

PART I

# Overview

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## CHAPTER 1

# Ethics in Finance\*

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## INTRODUCTION

Although finance raises many ethical issues, the academic study of finance ethics has received surprisingly little attention from scholars in either finance or business ethics. The neglect by finance scholars is understandable given the research paradigm in the field, which not only excludes normative questions from study but also demands the use of particular analytical tools and methodologies. For most finance scholars, the task of addressing ethical issues is simply not what they are trained to do. Business ethicists, who have the training, often ignore finance ethics due to unfamiliarity with financial theory and practice. This book is intended to advance the understanding and appreciation of the critical ethical issues in financial theory and practice and to encourage academic research and instruction by scholars in both finance and business ethics. To this end, it draws together the contributions of distinguished scholars from a wide range of disciplines, including finance, economics, philosophy, management, and law, and from many parts of North America and Europe. Because this book offers authoritative surveys of problem areas as well as original scholarly works, it constitutes a valuable resource for students and general readers interested in finance ethics. The task of this introductory chapter is to provide an overview of the field of finance ethics that organizes the ethical issues in finance and introduces the various chapters that follow.

Finance may be defined broadly as the generation, allocation, exchange, and management of monetary resources. The main topic areas in finance so defined are (1) *personal finance* by which individuals save, invest, and borrow money in order to conduct their private lives; (2) *corporate finance* by which business organizations raise capital through the issuance of securities and allocate it to its most productive uses; and (3) *public finance* by which government raises revenue through taxation and borrowing and spends it to provide services to its citizens. These activities are facilitated or mediated by a variety of financial *markets* and financial *institutions*, such as securities and commodities exchanges, commercial and investment banks, insurance companies, mutual and pension funds, and the like. In addition, finance includes the academic subject called finance that is

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\*This chapter is drawn in part from Boatright (1999, 2008a, and 2008b).

studied in business schools and constitutes the training that people in finance—both scholars and practitioners—receive. Accordingly, the subject of finance ethics can be conveniently divided into four parts: finance theory, financial markets, financial services, and financial management. This framework is employed in this book as the major organizing principle.

Finance ethics as an academic field is concerned with the moral issues that arise in each of these four areas and with the moral norms that apply to the activities that take place in them. Although the academic study of finance ethics is relatively new, the examination of these issues and norms is of long standing since they form the basis of much of the regulation of financial markets and institutions, including industry and firm self-regulation, and underlie much of the popular concern with financial activity that is reflected, among other places, in the business press. From the very beginning of rudimentary financial activity, people have raised questions about what is fair in markets and what are the rights and duties of participants in these markets. And as financial institutions have grown in size and importance, ethical concerns about fairness, rights, and duties have arisen about their operation. Despite the popular cynical view that there is no ethics in finance, a moment's reflection reveals that finance could not exist without it. Without an assurance of fairness and the observance of basic rights and duties, no one would make exchanges in a market or place their assets with financial institutions. So even if finance ethics as an academic field of study is relatively new, consideration of the ethical issues in finance has a long and rich history.

Given this history of concern, it is the lack of recognition of ethics in finance, and not the present attention it is receiving, that requires explanation. One reason for this oversight is the ubiquity of law and regulation in finance, which has had two effects. One effect is to obscure the role that ethics has played in the development of law and regulation, which has been guided by moral considerations to the extent that in advanced economies much of what is unethical is also illegal. Ethical issues in finance are often perceived as *merely* legal or regulatory matters, thus disguising the role of ethics in law and regulation. The other effect is to leave the role of prescribing conduct and developing rules to law and regulation or to public policy. People who work in the financial world often believe that the task of creating and enforcing ethical rules and standards is the job of legislators and regulators, not themselves. Within finance theory, ethical issues are typically conceptualized as side constraints, externalities, or market failures, which they often are; but the effect of this conceptualization is to dismiss these issues as problems to be addressed by law and regulation or by public policy and not considered within the field of finance. Conversely, people in finance often contribute to the discussion of ethical issues and even lobby, sometimes aggressively, on proposed laws, regulations, and public policies without realizing that they are addressing ethical matters. Thus, ethics is actually a pervasive subject of concern in finance without being recognized as such.

## FINANCE THEORY

Finance as an academic field is an area of applied economics that is scarcely more than half a century old. Prior to 1950, the main concerns of modern finance theory—namely, the functioning of credit markets and the pricing of assets—were

largely ignored or dismissed by economists as unsuitable topics for economic analysis. Financial markets were viewed by economists such as John Maynard Keynes as mere “casinos” or “beauty contests,” in which assets were not priced in any rational way that could be described by economic laws. Before the development of finance theory, practicing traders operated by gut feelings or rules of thumb derived from experience, which they thought enabled them to take advantage of underlying trends that could be detected and charted but whose sources remained mysterious.

