- 107. Remember the man. (The late Bill Bowerman, Nike co-founder)”

- 

- **Procter & Gamble**

- 108. Integrity
- 109. Leadership
- 110. Ownership
- 111. Passion for Winning
- 112. Trust

# Core Values of Companies

- **Rackspace**

- 113. Fanatical Support in all we do.
- 114. Results first, substance over flash.
- 115. Committed to Greatness
- 116. Full Disclosure and Transparency
- 117. Passion for our Work
- 118. Treat fellow Rackers like Friends and Family

- 

- **Southwest Airlines**

- 119. Work Hard
- 120. Desire to be the best
- 121. Be courageous
- 122. Display urgency
- 123. Persevere
- 124. Innovate
- 125. Follow The Golden Rule
- 126. Adhere to the Principles
- 127. Treat others with respect
- 128. Put others first
- 129. Be egalitarian
- 130. Demonstrate proactive Customer Service
- 131. Embrace the SWA Family
- 132. Have FUN
- 133. Don't take yourself too seriously
- 134. Maintain perspective
- 135. Celebrate successes
- 136. Enjoy your work
- 137. Be a passionate Teamplayer
- 138. Safety and Reliability
- 139. Friendly Customer Service
- 140. Low Cost

-

# Core Values of Companies

- **SquareSpace**

- 141. Be your own customer
- 142. Empower individuals
- 143. Design is not a luxury
- 144. Good work takes time
- 145. Optimize towards ideals
- 146. Simplify

- **Starbucks Coffee**

- 147. Creating a culture of warmth and belonging, where everyone is welcome.
- 148. Acting with courage, challenging the status quo and finding new ways to grow our company and each other.
- 149. Being present, connecting with transparency, dignity and respect.
- 150. Delivering our very best in all we do, holding ourselves accountable for results.

# Core Values of Companies

- **Teach for America**

- 151. Transformational Change
- 152. Leadership
- 153. Team
- 154. Diversity
- 155. Respect and Humility

- **Twitter**

- 156. Grow our business in a way that makes us proud.
- 157. Recognize that passion and personality matter.
- 158. Communicate fearlessly to build trust.
- 159. Defend and respect the user's voice.
- 160. Reach every person on the planet.
- 161. Innovate through experimentation.
- 162. Seek diverse perspectives.
- 163. Be rigorous. Get it right.
- 164. Simplify.
- 165. Ship it.

# Core Values of Companies

- **Virgin Airlines**

166. We think customer

167. We lead the way

168. We do the right thing

169. We are determined to deliver

170. Together we make the difference

- **Warby Parker**

171. Treat customers the way we'd like to be treated.

172. Create an environment where employees can think big, have fun, and do good.

173. Get out there.

174. Green is good.

# Core Values of Companies

- **Yahoo!**

- 175. Excellence
- 176. Innovation
- 177. Customer Fixation
- 178. Teamwork
- 179. Community
- 180. Fun

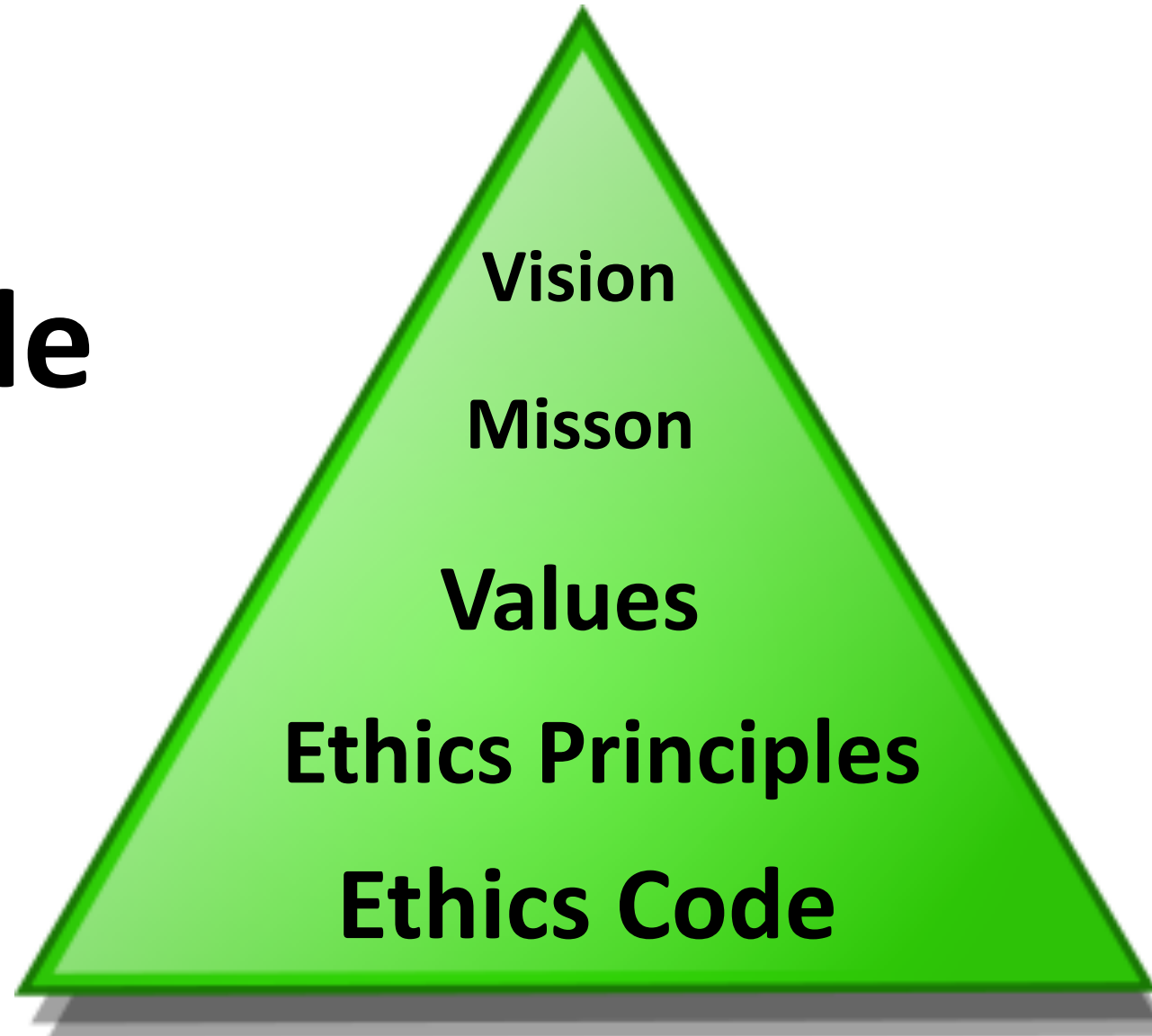
- **Zappos**

- 181. Deliver WOW Through Service
- 182. Embrace and Drive Change
- 183. Create Fun and A Little Weirdness
- 184. Be Adventurous, Creative, and Open-Minded
- 185. Pursue Growth and Learning
- 186. Build Open and Honest Relationships With Communication
- 187. Build a Positive Team and Family Spirit
- 188. Do More With Less
- 189. Be Passionate and Determined
- 190. Be Humble

# Values most commonly listed by 50 banks

- 1. Integrity – 34 banks
- 2. Teamwork – 15 banks
- 3. Excellence – 11 banks
- 4. Commitment – 10 banks
- 5. Honesty – 10 banks
- 6. Respect – 10 banks
- 7. Service – 10 banks
- 8. Professionalism – 8 banks
- 9. Customers – 7 banks
- 10. Trust – 6 banks
- 11. Community – 6 banks
- 12. Loyalty – 6 banks
- 13. Innovation – 5 banks
- 14. Responsibility - 5
- 15. Do the Right Thing - 4

# **Ethics Code Triangle**





ES&G  
Environmental,  
Social &  
Corporate Governance



# Ethics Discipline

- 1. Determine **VISION**
- 2. Determine **MISSION**
- 3. Select **VALUES**
- 4. Choose **ETHICS PRINCIPLES**
- 5. Appoint a **Board of Directors Member** responsible from Ethics
- 6. Appoint an «**Ethics Manager**» (Ethics Officer)
- 8. Write an «**ETHICS CODE**»
- 9. Conduct «**ETHICS TRAINING**» for personnel
- 10. Perform «**ETHICS COMPLIANCE AUDIT**» (internal & external audit)
- 11. Get «**ETHICS COMPLIANCE AUDIT REPORT**» take actions to comply with company's Ethics Code

# Ethics and Law

	Ethical	Unethical
Legal	Case 1	Case 2
Illegal	Case 3	Case 4

# Ethics and Law

- The law is a rather **crude instrument** that is **not** suited for **regulating all aspects** of financial activities.
- A moral rule «**Be fair!**» or a standard of suitability may be more effective than a precise legal rule of the form «**Do such-and-such**».
- Precise rules can often be «**gamed**» to produce unfair results. (tax shelter)
- The law often develops as a **reaction** to activities that are considered to be unethical.
- Obeying the law is **insufficient** for managing an organization or for conducting business because **customers**, employees and other stakeholders **demand ethical treatment**.

# Financial Markets

- The first obligation or duty in any market exchange is to **abide by the agreements** made. (keep your promise)
- Failures to abide by agreements or contracts in market exchanges results in nonperformance or **breach** of contract. (default)
- The parties can also **take advantage** of any **ambiguity** or **omission** in an agreement or contract to advance their own interests.
- All market exchanges are **governed by** a general prohibition against **force** and **fraud**.
- Many of the rules and expectations for markets are concerned with **fairness**.
- Market exchange between two parties often have **third party effects**. They affect others who are not parties to a transaction.

# Financial Services - Financial Intermediaries

## Types of Banks

- Commercial Banks
- Investment Banks
- Merchant Banks
- Islamic Banks (participation banks)
- Development Banks
- Off Shore Banks
- Special Purpose Banks

# Financial Services - Financial Intermediaries

## Non Bank Financial Institutions

- Factoring
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- Pension Funds
- Brokerage Houses
- Consumer Finance
- Islamic Finance
- Venture Capital Finds
- Investment Funds
- Mutual Funds
- Mortgage Funds
- Foreign exchange offices
- Money transfer companies
- Real Estate Property Funds

# Financial Services

- Financial products that that firms offer should meet certain **standards of integrity**. These **products** should:
- fit people's needs
- be financially sound
- marketed in a responsible manner
- be fairly priced
- offer good value
- suitable for the buyer



# Financial Services

- **Firms should avoid:**
- false, misleading, deceptive claims
- unfair pricing
- conflict of interest
- to abuse the trust invested in them
- betraying customers
- communication with customers that may contain omissions & interpretations that give a misleading Picture of the truth.

# Financial Services

- **Firms should disclose:**
- relevant information
- level of risk
- correct cost of each service & product

# Financial Services

- **Firms have a duty:**
- to safeguard customer assets & wealth
- to execute customer instructions promptly and accurately
- to execute customer payments faithfully
- to use the necessary skills and knowledge in serving the customer

# Financial Management

- **BOB** - Board of Directors
- **CEO** - Chief Executive Officer (Chief Ethics Officer)
- **CFO** - Chief Financial Officer
- **CRO** - Chief Risk Officer
- **CTO** - Chief Technology Officer
- **CIO** - Chief Informations Officer
- **COO** - Chief Operations Officer
- **CAO** - Chief Audit Officer

# Financial Management

- **2002 Sarbenes-Oxley Act** (section 406)
- Companies should adopt a **code of ethics** for senior financial officers to promote:
- (1) honest & ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships.
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer.
- (3) compliance with applicable governmental rules & regulations.

# Financial Management

- **Main ethical matters that arise for CFO:**

- Fraud
- Accurate Accounting
- Accurate Reporting
- Conflict of Interest
- Insider Trading

# Key elements of Ethics can be expressed as 6 Questions

- **The key elements of Ethics can be expressed as 6 Questions:**
- 1. **Welfare:** Is anyone being harmed, & if so, can the harm be justified
- 2. **Duty:** What is my duty or obligation in this situation?
- 3. **Rihgts:** Are anyone's rights being violated, & if so, can the violation be justified?
- 4. **Justice:** Is everyone being treated fairly or justly?
- 5. **Honesty:** Am I being entirely honest in my action?
- 6. **Dignity:** Am I showing respect for all persons involved?

# Force, Coercion, Fraud

- **Force**
- In a perfect market there is no place for force or coercion.
- **Coercion** is defined as inducing a person to choose an undesirable alternative under some threat, and such an action is not necessarily wrong as long as no right is violated.
- **Fraud**
- Wrongful or criminal deception intended to result in financial or personal gain.



# Market Ethics principles

- **Market Ethics principles:**
- Do not lie
- Do not steal
- Keep your promises
- Abide by agreements made (breach of contract)
- Do not force customers to make financial decision. Let them use their freedom & liberty to make their own choices.
- Do not threaten customers for a decision or choice
- Do not violate the rights of customers

# Market Ethics Principles

- **Market Ethics Principles:**
- Do not hide important information from customers
- Do not mislead customers by incorrect information
- Do not confuse customer's mind by technical or sofisitcaed explanations
- Always protect the customer's welfare, assets and reputation
- Tell the truth
- Show due care to customers
- Do not harm the customer

# Agents, Fiduciaries, Professionals

- **Agents, Fiduciaries, Professionals**
- An **Agent** is a party that has been engaged to act on behalf of another, called the **Principal**.
- A **Fiduciary** is a person or organization that has been entrusted with the care of another's (**Beneficiary**) property or assets and that has a responsibility to exercise discretionary judgement in this capacity solely in this other persons' interest.
- **Professionals** are individuals who are working in financial institutions and providing financial services to their customers.

# Fundamentals of Finance Ethics

- **Duties of Agents & Fiduciaries**
- **Violation of an Agent's duty:**
  - To use principal's property, assets or information for personal gain. **(self-dealing)**
  - To do «**Insider's Trading**»
  - Personal use of confidential information gained in an agency or fiduciary relationship
  - It is wrong for a fiduciary to gain some personal benefit, even if the beneficiary is not harmed.

# Fundamentals of Finance Ethics

- The **duty of a fiduciary** is to **act solely in the interest of the beneficiary** within the scope of the relationship **without gaining** any material **benefit** except with the knowledge and consent of the beneficiary.
- The fiduciary relationship has two elements: 1) **Trust** & 2) **Confidence**
- **A Fiduciary relationship** can be **created** by a **contract**, as when one person (called **Trustor**) creates a trust & another agrees to be a «**Trustee**» who manages the trust.

# The 3 elements of Fiduciary Duty

- **The 3 elements of Fiduciary Duty:**
- **1. Candor**
- Everyone has an obligation of **honesty** or **truth-telling**.
- It is wrong to **say something wrong**.
- It is wrong to make a **material misrepresentation**.
- Market actors are **not required** to **disclose all** information that others want to know.
- A fiduciary has a **duty of candor**. Extensive obligation **to disclose information** that the beneficiary would consider relevant to the relationship.
- The director of a company would fail in a fiduciary duty by **remaining silent** about a matter that is critical to a decision under discussion.

# The 3 elements of Fiduciary Duty

- **The 3 elements of Fiduciary Duty:**
- **2. Care**
- A fiduciary should manage what is entrusted with **due care**.
- **Due Care** is the care that a reasonable , prudent person would exercise.
- A fiduciary is expected not to act **negligently**.
- A fiduciary has a duty to act **in all matters** with a **high level of care**.

# The 3 elements of Fiduciary Duty

- **The 3 elements of Fiduciary Duty:**
- **3. Loyalty**
- A duty of Loyalty has 2 aspects:
  - 1) It requires a fiduciary **to act** in the interest of the beneficiary &
  - 2) **To avoid** taking any **personal advantage** of the relationship



# Duty of Agents & Fiduciaries

- Another important **duty of** both **Agents & Fiduciaries** is to maintain «**Confidentiality**».
- Agents & Fiduciaries have access to **sensitive, privileged** information of the beneficiary.
- Agent or Fiduciary provides assurances that the information will be held in confidence & used only for the purpose for which it was provided.
- Agent or Fiduciary have a duty **to avoid** «**Conflict of Interest**»

## 3 Features of a Profession:

- **3 Features of a Profession:**
- 1) A **specialized body of knowledge**
- Professionals possess a high developed technical body of knowledge that requires years of training to acquire.
- 2) A high degree organization & self-regulation
- 3) A commitment to public service

## 3 Features of a Profession:

- **3 Features of a Profession:**
- **2) A high degree organization & self-regulation**
- Professionals have considerable **control over their work** & largely through Professional Organizations,
- They are able to **set standards for practice** & to discipline members who violate them.
- The standards of profession include both «**Technical Standards**» & «**Ethical Standards**»
- Ethical Standards are presented in a «**Code of Ethics**» «**Ethics Code**». A CoE is the 1st step taken by an occupational group that is seeking recognition as a profession.
- A Code of Ethics is **not an option**, it is required by the nature of professionalism itself.

## 3 Features of a Profession

- **3 Features of a Profession:**
  - 1) A specialized body of knowledge
  - 2) A high degree organization & self-regulation
  - 3) A **commitment to public service**
- The knowledge possessed by professionals serve some important social need.
- Professionals are committed to using their knowledge for the benefit of all.