The field of finance is generally dated from the development of modern portfolio theory (MPT) in the 1950s, which demonstrates the possibility of constructing an optimal portfolio that offers the highest return for any given level of risk. This possibility frees portfolio selection from any need to consider specific risk and allows (diversified) investors to consider only systemic risk. The next step for finance theory was to develop a means for assessing the risk-to-return characteristics, and hence the specific risk, of any given security or asset. This was done with the development of the capital asset pricing model (CAPM) in the 1960s, which allows the calculation of the expected return on an asset that compensates an investor for the additional risk of that asset above the return on a risk-free asset. The problem of pricing options, which had been vexing, was eventually solved in the 1970s with the Black-Scholes option pricing model.

Other building blocks of modern finance include the Miller-Modigliani hypothesis or theorem (M-M) and the efficient market hypothesis (EMH). According to M-M, the capital structure of a firm is irrelevant to its valuation insofar as investors can adjust their personal portfolios to achieve the desired risk/reward ratio. In consequence, the market will not reward firms for their management of specific risk. Finally, EMH holds that markets are generally efficient in that the prices of assets reflect all available information. If this is true, then investors cannot “beat the market” without having any new information that has yet to be registered in the market. With all these elements, which were in place by the 1980s, modern finance theory as it is conceived and practiced today was largely complete.

As Robert W. Kolb observes in Chapter 2, “Ethical Implications of Finance,” finance theory is regarded, at least by its adherents, as ethically neutral or without normative import. However, the main assumptions of the theory, such as those about rational or self-interested behavior, and the outlook induced by adopting the theory, including CAPM and EMH, lead to conclusions about how people (morally) ought to behave, as well as to how firms (morally) ought to be organized and operated. For example, the propositions that firms ought to be controlled by shareholders and that they ought to be managed so as to maximize shareholder wealth are thoroughly normative. One writer observes that a critical transition occurs when ideas that may be initially ethically neutral are advocated as a basis for decision making (Horrigan 1987, 97). Thus, if everyone in a world thinks in the terms of modern finance, there are consequences that need to be morally evaluated, and, in the view of this writer, the world of modern finance “is not a nice place ethically” (Horrigan 1987, 107). Niall Ferguson (2008) has coined the term “Planet Finance” to describe a world in which financial thinking has resulted in the creation of the vast edifice of exotic collateralized and derivative securities that collapsed in the recent financial crisis. Clearly, whether Planet Finance is a good place to live is a fit subject for moral inquiry.

Kolb begins this inquiry with an examination of the ethical implications of the basic assumption of economics that rationality is the maximal satisfaction of individual preferences or utility and of the key concepts of finance theory, such as the time value of money and the reward for risk taking. These assumptions and concepts, as well as the basic tools of finance, such as the capital asset pricing model and option pricing theory, raise normative concerns, in Kolb's account, mainly when they are used in practice to guide individual portfolio management or the management of business corporations. Although the elements of modern finance were in place by the mid-1980s, Kolb discerns two more recent developments that also involve ethical issues, namely the nascent fields of enterprise or integrated risk management and behavioral finance. As a result of MPT, CAPM, and M-M, which consider mainly systemic risk, finance theory has tended to minimize the need to manage specific risk and along with it the impact of corporate decisions on employees and other stakeholder groups, who are affected by specific risk. However, finance today has a greater appreciation of the importance of managing total risk—both systemic and specific—in increasing the value of a firm, which also leads to a greater concern for all stakeholders and not merely shareholders. Finally, the field of behavioral finance is the result of advances in psychology that yield a more realistic understanding of people's actual financial decision making. The result has been to replace the simple view of *homo economicus* as a perfect utility maximizer with a more complex conception that must be considered by managers in their efforts to increase firm value.

The remaining chapters in Part II on finance theory provide more thorough treatment of the subjects introduced in Kolb's chapter. In Chapter 3, "Behavioral Assumptions of Finance," author John Dobson examines the basic assumption of economics and finance that economic agents are purely self-interested utility maximizers. Ranging far and wide from the Scottish enlightenment thinkers Adam Smith and David Hume, who fathered economics, to modern game theorists, social psychologists, evolutionary biologists, and neuroscientists, Dobson compiles an extensive body of evidence to counter the simplistic view of *homo economicus* that underlies economics and finance. The conclusions of this chapter not only bear on finance theory but also have practical implications for corporations—for example, in the design of incentives that were critical in, among other cases, the collapse of Enron—and for business education with its narrow focus on managerial effectiveness. In Dobson's view, a more realistic understanding of human rationality might perhaps return business education to a traditional, broader focus that includes moral development.