# Conflict of Interest

- **Conflict of Interest**
- A Conflict of Interest occurs when a personal or institutional **interest interferes with the ability of** an individual or institution **to act in the interest of another party** , when the individual or institution has an ethical or legal **obligation to act** in that **other party's interest**.
- **Conflict of Interest** a situation in which a person is in a position to **derive personal benefit** from **actions** or **decisions** made in their **official capacity**.

# Conflict of Interest

- **Actual Conflict of Interest**
- ACI occurs when an individual or institution acts against the interest of a party whose interest that individual or institution is pledged to serve.
- **Potential Conflict of Interest**
- PCI is a situation in which an actual conflict of interest is likely to occur.

# Conflict of Interest

- **Personal Conflict of Interest**

- A lawyer who stands to benefit personally by acting against the interest of a client is a PCI.

- **Impersonal Conflict of Interest**

- A lawyer who has two client with opposed interests faces a COI which is ICOI. (two masters problem)
- How will a broker allocate a profitable security which is in short supply between his customers? Who to favour?
- How to share the important market-moving information with clients? First with large clients?

# Conflict of Interest

- **Individual Conflict of Interest**

- An individual who acts as an agent & assumes fiduciary duties can fail to serve the interests of a principle or the beneficiary of a trust even when no individual is at fault.
- Can an agent use the confidential information of his client & share it with others? (confidential information)
- «**Chinese Walls**» can be built in the company to prevent the flow of confidential information.

- **Organizational Conflict of Interest**

- One department in an organization shares the confidential information of its client with another department.



# Managing (Avoiding) Conflict of Interest

- **How to manage (avoid) Conflict of Interest:**
- **Disclosure & Transparency**
- Disclosure of **adverse interests** (politicians disclose their investment holdings)
- Detailed disclosure of transactions with «**Affiliated Persons**»
- Disclosure of **performance data** of all kinds, including level of risks
- Disclosure (announcing) of policies & procedures in advance
- Sometimes disclosure may worsen the conflict of interest if the agent uses this as an excuse saying that the other party is warned.  
Rationalisation of the behaviour that generates COI.

# Managing (Avoiding) Conflict of Interest

- **How to manage (avoid) Conflict of Interest:**
- **Rules, Policies & Procedures**
- Establish well written «**Ethics Code**», **Policies & Procedures** Manuals
- Specific rules, policies & procedures serve to reduce COI by prohibiting conduct that constitutes or facilitates conflicts.
- Broad (general, vague) rules & policies for financial companies are likely to be less effective than finely crafted ones.
-

# Managing (Avoiding) Conflict of Interest

- **How to manage (avoid) Conflict of Interest:**
- **Structural Changes:**
- COI in financial organizations result from **combining** different functions **in one firm**.
- COI in financial organizations result from **combining** different functions in **one single department**.
- COI in financial organizations result from **combining** different functions in **one single manager**.

# Managing (Avoiding) Conflict of Interest

- **How to manage (avoid) Conflict of Interest:**
- **Structural Changes:**
- Separate the functions of Trust Management & Commercial Banking
- Separate the functions of Underwriting & Investment Advising
- Separate the functions of Retail Brokerage & Principal Trading
- Build «Chinese Wall» to create impermeable barriers between functional units
- Seek Independent Judgement from outside the financial company (independent trustees on the Boards of Mutual Funds, independent appraisers, independent proxy advisors)

# Managing (Avoiding) Conflict of Interest

- **How to manage (avoid) Conflict of Interest:**
- **Other Measures:**
- **Training** of personnel about COI with specific case studies.
- Internal & External **Audit** of COI matters in the company.
- Establish **Committees** to decide for important matters in the company.
- **Share** important decisions of the company with personnel.
- Establish «**Approval Limits**», «**Transaction Limits**» for management.
- Establish «**Ethics Red Line**» to report COI.
- Appoint «**Ethics Officer**» to consult on COI & resolve COI problems.

# Ethics & the Retail Customer

- In serving Retail Customers financial services industry relies heavily on «**Personal Selling**».
- Personal Selling generates opportunities for **abuse**.
- Customers who are unhappy **blame the seller** of the product, sometimes **unfairly**.
- There are «**Bad Apples**» in every industry.
- **Unethical sales practices** in financial industry damaged the reputation of banks & other financial institutions. (deception, manipulation, concealment, churning, abuse)

# Deception & Concealment

- A person is deceived when that person **holds a false belief** as a result of some **claim made by another**.
- The claim may be either **false** or **misleading statement**. A statement that is **incomplete** in some crucial way.
- Regulators employ a **three-factor test** for deception:
  - 1) How **reasonable** is the person who is deceived? A customer of ordinary intelligence & knowledge would draw a mistaken conclusion from a claim.
  - 2) How **easily** could a person **avoid** being deceived? A customer may check dollar rate from internet, central bank site, tv, newspaper, etc.
  - 3) How **significantly** is the person **harmed** by the deception? A misleading statement that leads to a trivial loss. Deception that would lead a person to suffer a significant financial loss or some other grave harm.

## 1) How **reasonable** is the person who is deceived?

- Some people are more easily deceived than others.
- Some claims could mislead only a few.
- Regulations may seek to **protect** even the **most ignorant** consumer.
- «**Reasonable Person Standard**».
- Ask yourself this **question**.
- «My a customer of **ordinary intelligence & knowledge** would draw a **mistaken conclusion** from a **claim**?»



## 2) How **easily** could a person **avoid** being deceived?

- Some information is widely available. Available everywhere. (TV, Newspaper, Web Sites, Competitors)
- Customer need not obtain that information only from the financial company.
- Some information is only available from the financial company.
- Fees, commission rates, Value Date implementation, of the financial company.
- Such information that can only be reached from the financial company is critical. If there is deception of such information the customer can not easily avoid it & may be harmed as a result.

### 3) How **significantly** is the person **harmed** by the deception?

- Sometimes deception may lead a person to suffer a **significant** financial loss or some other grave harm.
- This is a greater concern to regulators than a misleading statement that leads to a **trivial loss**.
- **False & Misleading** claims are **morally** objectionable because they are forms of «**Dishonesty**».

# Concealment

- Concealment of information is more problematic.
- If the financial company **hides** from its customer an **important information** which may change the decision of the customer how can the customer discover this before any harm is generated?
- Whether a claim is false or misleading **a matter of fact.**
- Whereas what information ought to be revealed & not revealed involves a value judgement. This is not an easy & straightforward judgement.
- This concealment behaviour sometimes may **not be dishonest** but is certainly **unfair.**
- Economic exchanges are generally **considered to be fair** if each party makes a **rational choice** or at least **has the opportunity to make** a rational choice.

## Economic Rationality

- In short, **economic actors** are assumed to be **egoistic utility maximizers**.
- The concept of «**Economic Rationality**» presupposes that:
  - 1. Both the Buyer & the Seller are **capable of making** a rational choice.
  - 2. Both the Buyer & the Seller have **sufficient information** to make a rational choice.
- Neither the Buyer nor the Seller is **denied the opportunity** to make a rational choice.

## Responsibility to Protect

- What is the **obligation of** broker's, agent's, or other salespersons in finance **to protect the interests of** those who buy financial products?
- It can range from «**Caveat Emptor**» (let the buyer beware) to «**Paternalism**».
- The **focus** of a seller's obligation is **on the product** itself & **on the way** in which it is **presented**.
- The **decision to buy** is left & the typical **seller** has **no obligation** to ensure that the **buyer** makes a **wise choice**.
- An underlying **assumption** of the market system is that **buyers** are the **best judge** of their **own interests** & should be **free to make** their **own decisions** once they are **fully informed**.

## Ethics & the Retail Customer Responsibility to Protect Abuse

- What is «**Abuse**» in financial services?
- Abuse is unfair advantage-taking. Trying to get unfair benefit by a wrongdoing.
- What constitutes Abuse? A difficult to answer question. Each case should be analyzed differently (case by case approach).
- People are generally **more vulnerable** in making **investment decisions** than in making typical consumer purchases.
- Therefore **failure to protect the customer's interests** may be regarded as «**Abuse**» or «**Unfair Advantage-Taking**».

# Churning, Twisting, Flipping

- «**Churning**» is **Excessive** or **inappropriate trading** for a client's account by a broker who has control over the account, with the **intent to generate commission** rather than to benefit the client.
- «**Twisting**» is **persuading a policy holder** by an insurance agent, to **replace an older policy** with a **newer one** that provides **little** if any additional **benefits**, but **generates a commission** for the agent.
- «**Flipping**» is to **replace an existing loan** of a client by a bank officer, **with a new one** that usually **provides the customer** with some **additional cash**. By **numerous fees & charges** the client pays excessive cost for the sake of getting additional cash from the new loan.
- The **poor** are frequently **targets of other abuses** by **loan providers**.
- It is a **breach of a fiduciary duty to trade in ways that are not in a client's best interest**.

# Churning

- **Legal definitions** of «Churning» offered in court decisions are:
- «**Excessive trading** by a broker **disproportionate** to the size of the account involved, in order to **generate commissions.**»
- «A situation in which **brokers** , exercising control over the **frequency & volume of trading** in the customer's account **initiates transactions** that are **excessive** in view of the **character of the account.**»
- The **legal definition** of Churning contains **3 elements**:
- 1. The broker **controls** the account
- 2. The trading is **excessive** for the character of the account
- 3. The broker **acted with intent**



# Churning

- Many brokers who have the **authority to control** an account still **consult with** the client & **seek approval** for specific trades.
- A broker **may claim** that the **questionable trades** were made with the **knowledge & consent** of the client.
- Some brokerage firms seek to **cover themselves** by sending «**Comfort**» or «**Happiness**» **letters** when a broker's company notes **unusual trading activity**.

# Churning

- The most difficult issue in the definition of churning is the **meaning of «Excessive Trading»**.
- 1. Whether trading is excessive depends on the **character of the account**.
- A client who is a more **speculative investor**, willing to assume higher risk for a greater return, should expect a higher trading volume.
- 2. High volume is not the only factor; **pointless trades** might be considered churning even if the volume is relatively low.
- Examples are «**in-and-out**» trading or «**switching**» in which one stock is replaced by another with similar characteristics, & «**cross trading**» blocks of stocks are transferred between two similar accounts.

# Churning

- 3. Churning might be indicated by a **pattern of trading** that **consistently favors trade** that yield **higher commission**.
- Several attempts have been made **to quantify «Excessive Trading»**.
- **ATR Annualized Turnover Ratio** of a portfolio is used to quantify Excessive Trading. (Turnover TL/Value of Portfolio)
- **2-4-6 Rule**
- **ATR 2** = Possible Churning
- **ATR 4** = Churning is presumed
- **ATR 6** = Conclusive proof of churning

# Suitability

- **Salespeople** have an **obligation to recommend** to his client only **suitable** securities & financial products.
- **Suitability** is difficult to define precisely.
- A **legal suit** alleging **unsuitability** must meet **3 tests**:
  - 1. The broker has made a recommendation
  - 2. The security in question is unsuitable
  - 3. The broker has acted knowingly (with scienter)
- «Know Your Customer» requires a broker to use due diligence in learning the essential facts about a customer.

# Suitability

- The **recommendation** of an **unsuitable security** can be made out of **incompetence** or **negligence** rather than with fraudulent intent.
- The most common **causes of unsuitability** are. Recommending:
  - 1. Unsuitable **types** of securities (bonds vs stocks)
  - 2. Unsuitable **grades** of securities (low rate vs high rate)
  - 3. Unsuitable **diversification** (vulnerable to market changes)
  - 4. Unsuitable **trading techniques** (margin, option, swap, forward)
  - 5. Unsuitable liquidity (difficulty to liquidate the stock quickly)

## Credit Cards Ethical Concerns

- Ethical concerns with **Credit Cards**, as well as **Debit Cards**, are usually broad.
- 3 important ethical concerns of credit & debit cards:
  - 1. Transparency
  - 2. Fairness
  - 3. Social welfare

## Transparency

- Plastic Cards should be made available to consumers **with full, accurate disclosure** of relevant **information**.
- Interest rates
- Service fees
- Penalty fees
- Payment requirements
- Liability for unauthorized use
- Resolution of disputes
- Notification of changes
- Insurance details
- Treatment of lost or stolen card expenses

## Transparency

- All necessary **information** should be **clearly disclosed** in ways that can be **easily known & understood** by the card holder.
- The ethical principle is «**Transparency**»
- All necessary details (terms & conditions) are usually expressed fully in the **standard** credit or debit card **contract** (agreement).
- The main **problem of contracts** are **readability**. Lack of readability.
- The **ability of the card holder** to **read & fully understand** in detail all the terms & conditions mentioned in the card contract.
- **Card Issuers benefit** from **befuddled, ignorant** customers.



## Fairness

- In addition to ensuring that the terms of a card agreement are transparent, that is clearly known & understood, the **second requirement** is that **the terms** be «**Fair**».
- The typical credit **card agreement** raises questions of **fair treatment** (fair process) since they are presented to the applicant on a **take-it-or-leave-it** basis.
- Because of **imbalance of power**, an applicant has virtually **no opportunity to bargain** or **seek better terms** elsewhere.
- Different portions of a cardholder's balance often have different interest rates, & payments may be credited first to reduce the amount owed on portions that carry the lowest interest rate regardless of when this balance was incurred. Is this fair?

## Social Welfare

- The **third** factor that raises ethical concerns about credit cards is their **impact** on «**Social Welfare**».
- The **marketing** of credit cards to people who **cannot** handle **dept responsibility** may lead to:
  - individual health problems, such as anxiety & depression
  - to family discord resulting in divorce & child neglect
  - to lifelong financial instability from impaired credit history & lack of savings
- Installment facility for credit cards? Is it ethical

## Other Ethical Concerns for Credit Cards

- **Marketing credit cards to students**
- Students are victims of manipulation
- Marketing on campus (carnival atmosphere & free gifts)(freshman or fresh meat)
- Assessing creditworthiness
- **Rates & Fees**
- Banks follow the standard practice of maximizing their revenues from plastic cards.
- Bank's computers are programmed to enter transactions so as to maximize the number of overdrafts which creates the highest yield to the bank.
- Exchange rates used to convert credit card foreign exchange payments to TL?
- Cash Advance fees?
- ATM transaction fees on cards?

## Other Ethical Concerns for Credit Cards

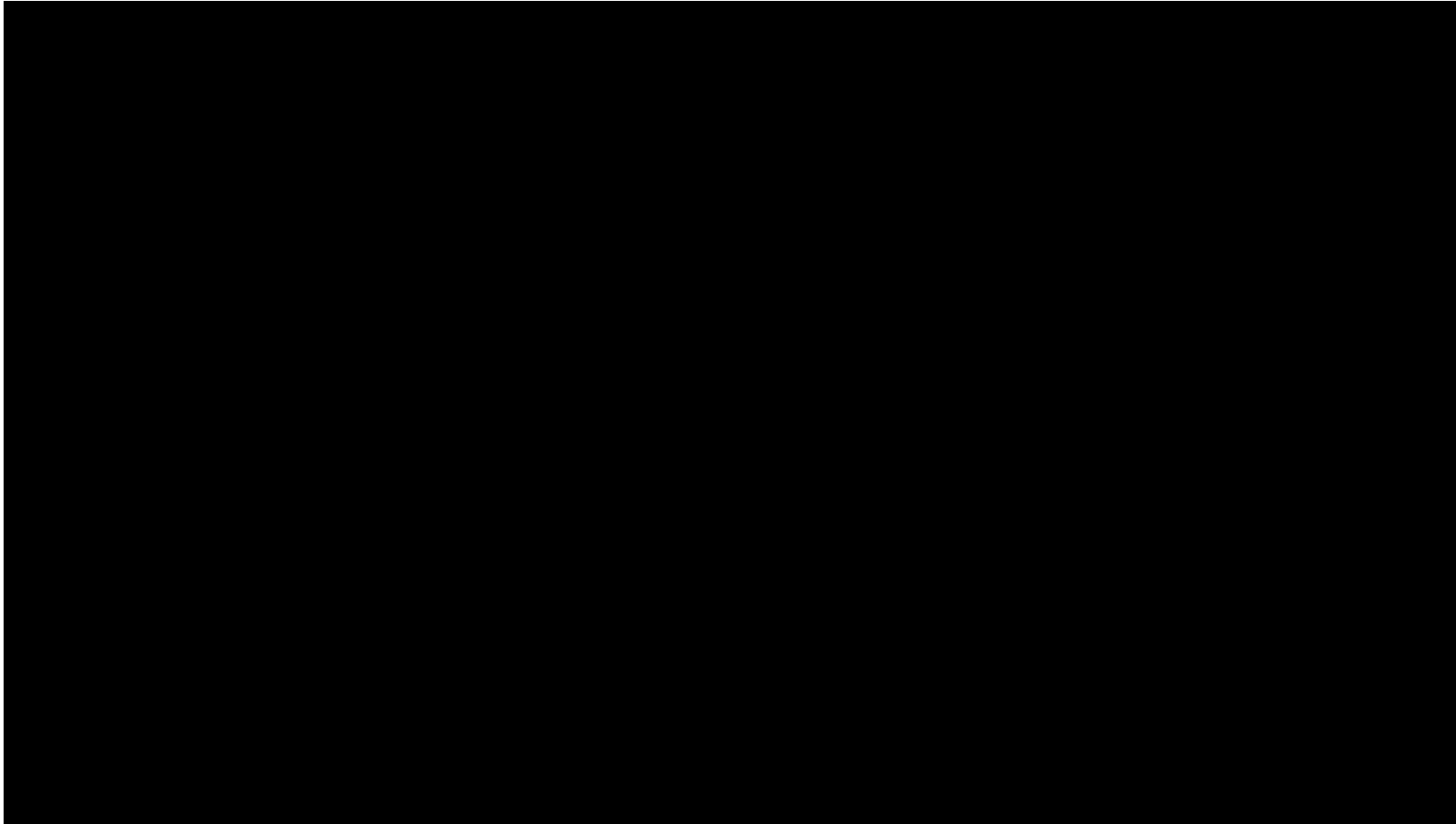
- **Rates & Fees**
- Credit card **campaigns**? To give incentives to poor customers to use their credit cards to end in payment difficulty. Is it ethical?
- To increase the credit **card limit** of a customer who can not pay?
- When to start **calculating interest** on credit cards? (purchase date, statement date, last payment date)
- **Annual fees** on credit cards?
- Applying high interest rate for **over-limit** card payments?

## Credit Cards Ethical Concerns

- Plastic Cards should be made available to consumers **without**
- **Deception**
- **Concealment**
- **Guile**

Ethics & the Retail Customer

# Mortgage Lending Ethical Issues



# **USA Subprime Loan Crises**

## **The Subprime Primer**

# Mortgage Broker Ofisinde

**At the Mortgage Broker's .....**

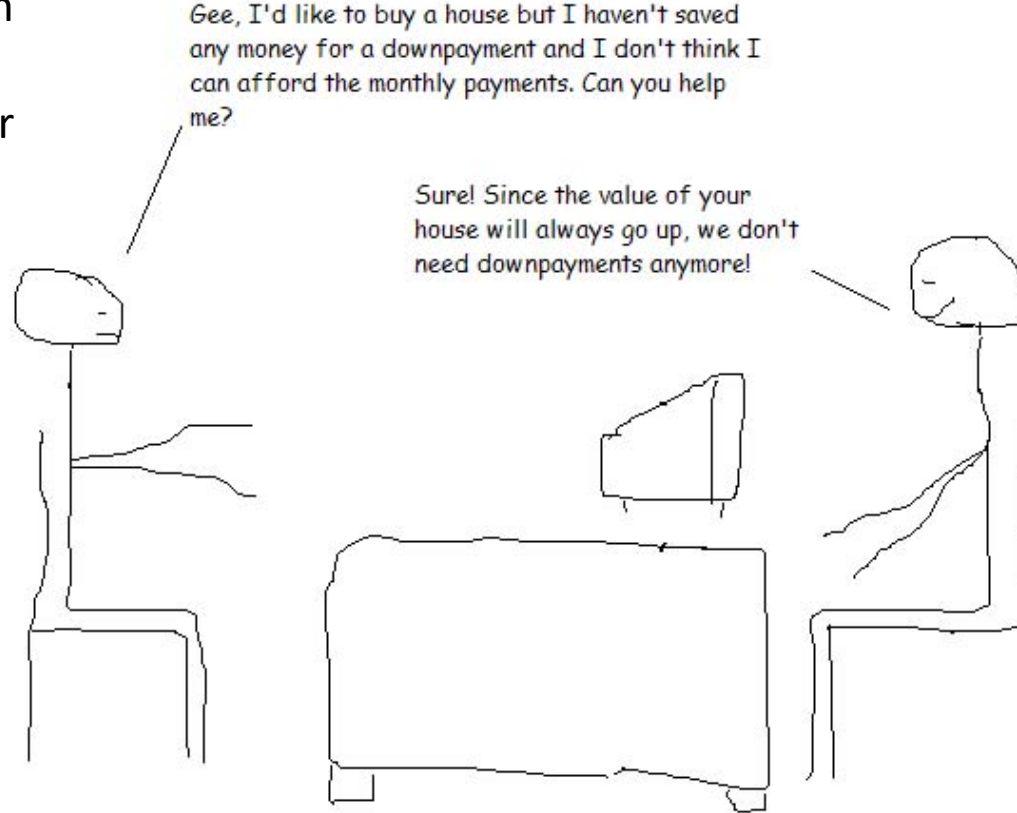


## Mortgage Broker Ofisinde – Hayallerinizi Gerçek Yaparız.

### Ace Mortgage Brokers

"We Make Your Dreams Come True"

Ev almak  
istiyorum ama ön  
ödeme yapacak  
birikimim yok. Bir  
de aylık taksit  
ödemelerini  
yapcak gücüm  
yok. Bana  
yardımcı olabilir  
misiniz?



Tabiki.  
Alacağınız  
evin değeri  
her zaman  
artacaktır. Ön  
ödeme  
yapmanıza  
artık gerek  
yok.

## Mortgage Broker Ofisinde – Hayallerinizi Gerçek Yaparız.

### Ace Mortgage Brokers

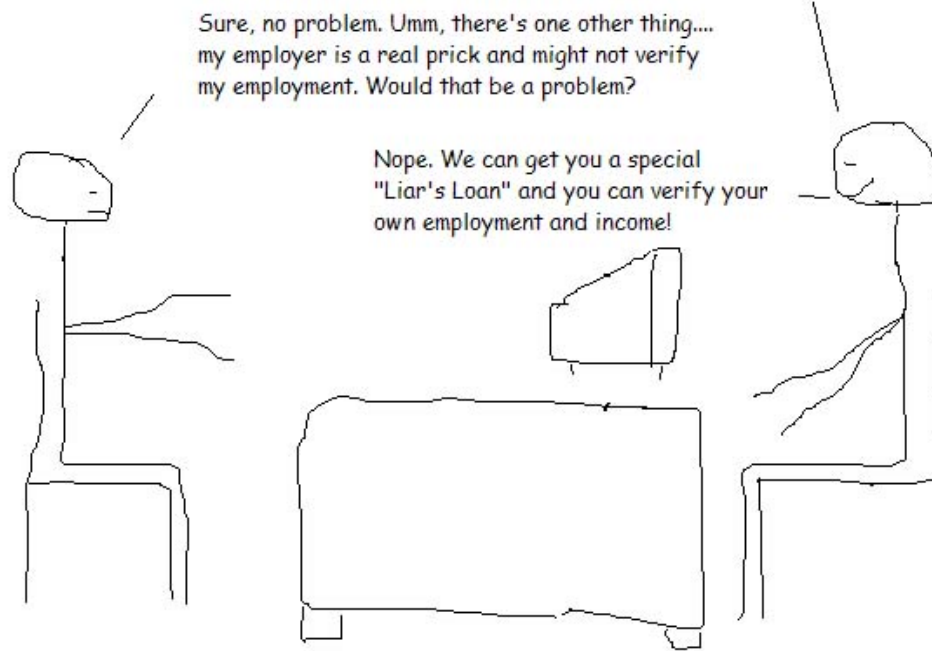
"We Make Your Dreams Come True"

And we can give you a really really low interest rate for a few years. We'll raise it later, okay?

Sure, no problem. Umm, there's one other thing... my employer is a real prick and might not verify my employment. Would that be a problem?

Nope. We can get you a special "Liar's Loan" and you can verify your own employment and income!

Olur. Sorun yok.  
Ancak bir şey  
daha var.  
Patronum biraz  
aksidir.  
Çalıştığımı size  
belgeleyemem.  
Bu bir problem  
olur mu?



Önden birkaç yıl size  
düşük faiz uyguluyoruz.  
Faiz oranını daha  
sonraki yıllarda arttırırız.  
Olur mu?

Sorun yok.  
Sizi özel  
"Beyana  
Dayalı Kredi"  
kategorisine  
sokarız.  
Kendi işinizi  
ve gelirinizi  
kendiniz  
beyan  
edersiniz.

## Mortgage Broker Ofisinde – Hayallerinizi Gerçek Yaparız.

## Ace Mortgage Brokers

"We Make Your Dreams Come True"

Şiz şahanesiniz.  
Benim gibilerle  
hakikaten  
çalışmak  
istiyorsunuz.

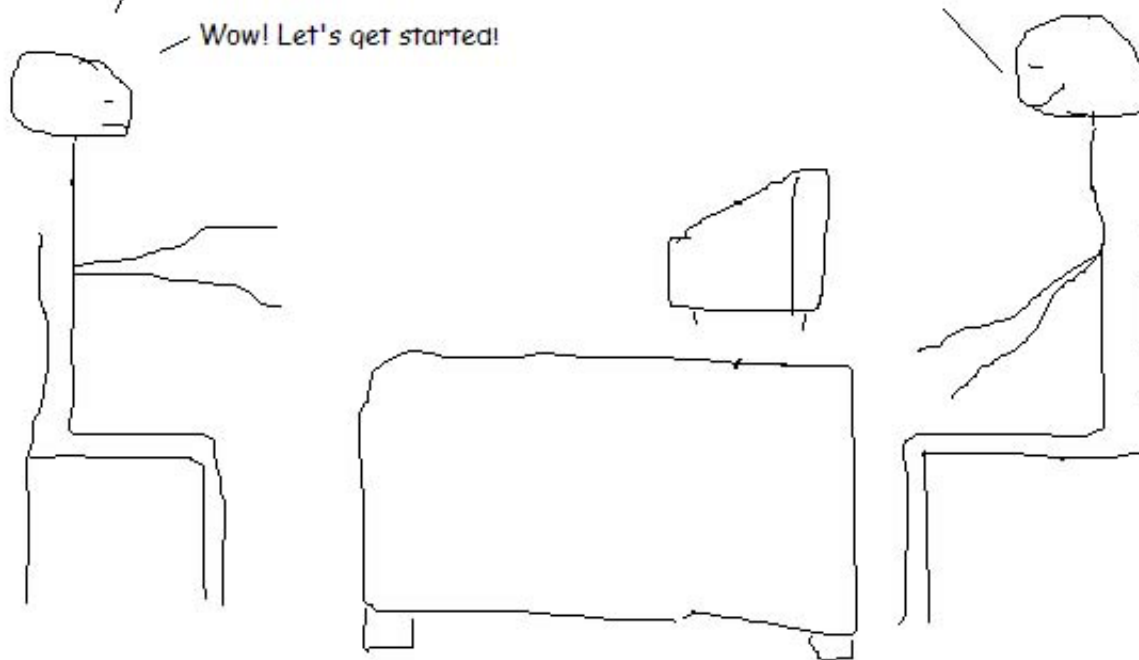
You guys are awesome! You are really willing to work with guys like me.

Well, we don't actually lend you the money -- a bank will do that -- so we don't really care if you repay the loan. We still get our commission.

Wow! Let's get started!

Hadi  
başlayalım  
o zaman.

Parayı size biz vermiyoruz ki. Banka verecek. O nedenle krediyi geri ödemişsiniz ödememişsiniz bizi ilgilendirmiyor. Biz her halukarda komisyonumuzu Bankadan alıyoruz.



**Birkaç hafta sonra Bankada . . . . .**

***A Few Weeks Later, at the Bank .....***

# First BANK'da – Yılbaşı Hesabınızı Bugün Açtırın

First Bank of Bankland, Inc

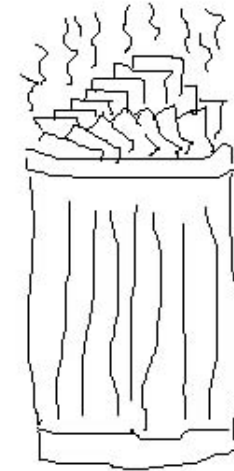
"Open Your Christmas Club Account Today"

Bu kötü kredilerden  
kurtulmam lazım.  
Bilançomu bozacak. New  
York'taki Yatırım  
Bankasındaki dahi  
arkadaşlar sağ olsun,  
bunları satın alacaklar.  
Sihirbaz bunlar.  
Hemen arıyayım.



I'd better get rid of these crappy mortgage loans. They are starting to stink up my office. Thankfully the really smart guys in New York will buy them and perform their financial magic! I'll call them right away!

NEW MORTGAGE  
FILE



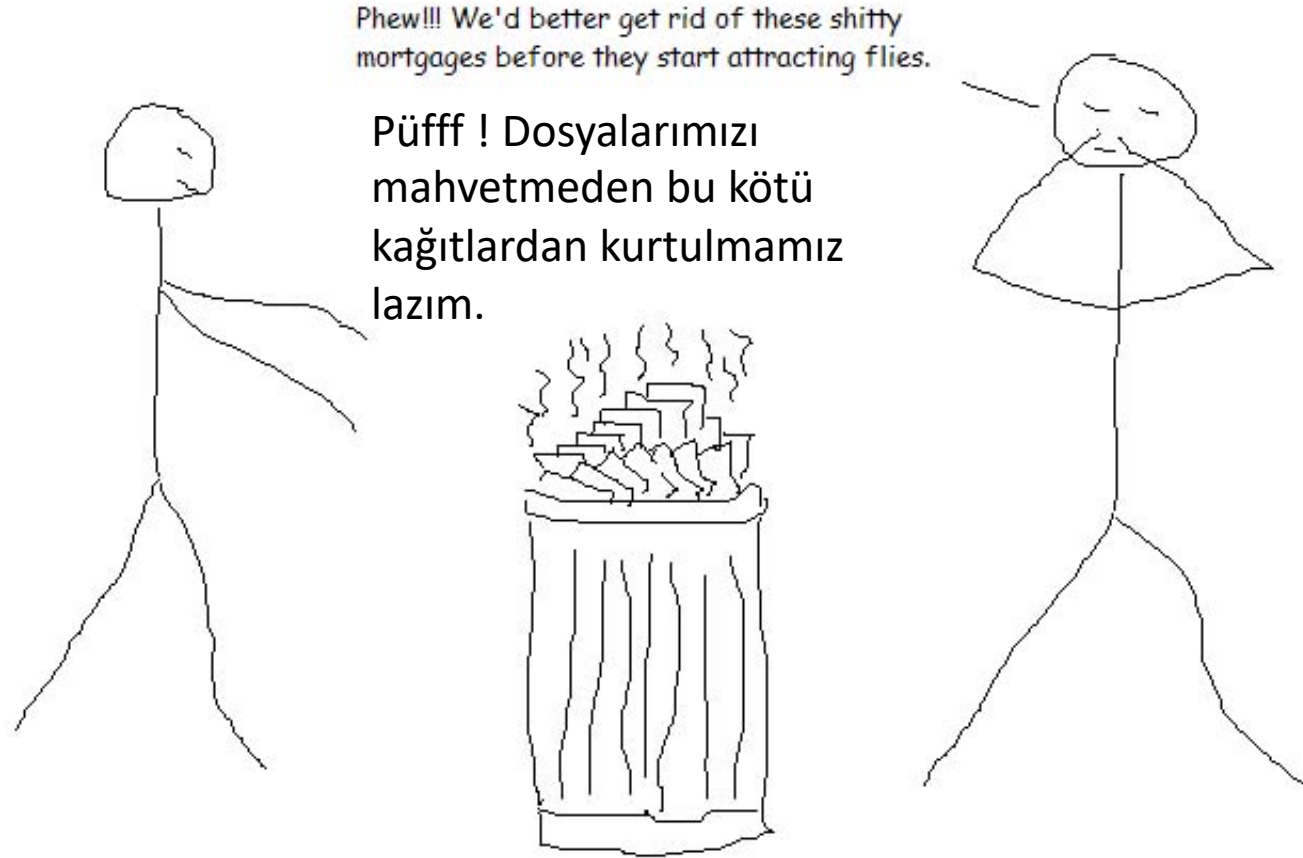
Mortgage  
Kredi  
Dosyaları

**Şimdi New York Yatırım Bankasındaki Zeki Çocuklar Ne  
Yapıyor Bakalım**

**Let's See What the Smart Guys Are Doing...**

## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"



## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

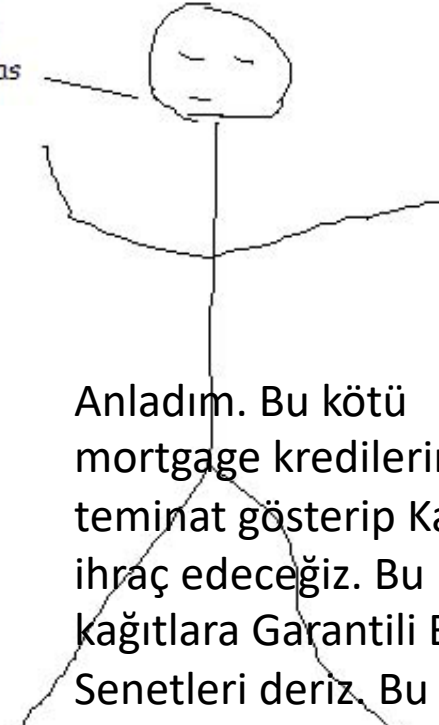
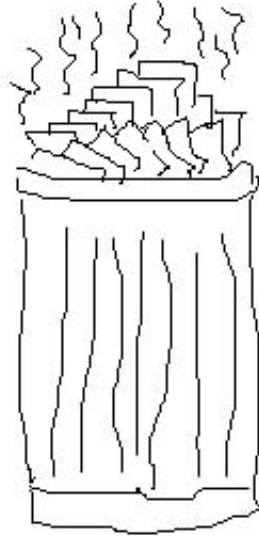
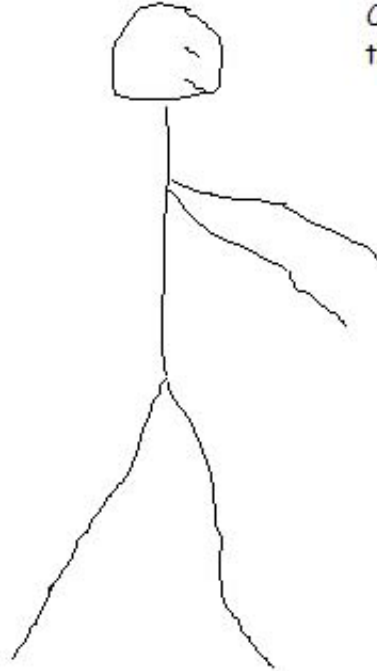




## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

I've got it! First We'll create a new security and use these crappy mortgages as collateral. We'll call it a CDO (or maybe CMO). We can sell that CDO to investors and promise to pay them back as the mortgages are paid off.