Nien-hê Hsieh's Chapter 4, "Efficiency and Rationality," offers a more detailed and technical account of rationality than that found in the preceding chapter by Dobson, and it introduces in the book a related key concept of economics and finance, namely efficiency. The aim of the chapter is to explain how these two concepts are defined and employed in economics and finance and to discuss the normative issues surrounding them. Whereas rationality is normative mainly as a prescription about how decisions ought to be made—by maximizing preferences—efficiency is normative as a criterion for evaluating outcomes: In general, more efficient outcomes ought to be preferred. Hsieh notes that the two concepts of efficiency—the efficient market hypothesis and Pareto efficiency—are

normative and raise ethical issues in their use, especially in cases of imperfect conditions where the assumptions of a perfect market fail to obtain.

A fundamental tenet of finance is that a return is due investors for the time an investment is made and for the risk taken. Whereas the time value of money is discussed in Chapter 2, Chapter 5, “Returns, Risk, and Financial Due Diligence,” by Christopher L. Culp and J. B. Heaton, explains the concepts of risk and return and the relationship between them. According to modern portfolio theory, investors seek the highest return for any level of risk. Generally, the return that investors receive along this *efficient frontier* is morally justified, and the main task is the technical one of determining the portfolio that produces the optimal risk/return ratio. This task requires some means for pricing assets according to risk so as to find the *alpha*, the amount of return in excess of this risk-adjusted return. Culp and Heaton explain and evaluate several forms of risk/return analysis, including CAPM and its variants. Aside from their use in portfolio selection, these models for asset pricing are useful for identifying the kind of too-good-to-be-true returns that occur in Ponzi schemes, such as the notorious Madoff funds. Culp and Heaton show how these models might have been used to exercise financial due diligence in discovering Bernard Madoff’s massive fraud.

Risk is usually understood as merely financial risk—and systematic rather than specific risk at that—but the recent development of enterprise or integrated risk management has focused attention on other kinds of risk. One of these is risk to a company’s reputation that can impose a cost greater than a failed strategy or external shocks. Chapter 6 by Ingo Walter, entitled “Reputational Risk,” explains what it is, why it arises, and how it can be valued. Although reputation can be easily understood as an object of risk, the difficulty of assessing how these risks might arise, what might be done to reduce them, and how to compare the costs and benefits of risk reduction pose difficult operational challenges. These challenges are especially great for financial services firms due to their special role as intermediaries, which depends so much on trust. The value of this chapter lies not only in identifying reputation as an object of risk but in showing how this risk can be measured and what can be done to reduce it through a combination of market discipline, effective government regulation, and company investment in self-regulation.

Finance theory has been enriched by theoretical developments unrelated to its core concerns of credit markets and asset prices. Among these are related developments in the study of the agent-principal relationship, which is ubiquitous in finance, and the structure of the firm. Both of these developments—agency theory and the theory of the firm—are the fruits of interdisciplinary work in economics, sociology, political theory, and law. Agency theory is useful for analyzing the economic, managerial, and legal structure of the relationships between agents and principals, which are designed to overcome the problems that result from such factors as opportunism, information asymmetry, uncertainty, and transaction costs. Agency theory also incorporates the related concepts (originally from insurance) of moral hazard and adverse selection, which figure prominently in finance theory. Thus, this theory is commonly applied in finance to the relationships of employer-employee, stockbroker-client, bank-customer, and the like. Agency theory was introduced into finance most prominently by Michael C. Jensen and

William H. Meckling (1976) to analyze the relationship between managers and stockholders, which leads directly into the theory of the firm as a nexus of contracts between the firm and its input providers. Corporate governance, which is the contract between a firm and its investors, is structured to ensure that managers act as faithful agents for the shareholder-principals.