Anladım. Bu kötü mortgage kredilerini teminat gösterip Kağıt ihraç edeceğiz. Bu kağıtlara Garantili Borç Senetleri deriz. Bu kağıtları yatırımcılara satarız. Krediler ödendikçe paralarını alırlar.

## RSG Investment Bank of Wall Street

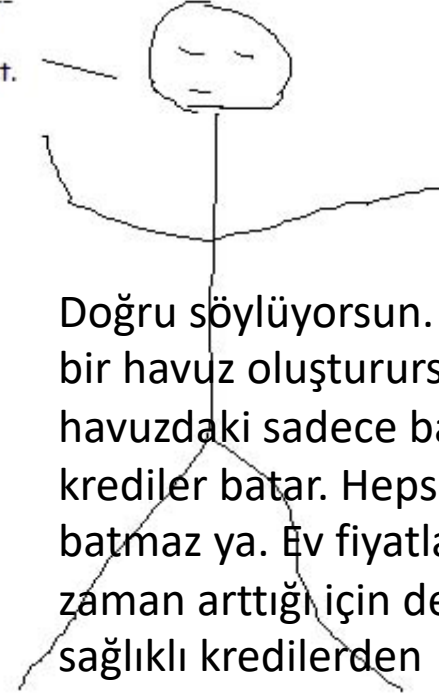
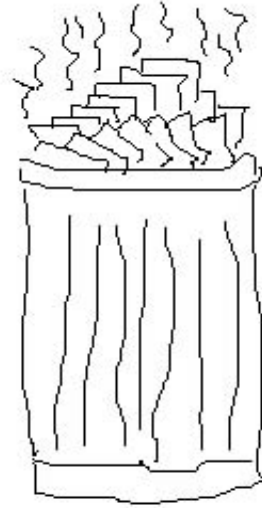
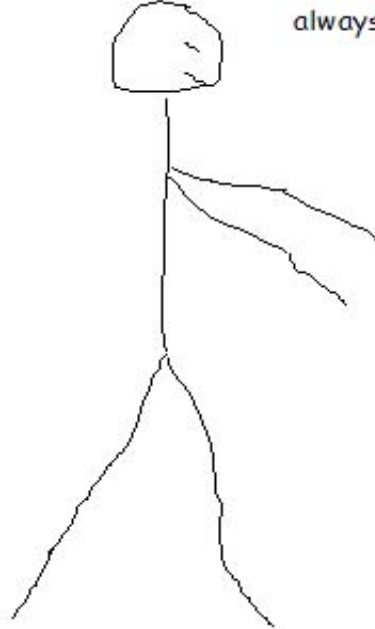
"Trust the 'Really Smart Guys' for All Your Investment Needs"



## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

Sure, individually these are pretty crappy loans, but if we pool them together only some of them will go bad -- certainly not all of them. And since housing prices always go up, we really have very little to worry about.

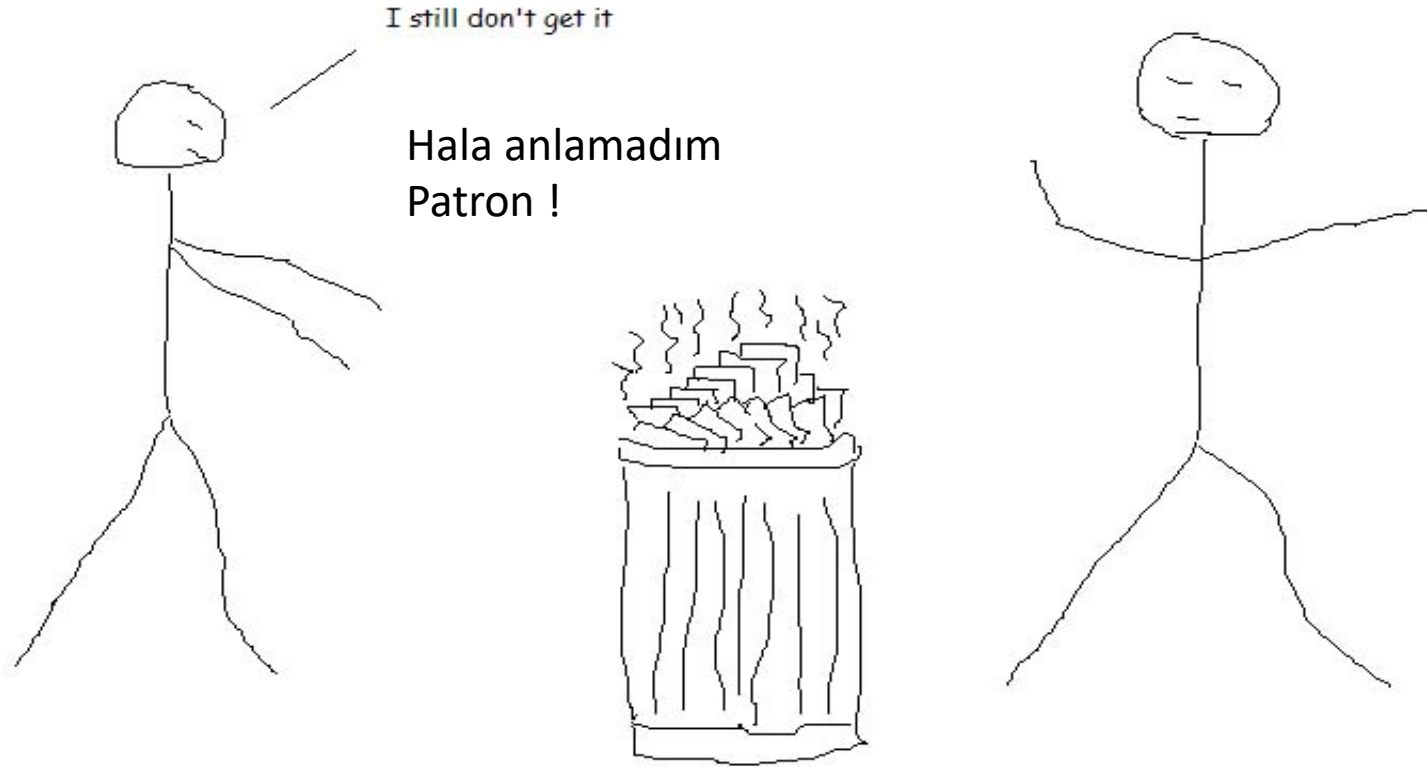


Doğru söylüyorsun. Ama bir havuz oluşturursak bu havuzdaki sadece bazı krediler batar. Hepsi batmaz ya. Ev fiyatları her zaman arttığı için de kalan sağlıklı kredilerden yapılacak tahsilatlar yeterli olur.

# RGS Yatırım Bankası – Tüm Yatırım İhtiyaçlarınız için Zeki Arkadaşlarımıza Güvenin

## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

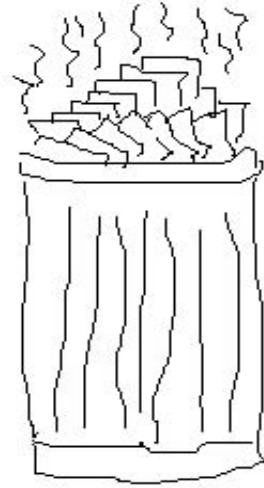
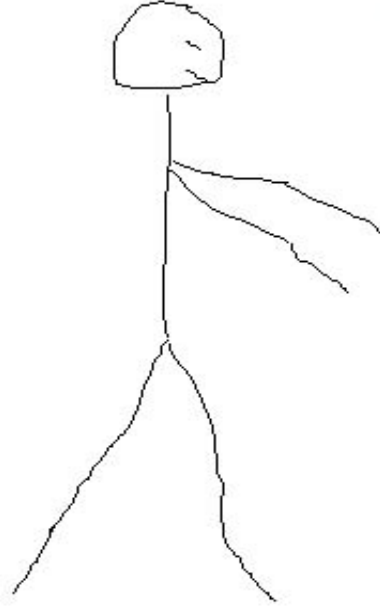


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The new CDO will work like this: It will be made up of three pieces (or "traunches") and we'll call them "The Good", "The Not-So-Good" and "The Ugly".

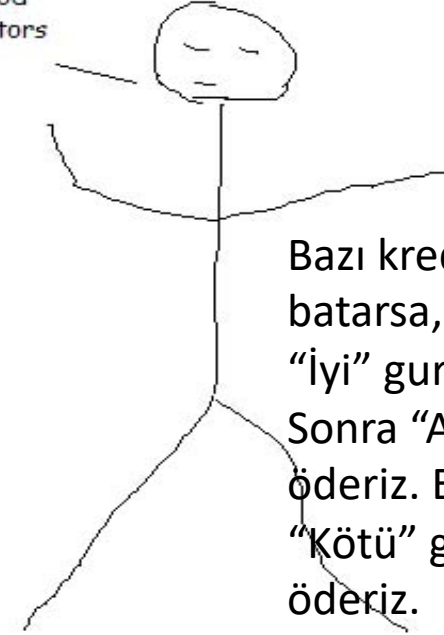
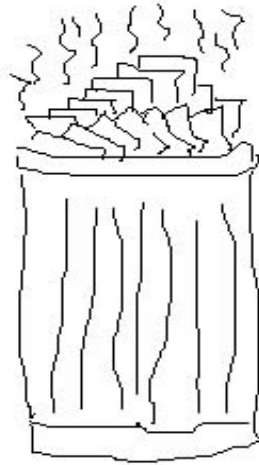
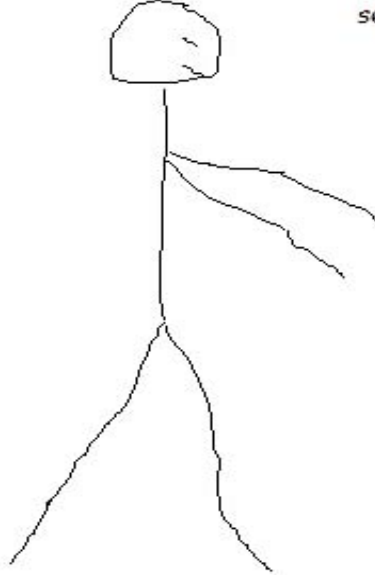


Garantili Borç Senedi  
şöyle işleyecek. Üç  
bölümden oluşacak.  
1.ciye "İyi" 2.ciye "Az  
İyi" 3.cüye de "Kötü"  
deriz.

## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

If some of the mortgages fail, as surely some might, we will promise to pay investors holding the "Good" traunch first. We'll pay the "Not-So-Good investors second, and the "Ugly" investors last.



Bazı krediler batarsa, biz önce "İyi" gurubu öderiz. Sonra "Az iyileri" öderiz. En son da "Kötü" gurubu öderiz.



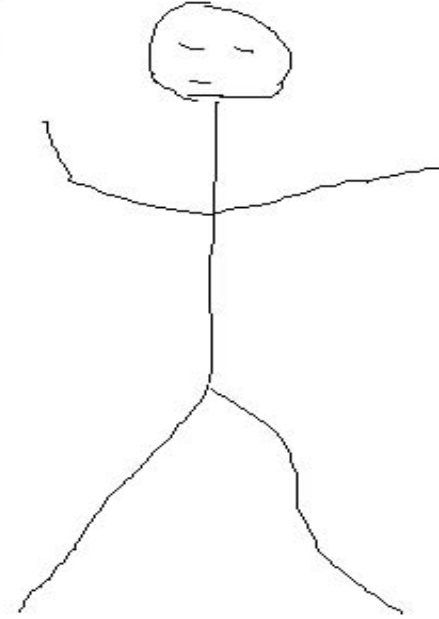
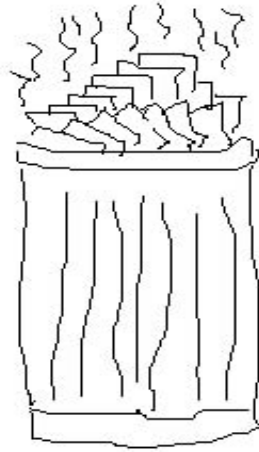
# RGS Yatırım Bankası – Tüm Yatırım İhtiyaçlarınız için Zeki Arkadaşlarımıza Güvenin

## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

I'm starting to get it. And because the "Good" investors have the least risk, we'll pay them a lower interest rate than the other guys, right? The "Not-So-Goods" will get a better interest rate and the "Ugly" guys will get a nice fat interest rate.

Anlamaya başladım galiba. "İyi" Gurubun riski az olduğu için onlara diğerlerinden az faiz öderiz. "Azıy" guruba biraz daha fazla faiz "Kötü" guruba da en yüksek faizi öderiz değil mi Patron?



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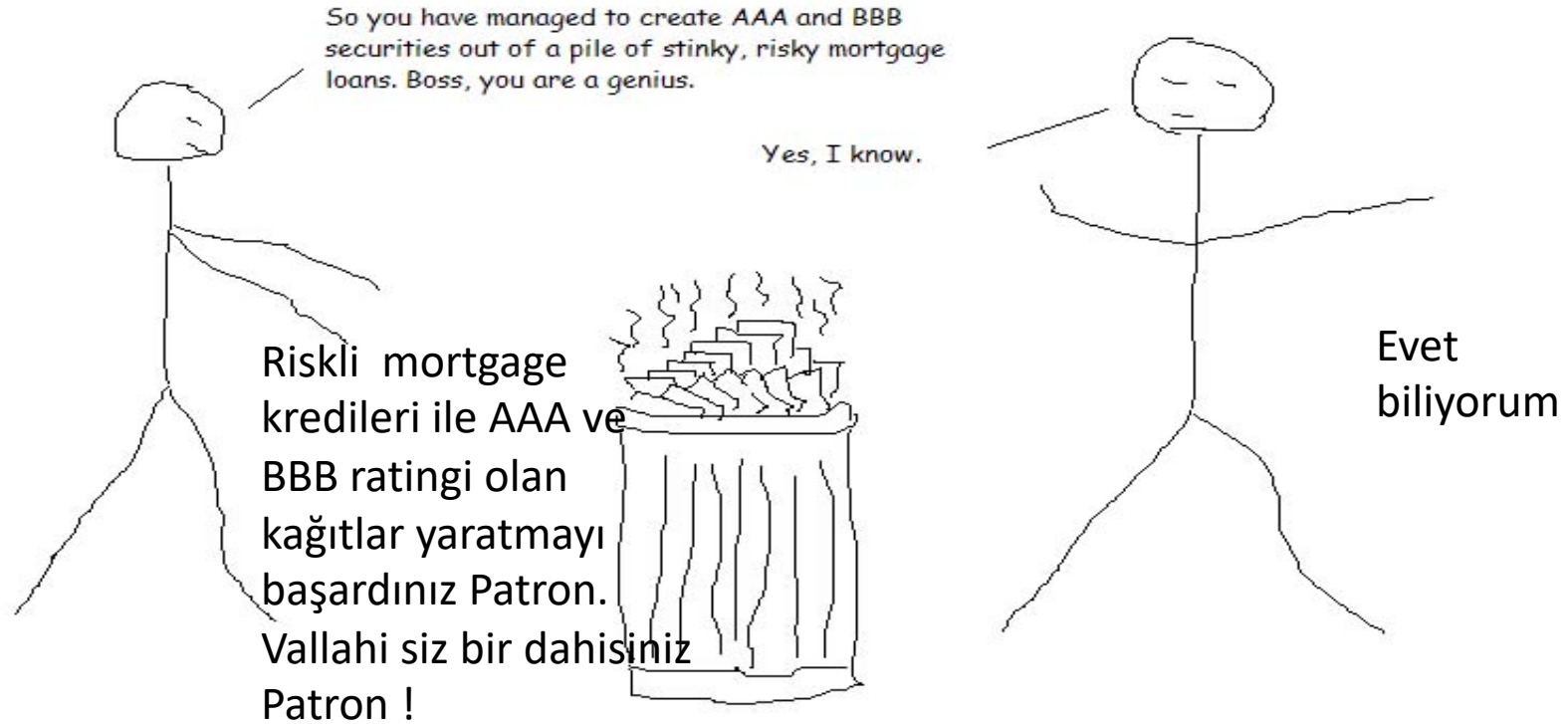




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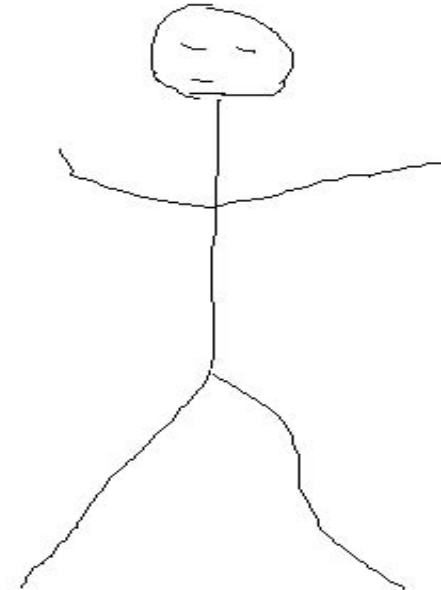
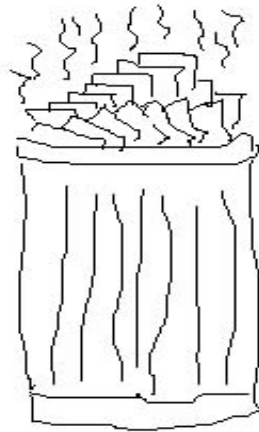
## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

Okay, now who are we going to sell  
the three pieces to?



Şimdi bu 3  
gurup kağıdı  
kime  
satacağz  
Patron?

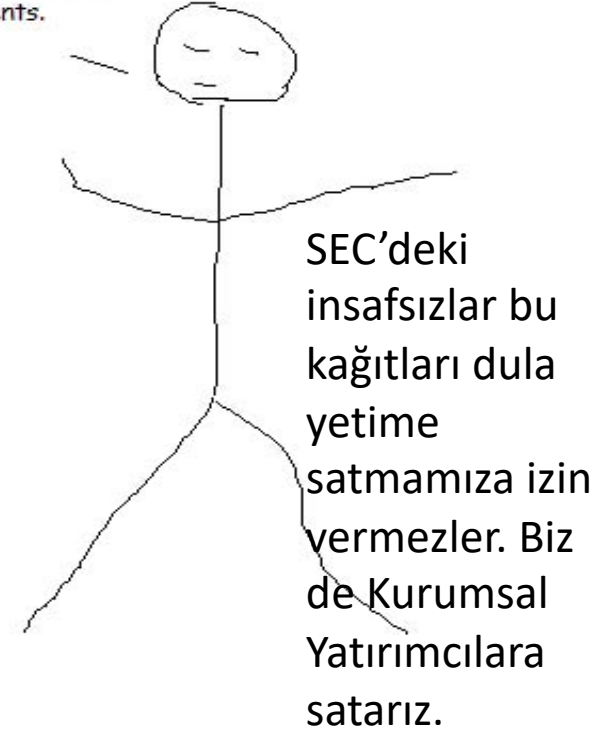
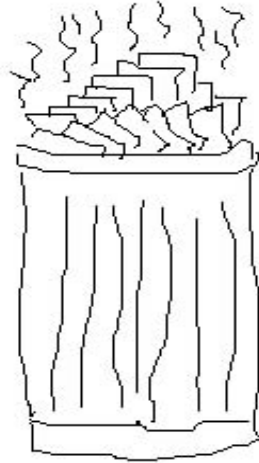
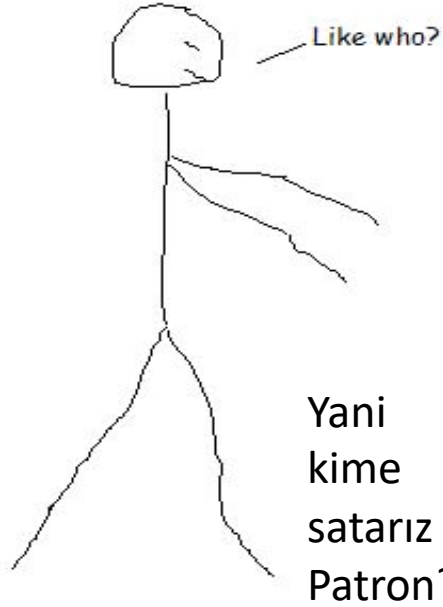


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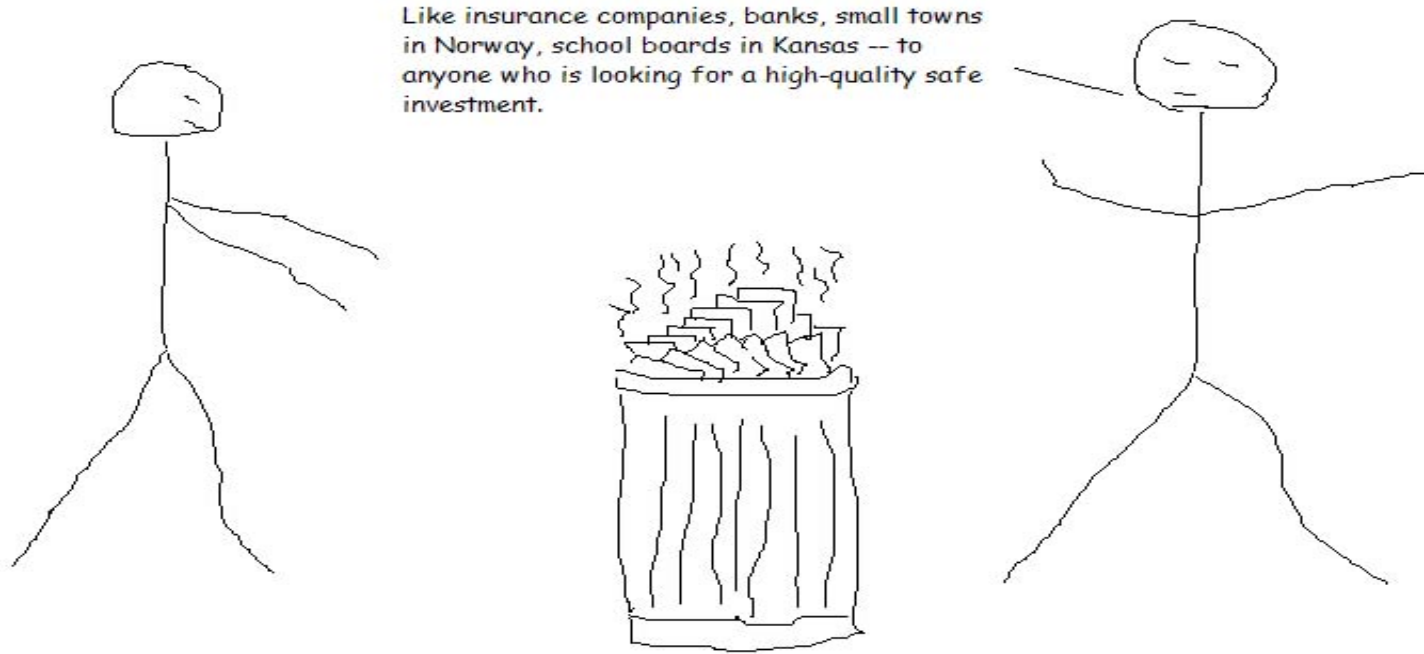
The assholes at the SEC won't let us sell this stuff to widows and orphans, so we'll sell it to our sophisticated institutional clients.



# RGS Yatırım Bankası – Tüm Yatırım İhtiyaçlarınız için Zeki Arkadaşlarımıza Güvenin

## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"



Sigorta Şirketlerine, Bankalara, Norveç'teki Kasaba Belediyelerine veya Fonlarına, Kansas'taki Okul Yönetimlerine, yüksek verim peşinde olan ve Güvenli yatırım isteyenlere satarız.

# RGS Yatırım Bankası – Tüm Yatırım İhtiyaçlarınız için Zeki Arkadaşlarımıza Güvenin

## RSG Investment Bank of Wall Street

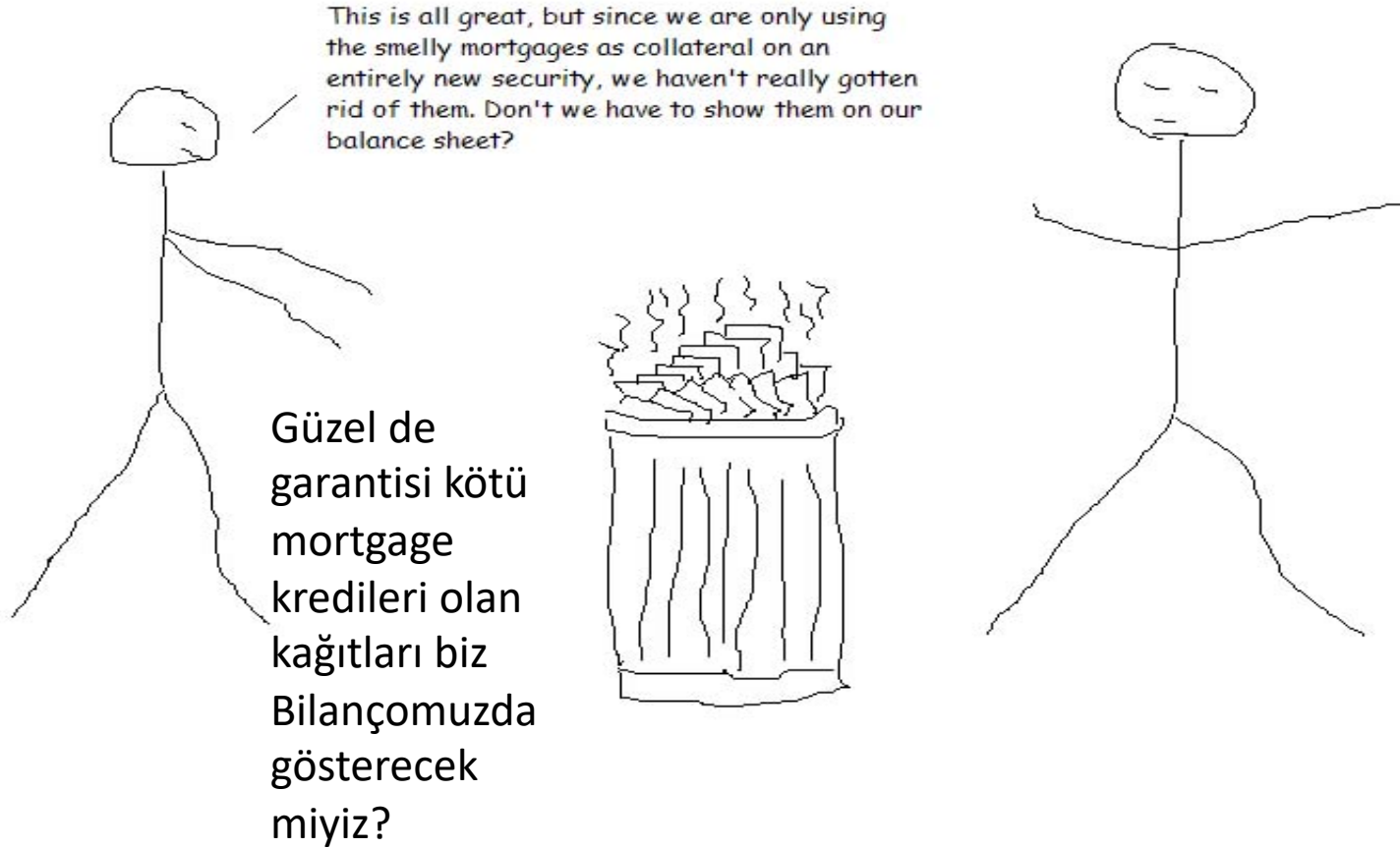
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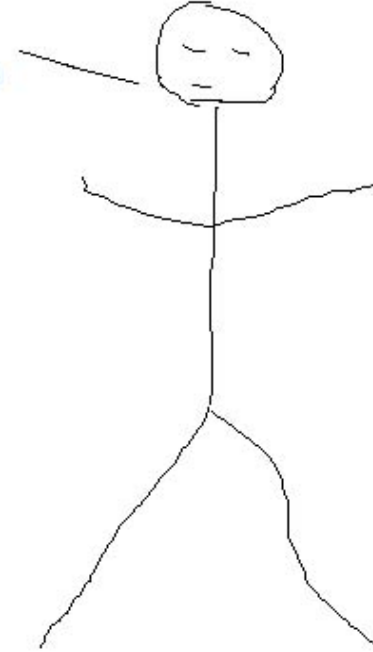
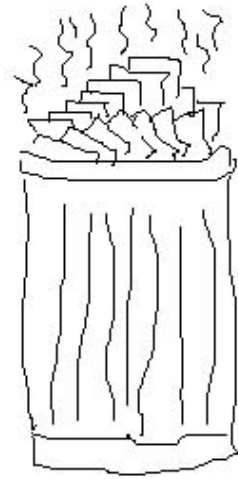
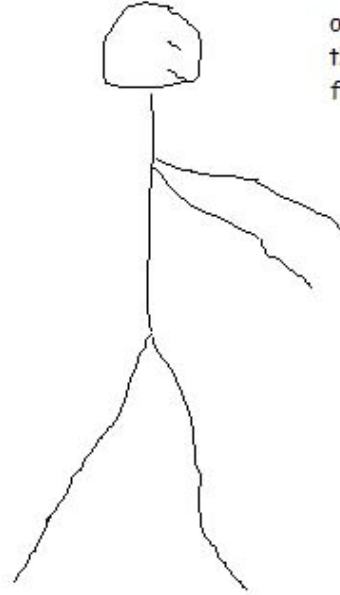


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## RSG Investment Bank of Wall Street

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No, of course not. The guys who write the accounting rules allow us to set up a shell company in the Caymen Islands to take ownership of the mortgages. The crap goes on their balance sheet, not ours. The fancy name for it is "Special Purpose Vehicle" or SPV.



Tabi ki biz  
Bilançomuzda  
göstermiyeceğiz.  
Muhasebe kuralları  
yazanlar bize  
Caymen Island'da  
Off Shore Paravan  
bir Şirket kurup kötü  
kağıtları ona  
satmamıza izin  
veriyor. Kötü Kağıtlar  
Paravan Şirketin  
Bilançosunda  
görünecek. Bunun  
adı "Özel Maksatlı  
Araç" olacak.



# RGS Yatırım Bankası – Tüm Yatırım İhtiyaçlarınız için Zeki Arkadaşlarımıza Güvenin

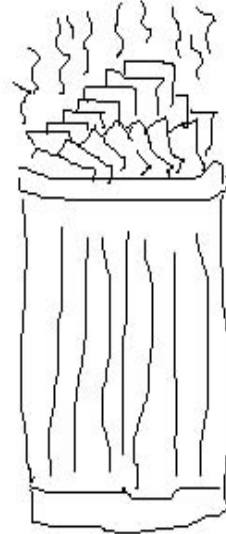
## RSG Investment Bank of Wall Street

"Trust the 'Really Smart Guys' for All Your Investment Needs"

Çok güzel Patron.  
Ama bunu  
yapmamıza niçin  
izin veriyorlar?  
Kendi pisliğimizi  
bir yerden diğer  
bir yere  
süpürdüğümüzü  
görmüyorlar mı?

That's great, but why would they let us do that,  
aren't we just moving our own crap around?

Sure, but we have convinced them that it  
is vitally important to the health of the  
U.S. financial system that investors not  
know about these complex transactions  
and what is behind them.



Tabiki görüyorlar. Biz  
onları inandırdık.  
Amerikan mali  
sisteminin sağlığı  
açısından  
yatırımcıların  
kompleks işlemlerin  
deyatını bilmesi  
gerekmiyor dedik.