Chapter 7, "Agency Theory," by Joseph Heath, is concerned mainly with defending agency theory, as it is used in finance and other fields of study, against criticism from some business ethicists. These critics oppose agency theory for its alleged role in supporting several positions that they find morally objectionable, including its assumption of rational, self-interested agents; the doctrine of shareholder primacy, by which shareholders exercise exclusive control rights over corporations; and the possible use of the agent-principal relationship to avoid responsibility by engaging agents to perform acts that are forbidden to the principals. Heath follows Kolb, Dobson, and Hsieh in questioning the assumption of rational self-interest as an accurate description of human behavior, but holds that "sophisticated practitioners" of agency theory are aware of the limitations of this methodological assumption and make allowances for them. With regard to agency theory and shareholder primacy, he argues that there is no necessary connection between them—shareholder primacy neither implies nor is implied by agency theory—but holds that agency theory may still be a valuable analytical tool in understanding the shareholders' role. Finally, the objection that agency relationships wrongly permit agents to do what is denied to principals is simply a conceptual error on the part of business ethicists. Agency theory is vindicated in Heath's analysis as a valuable tool in finance theory.

The doctrine of shareholder primacy, which Heath holds is not logically tied to agency theory, is nevertheless a central part of finance theory with links to other elements, most notably efficiency. The theory of the firm as it has developed in recent decades starts with the assumption that the firm has evolved in a market through a search for the most efficient forms of economic organization. Finance theory conceives the firm as a nexus of contracts. That is, for analytical purposes, the firm is understood in finance as the totality of all the contracts that are formed with various groups in the process of production. These groups include employees, suppliers, customers, and, of course, investors. On the assumption that each group as well as the managers of firms are operating in a market with a view to maximizing their own gain, the organization that results—that is, the result of this totality of contracts—represents a search for the most efficient ways of organizing the productive process. If any given form of organization is not fully efficient, then, in theory, another firm that is more efficient will drive it out of business.

Shareholder primacy—the doctrine that shareholders have the right of control and a right for their interests to be the objective of the firm—is considered in finance to be, in most instances, the most efficient form of governance. A question that must be left to ethics, though, is whether such an arrangement is not merely efficient but also ethically ideal. That is, is shareholder primacy morally justified? In Chapter 8, "The Financial Theory of the Firm," Wayne Norman examines both the financial argument that the standard investor-owned firm is efficient and the ethical argument that it is also morally justified. Although some ethicists, especially those who espouse stakeholder theory as an alternative to the stockholder- or shareholder-centered firm, criticize shareholder primacy as giving undue



prominence to shareholders in corporate governance, the ethical argument shows that shareholder control actually serves the interests of all groups and, moreover, is justified, in part because it is based on voluntary contracting in a market.

## FINANCIAL MARKETS

Much of the activity of finance takes place in markets, in which currencies, commodities, and financial instruments, such as stock, bonds, futures, options, swaps, and derivatives, are traded. Commonly, these markets are organized exchanges, such as stock and bond markets or currency or commodities or futures exchanges, which operate according to established laws, rules, and procedures. However, transactions can also take place privately, through dealers or middlemen in over-the-counter markets, or face-to-face between a buyer and a seller, as when an individual or company secures a loan from a bank or an insurance policy from an insurer. These are all market transactions.

The fundamental ethical requirement of financial markets is that they be *fair*. Fairness in financial markets can be analyzed by identifying instances of unfairness. These may be due to unfair *trading practices*, such as manipulation and fraud; unfair *conditions*, which are commonly described as an unlevel playing field; or unfair *contracts*, in which one party has taken morally impermissible advantage of another. Unfair conditions or an unlevel playing field typically result from asymmetries in information, bargaining power, or other resources. Whether an asymmetry is a cause of unfairness and ought to be corrected by regulation or other means is a difficult question that generally hinges on other rights and duties. Thus, a prospectus may be required for the issuance of a security, thereby correcting an information asymmetry, because investors are judged to have a *right* to make an informed decision. Similarly, insider trading is considered to be wrong because it involves a breach of a fiduciary *duty*. Fairness may be defined either *substantively*, as when a security is accurately priced, or *procedurally*, as when a security is sold with full disclosure so that the buyer can assess its value. Thus, *blue-sky laws*, which require expert evaluation of securities offered for sale, aim at substantive fairness, whereas regulations that merely require disclosure of relevant information aim at procedural fairness.

Fairness is a notoriously complex moral concept that has a wide range of application and standards. In some instances it denotes impartiality or a lack of bias, in others an equitable outcome or a distribution based on merit or desert. Fairness may be applied to discrete market transactions, market rules, or market outcomes and also to practices and institutions, such as insider trading or a tax system. Fairness is often regarded as being the same as *justice*, while some distinguish the two concepts. Chapter 9, "Fairness in Financial Markets," by Eugene Heath, explores the elusive complexity of the concept of fairness. Taking a philosopher's perspective, Heath describes not only the many aspects of fairness but also the ways in which moral philosophers have attempted to formulate the essential thread that runs through all these disparate uses. Following this, he shows how the concept of fairness can be applied to diverse financial matters, including lending and securities transactions.