**Şimdi de Muhasebecilerin Bağımsız Dış Denetim Şirketlerinin ne yaptıklarına  
Bakalım.**

**Let's drop in to see the Accountants.....**

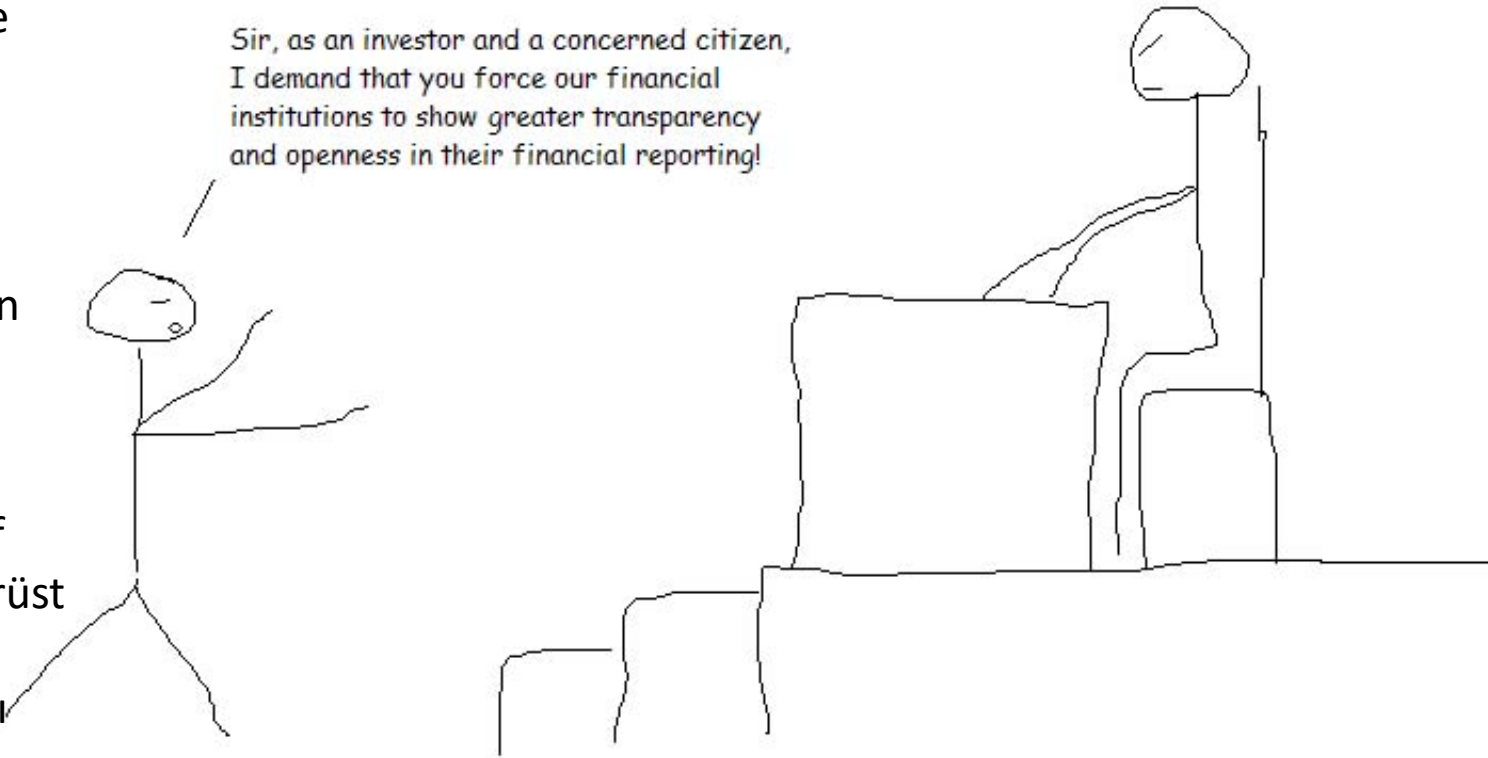
CZAR BAĞIMSIZ DENETİM ŞİRKETİ

## Office of the Czar of Accounting

## "No Nit Too Small to Pick"

Yatırımcı ve  
sorumlu  
vatandaş  
olarak  
Finasman  
Şirketlerinin  
Mali  
Tablolarını  
hazırlarken  
daha Şeffaf  
Açık ve Dürüst  
olmalarını  
zorlamanızı  
istiyorum.

Sir, as an investor and a concerned citizen, I demand that you force our financial institutions to show greater transparency and openness in their financial reporting!



## Office of the Czar of Accounting

"No Nit Too Small to Pick"



**Felaketin geldiğini göremedik**

***Gee, We Never Saw it Coming.....***

## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

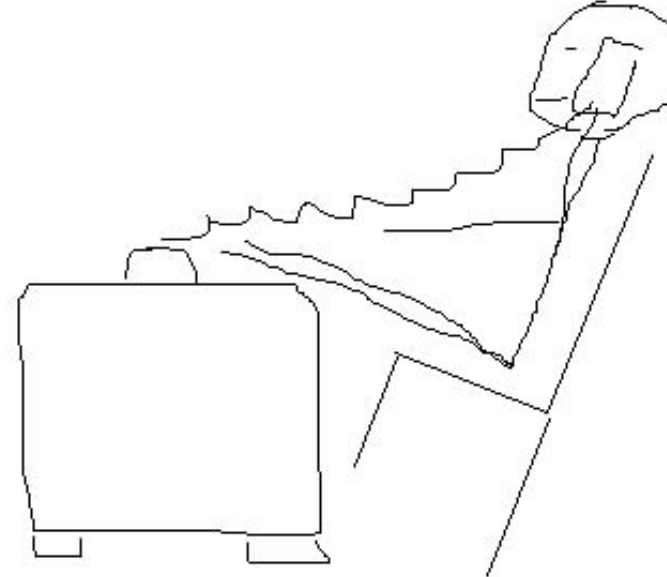
Hey man, what the hell is up?  
We're not receiving our  
monthly payments!



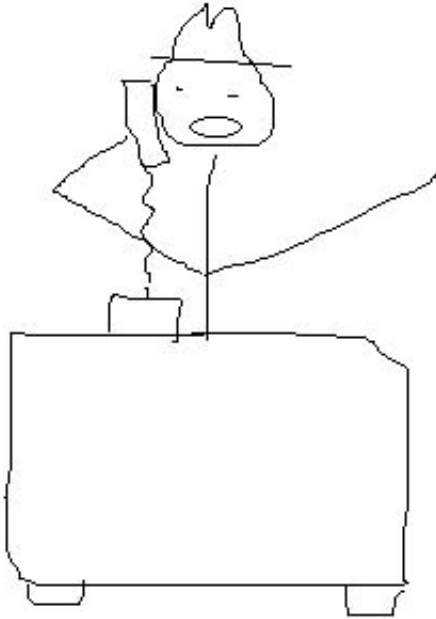
Hey Beyim, Ne  
oluyor orada?  
Biz aylık  
ödemelerimizi  
alamıyoruz.

## RSG Yatırım Bankası

### RSG Investment Bank



## Norwegian Village Pension Fund



## RSG Investment Bank

Yeah, I meant to call you but it's been really crazy around here. It seems that the assholes who took out the mortgages backing your CDO aren't able to pay them off.

Evet ben de sizi arayacaktım.  
Burada işler kötü. Sizin  
aldığınız Kağıtların teminatı  
olan Mortgage Kredileri  
taksitlerini ödemiyorlar.



## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

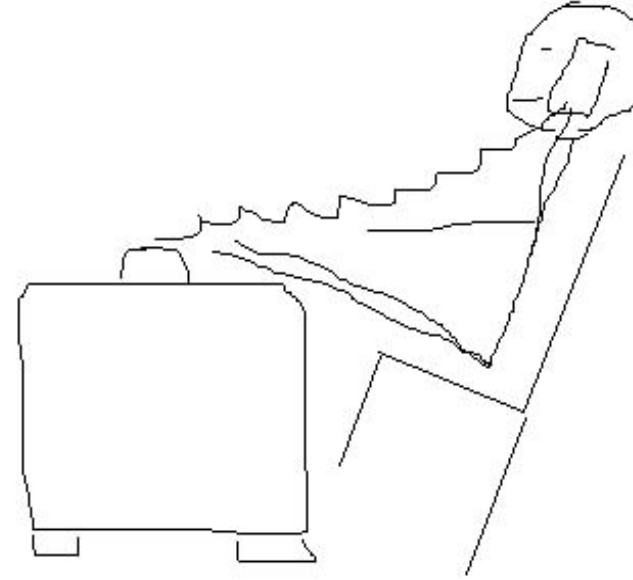
Wait a minute! We bought the AAA "Good" piece of the CDO. You know? The safe one. We're supposed to be getting paid first.



Bir Dakika. Biz Ratingi AAA olan "İyi" Kağıtları almıştık. Garantili Kağıtları. Önce Bize ödeme yapılmalıydı.

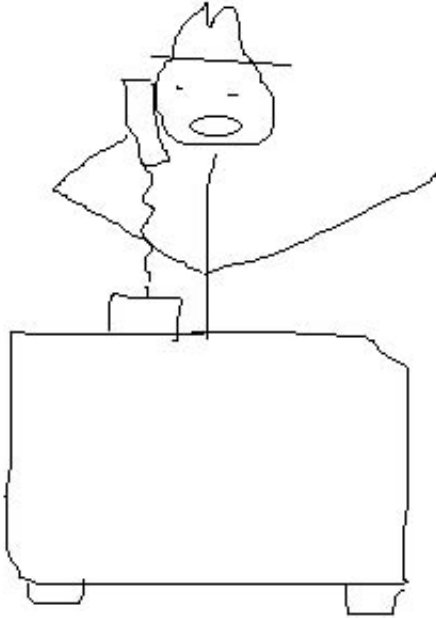
## RSG Yatırım Bankası

### RSG Investment Bank



## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**



## RSG Yatırım Bankası

**RSG Investment Bank**

*Well unfortunately the loans were quite a bit crappier than we originally thought and there is very little cash coming in. Frankly, I assure you that we are as disappointed as you are.*

Vallahi krediler umduğumuzdan biraz daha kötü çıktı. Ödemeler çok azaldı. İnan olun ki biz de sizin kadar şaşkınsınız ve hayal kırıklığına uğradık.





## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

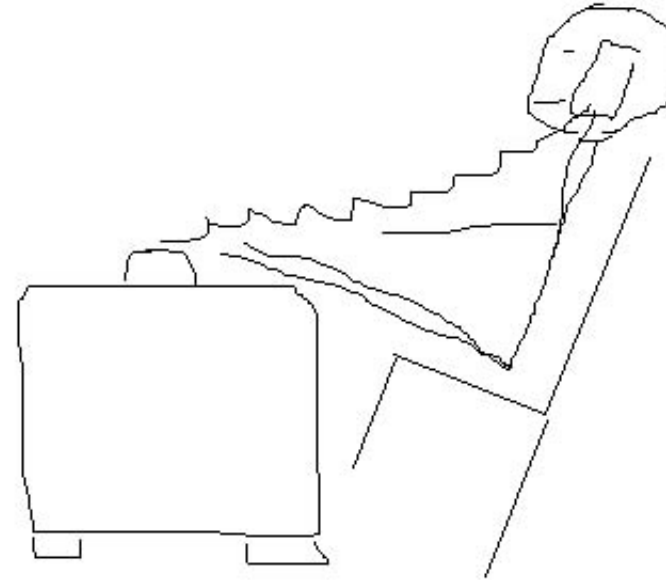
*But you told me that housing prices  
always go up and that your borrowers  
could always refinance their mortgages!*



Ama siz ev fiyatları hep artar  
 demiştiniz.  
Kredi ödemelerinde sorun  
 olmaz demiştiniz.

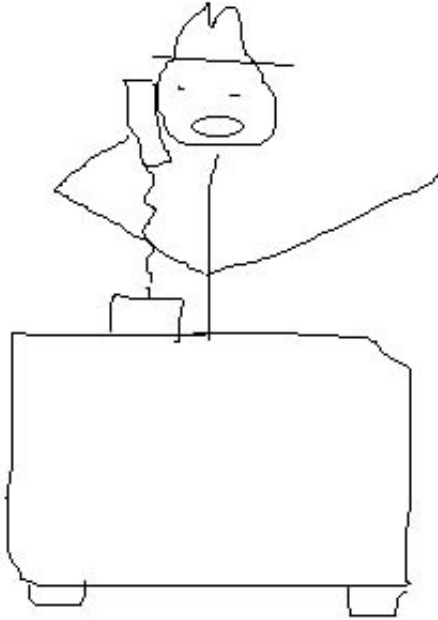
## RSG Yatırım Bankası

### RSG Investment Bank



## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**

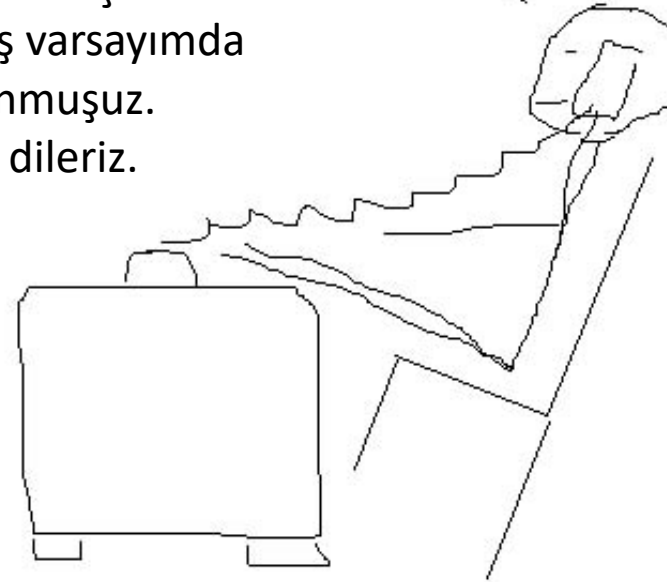


## RSG Yatırım Bankası

**RSG Investment Bank**

Yeah, that was a bad assumption.  
We fucked up. Sorry.

Evet demiştik.  
Yanlış varsayımda  
bulunmuşuz.  
Özür dileriz.



## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

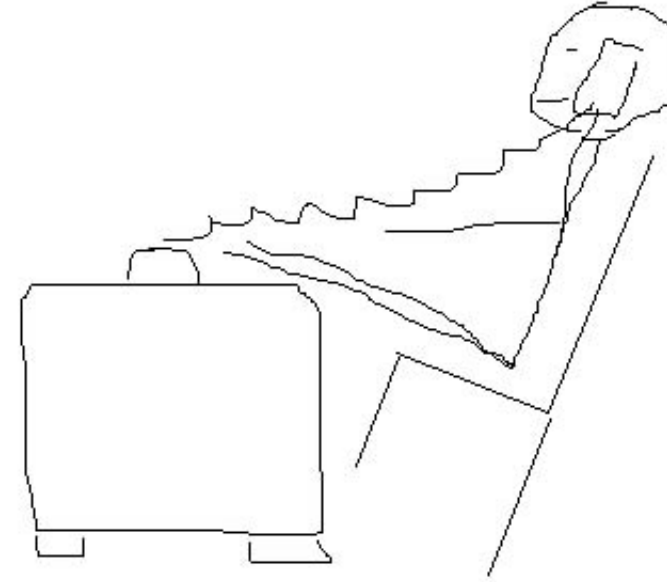
Bad assumption my frigid Norwegian ass! What about the AAA rating from the agencies?



Kötü varsayım.  
Peki Derecelendirme  
Kurumu aldığımız Kağıtlara  
AAA Rating notu vermişti?  
Ne oldu bu nota?

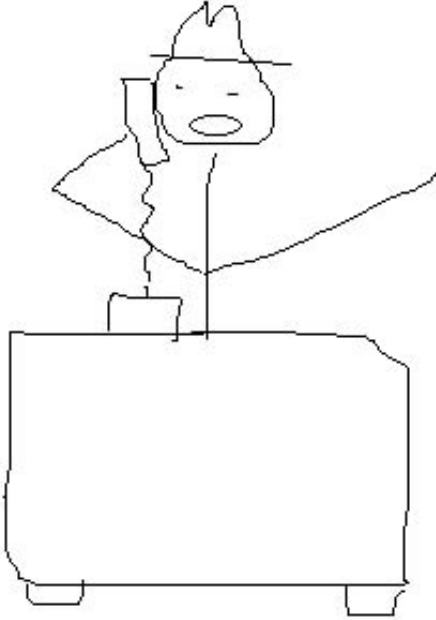
## RSG Yatırım Bankası

### RSG Investment Bank



## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**

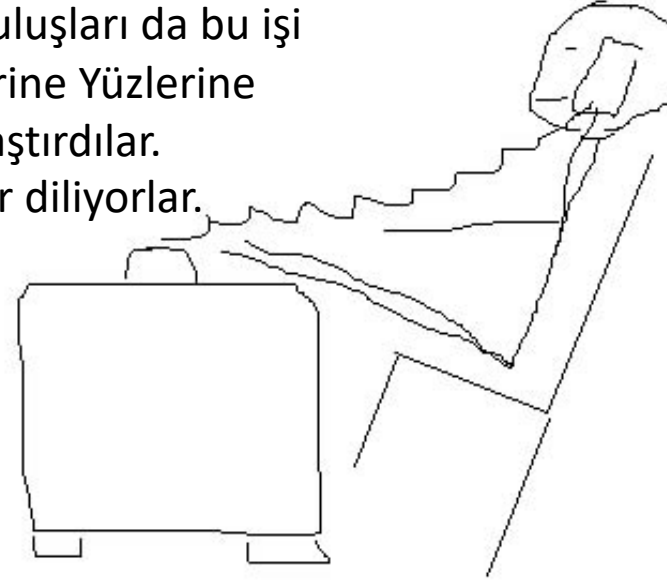


## RSG Yatırım Bankası

**RSG Investment Bank**

They fucked up too.

Derecelendirme  
Kuruluşları da bu işi  
Ellerine Yüzlerine  
Bulaştırdılar.  
Özür diliyorlar.



## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

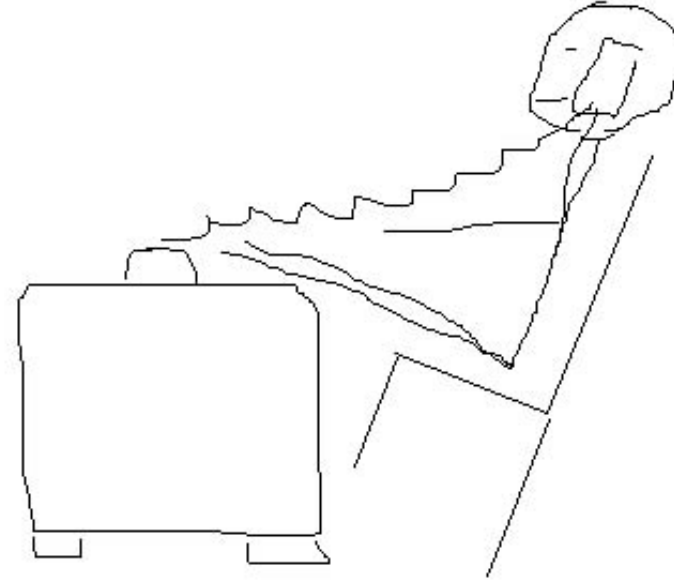
But this security was insured! What about the insurers?



Ama bu Kağıtlar  
Sigortalıydı.  
Sigorta Şirketine ne  
oldu?

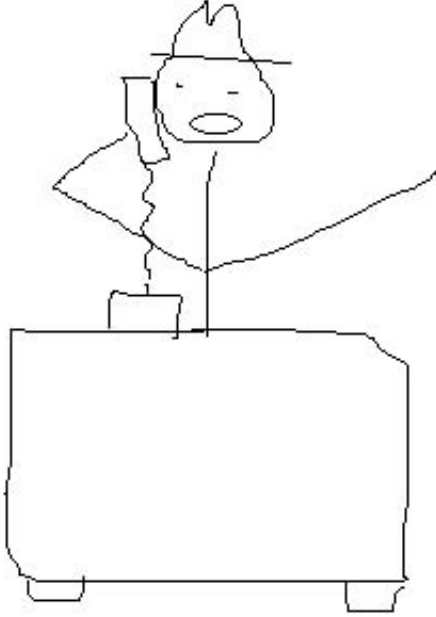
## RSG Yatırım Bankası

### RSG Investment Bank



## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**



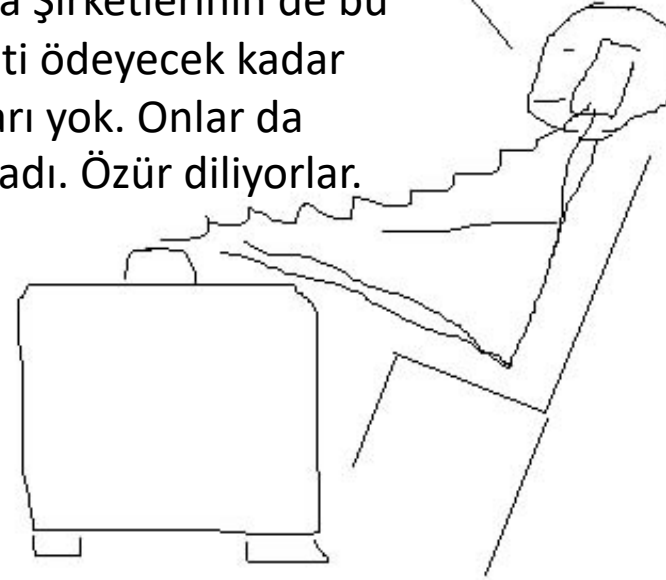
## RSG Yatırım Bankası

**RSG Investment Bank**

Are you kidding? There's no way they  
have enough money set aside to cover  
this mess. They fucked up.

Şaka mı yapıyorsunuz?

Sigorta Şirketlerinin de bu  
rezaleti ödeyecek kadar  
paraları yok. Onlar da  
çuvalladı. Özür diliyorlar.



## Norveç'te Kasaba Emekli Fonu

### Norwegian Village Pension Fund

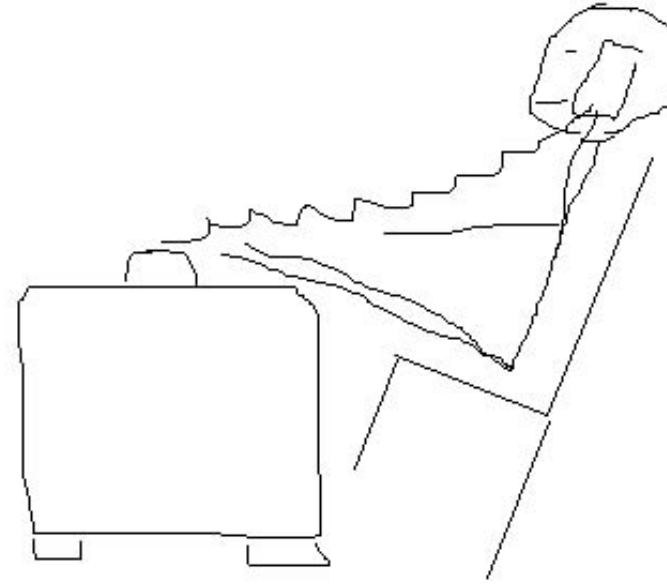
Well that's just great, asshole.  
What am I supposed to tell my  
villagers?



B y k  
skandal.  
Ben Kasaba  
Halkına ne  
diyeceđim  
řimdi?

## RSG Yatırım Bankası

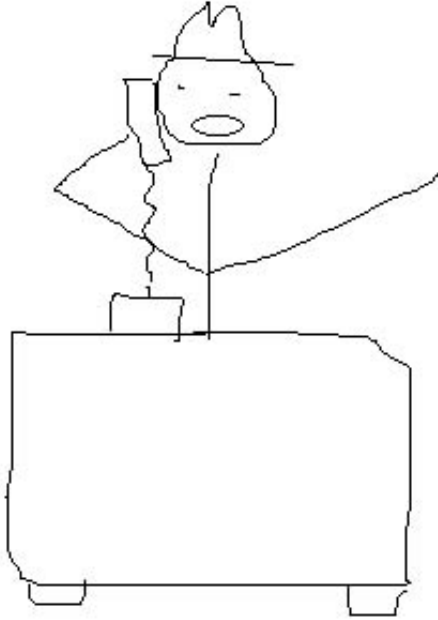
### RSG Investment Bank





## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**



## RSG Yatırım Bankası

**RSG Investment Bank**

Tell them you fucked up.

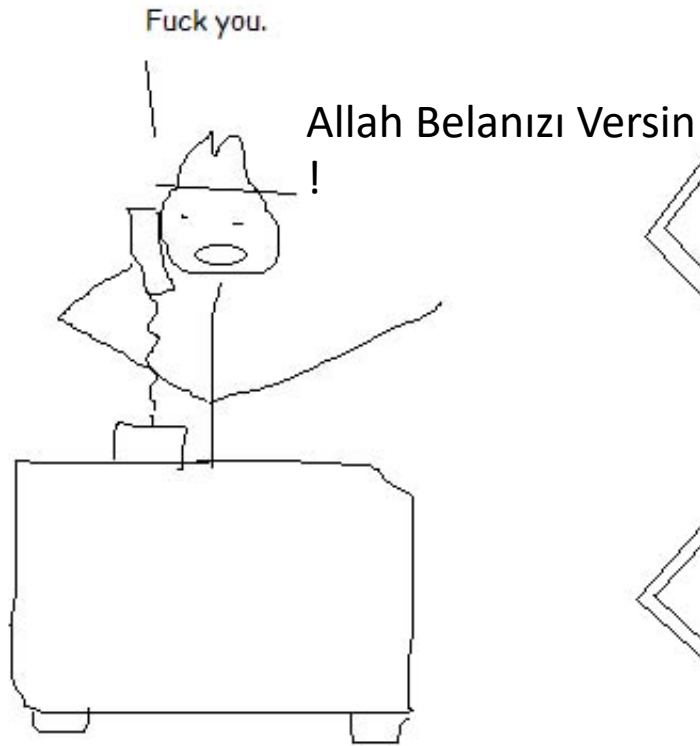
Beceremediğini söyle.





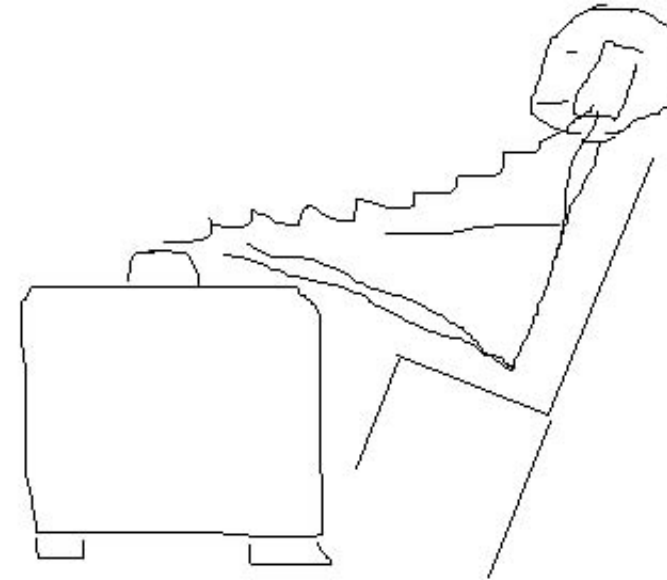
## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**



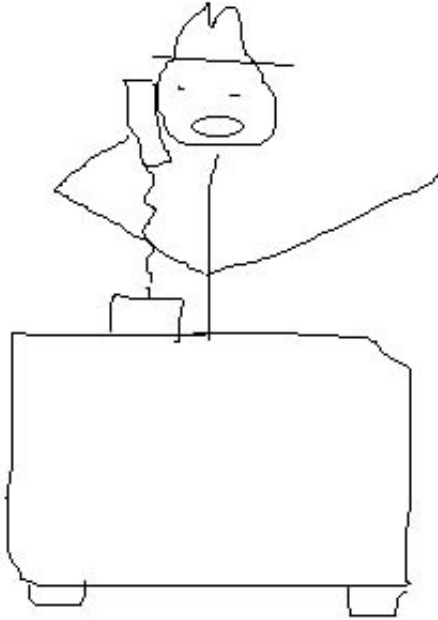
## RSG Yatırım Bankası

**RSG Investment Bank**



## Norveç'te Kasaba Emekli Fonu

**Norwegian Village  
Pension Fund**

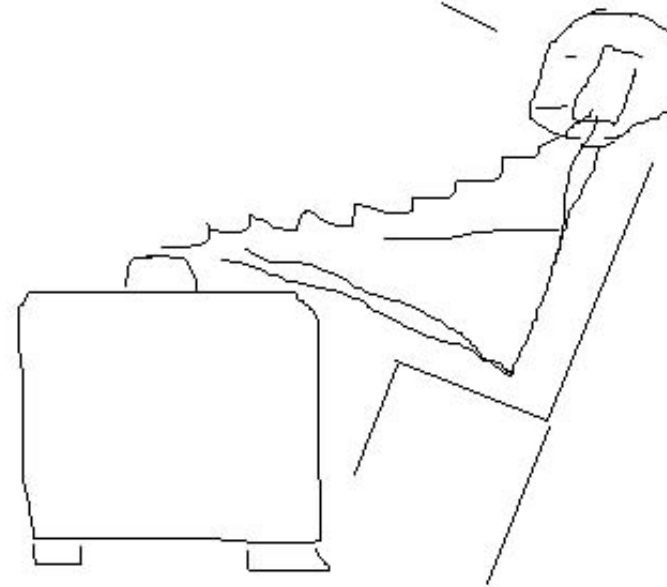


## RSG Yatırım Bankası

**RSG Investment Bank**

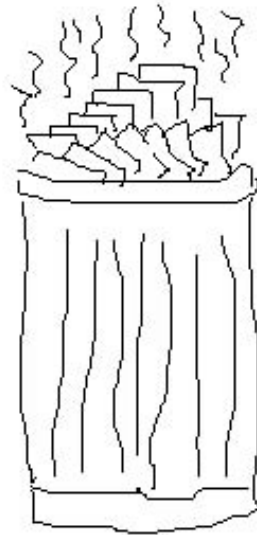
Senin de !!!

Fuck you.



# Mutlu Son

## The End



## Ethics in Investment Mutual Funds

- A mutual fund is an **investment vehicle** made up of a pool of moneys collected from many investors for the purpose of **investing** in **securities** such as **stocks, bonds, money market** instruments and other **assets**.
- Mutual funds are operated by **Professional Money Managers** , who allocate the fund's investments and attempt to produce **capital gains** and/or **income** for the fund's **investor**.
- A mutual fund's **portfolio** is structured and maintained to match the **investment objectives** stated in its **prospectus**.

## Ethics in Investment Mutual Funds

- **3 Ethical Issues in managing a Mutual Fund:**
  - 1. Market Timing
  - 2. Late Trading
  - 3. Personal Trading
  - 4. Soft-Dollar Brokerage

## Market Timing

- «**Market Timing**» is the act of moving **in and out** of the market or **switching** between asset classes based on using predictive methods such as **technical indicators** or economic data in order to benefit from temporary changes in security prices.
- "Market-timing trades are **short-term**, in-and-out buying and selling to take advantage of **news announced** during the hours **before the next day's price is set.**"
- The market timer seeks to **sell** at the "**top**" and **buy** at the "**bottom.**»
- Market timers are more likely to use **leverage** in order to produce better results.
- Market Timing is especially attractive in international funds due to **time lag** in distant markets.
- Although that sort of trading **is not illegal**, it is certainly **unethical** when **fund companies prohibit** the practice and then **secretly allow** it for a **favored few investors.**

## Late Trading

- «**Late-day trading**», or late trading, occurs when hedge funds **place orders** to buy or redeem mutual fund shares **after the time** at which the **net asset value is calculated**, but **receive the price** based on the **prior NAV** already determined that day. These trades violate federal securities laws and defraud innocent investors.
- Illegal **late-day trading** schemes involve hedge funds working out special relationships with mutual funds to buy and sell shares **after hours** but **record the trades** at 4:00pm Eastern Time.
- The practice provides hedge funds with an **opportunity to profit** when **new information** is released **after market close**.
- Late trading of mutual fund shares occurs when investors placing trades after 4 PM receive the 4 PM price. These late traders can use the information revealed after 4 PM to guide their trades: **buying funds** when their current value is greater than their 4 PM value and **selling the funds** when the reverse is true. Doing so allows them to earn expected **abnormal returns** at the expense of the fund's **long-term shareholders**.

Ethics in Investment  
Mutual Funds  
Market Timing

- **What is wrong with timing?**
- 1. It allows a few **avored clients** to trade under terms that are unavailable to the vast majority of ordinary investors. (**unequal treatment & no transparency**)
- 2. Allowing market timing **hurts long-term mutual fund investors** by **increasing** a fund's **expense** by adding other overhead costs & **reducing** its **returns**.
- 3. Market timing is **unfair & harmful** to **ordinary investors**.
- 4. Directors & **executives** of mutual fund companies are **violating** a **fiduciary duty** to serve investors' interests.



## 3 Important Principles for Dealing with Customers

- **3 Principles:**
- 1. You must deal with clients “**Fairly**” and “**in Good Faith**”.
- 2. You must never put the **interests of** your firm **ahead of** the interests of **the customers**.
- 3. You must **never compromise** your personal ethics or integrity, or **give the appearance** that you may have done so.

## Reforms Proposed to Manage Mutual Funds

- In the wake of mutual fund scandal, the following reforms have been proposed:
  - **1. Governance**
  - **2. Disclosure**
  - **3. Pricing**

## Reforms Proposed to Manage Mutual Funds

- **1. Governance**
- Board of Directors of mutual funds **serve in dozens** of boards.
- Many of the Board of Directors are **also company executives**.
- Many Board of Directors are **not independent**.
- Many Board of Directors face a “**Conflict of Interest**” problem.
- **Limit** the number of Boards each Board Member may serve.
- **Increase** the number of “**Independent**” Board Members.
- Require that the **Chairman** of the Board be an “**Independent**” member.

## Reforms Proposed to Manage Mutual Funds

- **1. Disclosure**
- Lack of disclosure makes it difficult for investors to detect losses or to assess the costs of a fund & compare the returns with competing funds.
- Disclosure of information about a fund's expenses that would enable investors to determine whether they are receiving adequate value for the fees they pay & whether their return is being reduced by market timing & other abuses in mutual fund trading.

## Reforms Proposed to Manage Mutual Funds

- **1. Pricing**
- **Market Timing**, especially in international funds , is possible because of the problem of “**Stale Prices**”.
- If the **net asset value** of a fund that is **reported** at **four o’clock** New York time **does not** accurately **reflect** the **current prices** of the **securities** in the fund’s portfolio, than an opportunity for “**stale price arbitrage**” exists.
- Mutual Funds should implement “**Fair-Value Pricing**”.

## Personal Trading

- **“Personal Trading”**
- Mutual Fund Managers **wear two hats.**
- They manage money **for others.**
- But they also trade for their **own accounts.**
- Even though most fund managers **refrain from giving stock tips**, they still have immense opportunity to **benefit personally** from their **privileged position.**

## Personal Trading

- **“Personal Trading”**
- Conflict of Interest from personal trading is possible for so-called **“Access People”**, that is **investment company personnel** such as portfolio managers, analysts, and traders who have **access to** proprietary research & **information** about **pending transactions**.
- Access People are in a position to use this information **to trade ahead** of a fund’s purchase (called **frontrunning**) & benefit from any upward price movement.
- An **access person** might be in a position to **influence transactions** that serve primarily to **protect** or **promote** that **person’s investment** in a security.
- **Conflict of Interest** also arise when a fund manager **allocates** a security that **is in short supply**.

## Personal Trading

- In order to prohibit any fraudulent, manipulative act by an access person in the purchase or sale of any security, **SEC** issued the following **Rule**:
- 1. **Prohibits** directors, officers & **employees** of investment companies (and the investment **advisers** & principal **underwriters** ) from engaging in **fraudulent, manipulative** or **deceptive** conduct in connection with their **personal trading** of securities **held** or to be **acquired** by the investment company.
- 2. Requires investment companies to adopt **code of ethics** & **procedures** reasonably designed **to prevent trading** prohibited by the rule.



## Personal Trading

- 3. Requires every **“access person”** to **file reports** with the firm concerning his or her **personal securities transactions**, within **ten days** of the **end of the quarter** in which the transaction was effected.
- 4. Requires **investment companies** to **maintain records** related to the **implementation of their procedures**.

## Soft-Dollar Brokerage

- **“Soft-Dollar Brokerage”**
- The term **soft dollar** refers to the **payments made by mutual funds** (and other money managers) **to their service providers**. The difference between soft dollars and **hard dollars** is that instead of paying the service providers **with cash** (i.e. hard dollars), the mutual fund will **pay in-kind** (i.e. with soft dollars) by passing on business to the brokerage.
- Soft dollars are a **means of paying brokerage firms** for their services **through commission revenue**, as opposed to through normal direct payments (hard-dollar fees). The investing public tends to have a negative perception of soft-dollar arrangements, because they believe that buy-side firms should **pay expenses out of their profits**, rather than **from investors' pockets**. As such, the use of hard-dollar compensation is becoming more common.
- The **costs of research and other bundled services provided** in the soft-dollar transaction are essentially **borne by the mutual fund investor**, yet they are **not disclosed by the fund**. They are **simply built into the cost of trades**, which impacts the **long-term performance** of the fund.

## Relationship Investing

- **“Relationship Investing”** may be defined as a situation in which an **investor takes an active interest** in a **corporation** and attempts to **influence the corporation’s operations**.
- Taking an **active role** in corporate governance has also been pursued as an **investment strategy** by some **institutional investors**, especially hedge funds, as an effective **way of increasing returns**.
- However **institutional investors** are typically **both shareholders and fiduciaries**, which **creates the potential for conflicts** between these **two roles**.
- Relationship investing **enables** present shareholders to bring about the same kind of **changes** that a **raider in a hostile takeover** might make.

## Socially Responsible Investing

- “**Socially Responsible Investing**” can be as simple as a policy to avoid “**Sin Stocks**”. (alcohol, tobacco, gambling, money laundering, smuggling, white slavery, weapon trading, pollution)
- These funds identify themselves by many names:
- Socially Responsible Investing
- Ethical Investing
- Sustainable Investing
- Triple Bottom-Line Investing
- Environmental & Social Issues Investing
- Governance Investing

## Ethics in Investment

# Microfinance

- **“Microfinance”**, also called **microcredit** (microlending) , is a type of **banking service** that is provided to **unemployed** or **low-income individuals** or groups who otherwise have **no other access to financial services**. (unbankables) (Bangladesi Muhammad Yunus, Grameen Bank)
- While institutions participating in the area of microfinance are most often **associated with lending** (microloans can be anywhere from **\$100 to \$25,000**), many offer additional services, including bank accounts and **micro-insurance** products, and provide financial and business education.
- Ultimately, **the goal** of microfinance is to **give impoverished people** an opportunity **to become self-sufficient**.

## Ethics in Investment Microfinance

- The **challenge of microfinance** is how to achieve **3 aims**:
- 1. Assuring high rates of **repayment**.
- 2. Becoming **self-sustaining**, thereby avoiding a reliance on subsidies or contributions.
- 3. Improving **people's lives**.

## Ethics in Investment Microfinance

- The **secret** of microfinance is “**Group Lending**”
- **Two members** of a group each receive a **small loan** with an initial payment **due quickly**, followed by a **frequent repayment schedule**.
- If these members make payments, the **next two** receive **small loans** sometime later, followed last of all by a loan to the **fifth member**.  
(**Dynamic Incentive**)
- When the first round is complete, members are **eligible for** successively **larger loans** (**Progressive Lending**).
- Although all transactions are **recorded**, **no contracts are signed**; **obligations** are based instead on **social relationships**.

## Ethics in Investment Microfinance

- Some ethical issues “**dark side**” of microfinance:
- **High interest** rates
- **Pressure** to secure payments.
- **Group collateral** (guarantee) obtained for a single loan.
- How well microfinance actually address the **financial needs** of the poor.
- Does microfinance **increase** the **income** of the poor?
- **Withdrawing** credit from **all members** of the group if any **one borrower defaults** (collateral substitutes). Create powerful **peer pressure** to make payments.



# Ethics in Financial Markets

- The broad aim of financial market regulation is to secure “**Fair & Orderly**” market “**just & equitable principles of trade**”.
- The concepts of “**Fairness**”, “**Justice**” and “**Equity**”.
- Fairness, Justice & Equity **serve** mainly to **forbid fraud** and **manipulation**, the **violation of** certain **rights** and the **exploitation of asymmetries** in such matters as **information** and **bargaining power**.
- Prohibitions of unfair market practices are designed to protect both market participants and the integrity of markets themselves.
- Specific areas where **unfairness** is often alleged are:
- **1. Insider Trading 2. Hostile Takeover 3. Financial Engineering**

# Classifications of Financial Markets

## 1. Debt Markets

- Short-Term (maturity  $< 1$  year) Money Market
- Long-Term (maturity  $> 1$  year) Capital Market

## 2. Equity Markets

- Common Stock

# Characteristics of Debt Markets Instruments

- Debt instruments
  - Buyers of debt instruments are suppliers (of capital) to the firm, not owners of the firm
  - Debt instruments have a finite life or maturity date
  - Advantage is that the debt instrument is a contractual promise to pay with legal rights to enforce repayment
  - Disadvantage is that return/profit is fixed or limited

# Characteristics of Equity Markets Instruments

- Equity instruments (common stock is most prevalent equity instrument)
  - Buyers of common stock are owners of the firm
  - Common stock has no finite life or maturity date
  - Advantage of common stock is potential high income since return is not fixed or limited
  - Disadvantage is that debt payments must be made before equity payments can be made

# Characteristics of Financial Markets

## 1. Debt Markets

- Although less well-known by the average person, debt markets in U.S. are much larger in total dollars than equity markets, due to greater number of participant classes (households, businesses, government, and foreigners) and size of individual participants (businesses, and government)

# Characteristics of Financial Markets

## 2. Equity Markets

- Although U.S. markets are highly efficient, the world's largest, and more familiar to the average person, they are far smaller than the U.S. debt markets largely due to the fact that the only applicable participants are businesses

# Classifications of Financial Markets

## 1. Primary Market

- New security issues sold to initial buyers

## 2. Secondary Market

- Securities previously issued are bought and sold

# Classifications of Financial Markets

## 3. Exchanges

- Trades conducted in central locations (e.g., New York Stock Exchange)

## 4. Over-the-Counter Markets

- Dealers at different locations buy and sell



# Fairness

- The main **aim** of financial market regulation is **to ensure both “Fairness” and “Efficiency”**.
- **Unfair markets** tend to **drive people away** and thereby **reduce participation**.
- **Efficiency** is itself an **ethical value**. Achieving the **maximum output** with the **minimum input**.
- However **“Fairness” and “Efficiency”** can sometimes **conflict**.

# Fairness in Markets

- **Fairness in Markets**
- The **core meaning** of fairness involves at least **two** familiar **ideas**:
- 1. Fairness consists of **treating people equally** in accord with some rule, agreement, or expectation (equal treatment) (fair deal, fair game).
- 2. **Outcomes** be in accord with **justified rules**. Fairness requires not merely that the rules be consistently applied but that they **also be the right rules**. Otherwise the outcome of the equality applied rules would still be unfair.

# Fairness in Markets

- Fairness is often relevant when some goods or some **benefits** and **burdens** are to be **distributed**.
- Thus we should aim to **distribute** the **good of income** or the benefits and the **burden of taxation** fairly.
- **Fairness** is an important element also in “**Financial Reporting**”.
- **Fair presentation** of company’s **financial position** and **results of operations** (Balance Sheet & Income Statement) is important.
- Company itself should **be fair** in **making disclosures**.
- **Corporate Governance** should ensure the **fair treatment of shareholders**, investors, customers, employees, suppliers and **other stakeholders**.

# Fraud & Manipulation

- The definition of fraud involves 5 elements:
- 1. Making of a **false statement** or **misrepresentation**. Sometimes false must be stated, written, implied or otherwise conveyed.
- 2. A material fact, that is, it must involve some **factual matter** that can be characterized as **true or false** and that it is **important** in some way (material) **to a decision**.
- 3. The party making the statement or representation **must know** that **it is false** and thereby **intend** that **others be deceived**.
- 4. It is necessary in fraud that the **other party** actually **relies on** the **false statement** or misrepresentation **in making a decision**.
- 5. That party must **suffer** some **loss** or **other harm** from **this reliance**.

# Fraud & Manipulation

- **Manipulation** generally involves the **buying or selling of securities** for the **purpose of creating a false or misleading impression** about the **direction of their prices** so as to **induce other investors** to buy or sell the securities at prices that are disadvantageous to them.
- Like fraud **manipulation** is designed **to deceive others**, but the effect is **achieved by creation of false or misleading appearances** rather than by false or misleading representations.

## Equal Information

- In all markets **information** is a **valuable** commodity. Those who possess it have a great **advantage** over those who lack it.
- **Competition** between parties with very **unequal information** is often regarded as **unfair**.
- The possession of unequal information strikes us as unfair mainly when the **information** has been **illegitimately acquired** or when **its use violates** some **obligation to others**.
- **Insider trading** can also be criticized on the grounds that **others do not have the same access** to the **information**, which leads us to the question of **equal information**, namely **equal access**.
- Another argument against insiders trading is that **insiders use information** that is not merely costly to obtain but that **cannot be obtained by an outsider** at any price. In other words, the information is **inherently inaccessible**.

## Equal Bargaining Power

- **“Equal Bargaining Power”** Generally, agreements reached by **arm’s-length bargaining** are considered **to be fair**, regardless of the actual outcome.
- **Agreements** can be criticized as **unfair**, when one party **takes undue advantage** of a **superior bargaining position**.
- **Unequal bargaining power** can **result from** many sources:
  - unequal information
  - unequal resources
  - unequal processing ability
  - other vulnerabilities
  - other weaknesses
- In most transactions **wealth is an advantage**. The **rich are better** able than **the poor** to **negotiate** over almost **everything**. Rich have more bargaining power.

# Insider Trading

- **Insiders Trading**
- “Insider Trading” is commonly defined as **trading in the stock of publicly held corporations** on the basis of **material, nonpublic information**.
- Corporate **executives** and **directors** are definitely “**insiders**”, but some “**outsiders**” have also been charged with insider trading.
  - **printer** who was able to identify the targets of several takeovers from legal documents given to him for printing.
  - a **stockbroker** who was tipped off by a client who was a relative of the president of a company who told him about the future sale of the company to big holding group.
  - a **lawyer** who got all the information from his client about an IPO and shared this information with his wife to buy the shares at low price and sell after IPO at high price.



# Insider Trading

- An **outsider person** who receives information **from an insider** and who knows that the insider source is **violating a duty of confidentiality** is also accepted as acting against insider trading rules.
- However, a person who **has no fiduciary ties** who **receives information innocently** (by overhearing a conversation) would still **be free to trade**.
- Everyone who could be called an insider has a fiduciary duty **to serve the interests of the corporation and its shareholders**, and the use of information that is acquired while serving as a fiduciary, **for personal gain**, is a **violation** of this duty.
- Those **who trade on material nonpublic information** are essentially **stealing property** that belongs to the corporation.
- By analogy, **insider trading** is like **playing poker with a marked deck**.

# Hostile Takeovers

- **What is a 'Hostile Takeover'**
- A hostile takeover is the **acquisition of one company** (called the **target company**) by another (called the **acquirer**) that is accomplished by **going directly** to the company's **shareholders** or **fighting to replace management** to get the acquisition approved.
- A hostile takeover is an acquisition that is opposed by the management of the target company.
- A hostile **takeover** can be accomplished through either a «**tender offer**» or a «**proxy fight**».

# Types of Acquisitions

- **Friendly:** the companies cooperate in negotiations target is unwilling to be bought or the target's board has no prior knowledge of the offer
- **Reverse Takeover:** a smaller firm will acquire management control of a larger company and keep its name for the combined entity.
- **Reverse Merger:** a deal that enables a private company to get publicly listed in a short time period. It occurs when a private company that has strong prospects and is eager to raise financing buys a publicly listed shell company, usually one with no business and limited assets.

Achieving acquisition success has proven to be very difficult, while various studies have shown that 50% of acquisitions were unsuccessful. The acquisition process is very complex, with many dimensions influencing its outcome.

# Tactics against Hostile Takeovers

- Back-end
- Bankmail
- Crown Jewel Defense
- Flip-in
- Flip-over
- Golden Parachute
- Gray Knight
- Greenmail
- Jonestown Defense
- Killer bees
- Leveraged recapitalization
- Lobster trap
- Lock-up provision
- Macaroni Defense
- Nancy Reagan Defense
- Non-voting stock
- Pac-Man Defense
- Pension parachute
- People Pill
- Poison pill
- Poison Put
- Safe Harbor
- Scorched-earth defense
- Shark Repellent
- Standstill agreement
- Staggered board of directors
- Targeted repurchase
- Top-ups
- Treasury stock
- Trigger
- Voting plans
- White knight
- White squire
- Whitemail

# Tactics against Hostile Takeovers

- **Shareholders Rights Plan (Poison Pill Flip-in)**
- **(Poison Pill Flip-in)**
- Under such plans, shareholders can **purchase** additional company stock at an attractively **discounted price**, making it far more difficult for the corporate raider to take control.
- **(Poison Pill Flip-over)**
- Enables stockholders to purchase the acquirer's shares after the merger at a discounted rate. For example, a shareholder may gain the right to buy the stock of its acquirer, in subsequent mergers, at a two-for-one rate.

# Tactics against Hostile Takeovers

- **Staggered Board of Directors**
- Groups of (B of D ) directors are elected at different times for multiyear terms, can challenge the prospective raider. Buyer can not change all board members at the same time.
- **Greenmail**
- A company may also pursue the greenmail option by buying back its recently acquired stock from the putative raider at a higher price in order to avoid a takeover.

# Tactics against Hostile Takeovers

- **White Knight**
  - a strategic partner that merges with the target company to add value and increase market capitalization.
- **Increasing Debt (Jonestown Defense)**
  - By increasing debt significantly, companies hope to deter raiders concerned about repayment after the acquisition.
- **Making an Acquisition**
  - Make an acquisition, preferably through stock swaps or a combination of stock and debt. This has the effect of diluting the raider's ownership percentage and makes the takeover significantly more expensive.

# Tactics against Hostile Takeovers

- **Acquiring the Acquirer ( Pac-Man defense)**
- To turn the tables on the acquirer and mount a bid to take over the raider. This requires resources and shareholder support, and it removes the possibility of activating the other defensive strategies.
- **Voting Rights Plans (Dual Class Stock)**
- Targeted companies may also implement a voting-rights plan, which separates certain shareholders from their full voting powers at a predetermined point. «**Preferred Shares**» with more rights give old shareholders more effective voting rights. (A type, B type shares)



# Tactics against Hostile Takeovers

- **Golden Parachute**
- Put a special clause in the employee agreement of the CEO and other top managers that in case of take-over they should be given high salary and bonuses.
- **People Pill**
- Threaten the acquirer that in case of takeover top management key personnel will resign and leave the company.

# Tactics against Hostile Takeovers

- **Lady Macbeth Strategy**
- Somebody from the company acts on the side of the acquirer first during takeover discussions and uses insider information later to block the takeover.
- **Crown Jewels Defense**
- All the personnel in a key department of the company will resign and leave the company if there is a takeover.

# Financial Engineering

- **Financial engineering** is the **use of mathematical techniques** to solve **financial problems**. Financial engineering uses tools and knowledge from the fields of **computer science, statistics, economics, and applied mathematics** to address current financial issues as well as to **devise new and innovative financial products**.
- All derivatives **involve a contract** made at some point in time (**now**) with a **settlement or delivery date** set sometime **in the future**.
- On or before that date either one party or both is **committed to an exchange** (is obligated to complete it) or else one party **has a right (but not an obligation)** to **insist** that the **exchange take place** (this is an **option**).

# Financial Engineering

- **Derivatives** are **zero-sum games** in which one party gains only to the extent that the other loses.
- The exchange has **no impact** on the **wealth** of the whole **economy**.
- **Derivatives:**
  - **Swaps** (exchange swap & interest swap) ,
  - **Options** (call option «buy» & put option «sell») ,
  - **Forwards**, (agree today the terms & conditions today with an obligation to settle in a future date) (forward buy & forward sell)
  - **Futures**, (value is determined on a Daily basis & may be sold any time prior to the specified date)

# Financial Engineering

- **CAMP Capital Asset Pricing Model**
- **CDS Credit Default Swap** is an **insurance policy** in which one party agrees, for a payment, **to compensate** the other party in the event that a **borrower defaults** on a loan.
- **CDO Collateralized Debt Obligation** is a **structured financial** product that **pools together cash** flow-generating **assets** and **repackages** this asset pool into discrete **tranches** that can be sold to investors.

# Financial Engineering

- **Problems with Derivatives:**
  - 1. These financial instruments are used for **speculation**, in ways that pose undue risks that make them socially undesirable.
  - 2. Some of the **derivatives** that have been **sold**, especially by **major banks**, have been **unsuitable** for relatively **unsophisticated clients**. And the issuing banks **take advantage of** such unsophisticated client to generate **benefit for the bank**.
  - 3. Proper **disclosure is not made** to the buyers about the **derivative risks**. Some degree of disclosure or **transparency is owed**, not only about **material information** on the securities themselves but also of any **conflicts of interest** the sellers may have should be **communicated to the buyers**.