The most commonly adopted means for ensuring fairness in markets is government regulation, although a significant degree of industry- and firm-level

self-regulation is also employed in finance. A great deal of deregulation has occurred in the past several decades, especially in the United States and Britain, but financial markets around the world still remain highly regulated. In addition to the amount of regulation, the parties to this debate also disagree on the most effective forms of regulation. The recent financial crisis has renewed and sharpened the debate over regulation, with opponents of deregulation placing blame for the crisis on the reduction in regulation and calling for a rollback of recent deregulation and an overall increase. Chapter 10, "Regulation," by Edward Soule, contributes to this debate, first by rejecting the claim that deregulation or too little regulation was at fault in the recent financial crisis. He argues that regulators had sufficient authority under the law to effectively prevent financial institutions from taking excessive risks; the fault lies rather with the use regulators made, or failed to make, of their authority. The solution, however, is not merely more diligent enforcement but also a change in the focus of regulation to the detection of weaknesses in the risk management culture of financial firms. This proposal is similar to the practice in auditing of not merely verifying the financial records of a firm but also assessing the effectiveness of its internal controls.

One particular kind of unfair market practice is insider trading, in which corporate insiders trade on information that they alone possess. As Peter-Jan Engelen and Luc Van Liedekerke observe in Chapter 11, "Insider Trading," this practice is part of a larger question of how much and what kinds of asymmetric information market participants may fairly use. Although insider trading is generally held to be unethical and is almost universally outlawed, the ethical justification for this ethical and legal prohibition is difficult to articulate. And some critics have held that the practice is, on the whole, beneficial and ought to be permitted for the reason that insider trading registers information about prices quickly at low cost. Engelen and Van Liedekerke survey the main arguments against insider trading, including those based on consideration of its alleged harmful consequences, market fairness in the possession of and access to information, property rights in information, and a market morality perspective. Their discussion leads to an understanding of both the ubiquitous condemnation of the practice and the difficulties in providing a cogent rationale for legal prohibitions.

Concerns about fairness and other ethical aspects of financial markets are not confined solely to market transactions but extend to the financial instruments that are created and subsequently sold and traded in these markets. The past decade has seen the remarkable development of exotic new products that offer great benefits in managing standard risks, even as they create new risks of their own. Chief among these new products are derivative contracts, which Warren Buffett has famously described as "financial weapons of mass destruction." James A. Overdahl, the chief economist of the Securities and Exchange Commission, examines these financial instruments in Chapter 12, "Derivative Contracts: Futures, Options, and Swaps," first by defining them and then by describing the five types of such contracts: forward contracts, futures, options, swaps, and structured products. After giving data on the size of the derivatives contract market, he discusses how they can be properly used—and possibly abused. Overall, he concludes that, despite Buffett's knock on them, derivative contracts are valuable financial products.

The participants in financial markets are most commonly individuals and institutional investors, such as banks, insurance companies, mutual funds, and pension

funds, which are still acting as custodians for the assets of individuals and other organizations. Investment banks engage in some proprietary trading for their own account, and although such activity occasionally gives rise to ethical issues, these have been, until recently, little different from the unfair trading practices that can also arise for individuals, such as market manipulation and fraud. However, many of the ethical issues in the recent financial crisis were the result of investment banks' activities in originating and securitizing loans and selling these collateralized debt obligations (CDOs) to others, as well as in buying and selling credit default swaps (CDSs). There are two other types of institutions of recent origin, though, that have become major market participants and whose activities raise ethical concerns. These are hedge funds and sovereign wealth funds.

Hedge funds are lightly regulated pools of capital, usually from wealthy individuals and large institutional investors—including pension funds and university endowments—which seek above-market rates of return (or *alpha*) by exploiting diverse markets with innovative (and usually proprietary) investing strategies. Because of their size and heavy use of leverage, hedge funds pose some risk to capital markets, as witness the collapse of Long Term Capital Management and Amaranth Advisors. In addition to the question of whether these funds should be more closely regulated to prevent this risk, they also raise ethical issues about their fee structures—the usual “2 and 20,” a 2 percent management fee and 20 percent of the returns—and about the tax treatment of returns. (The returns are classified as *carried interest* and thus are taxed at capital gains rates rather than the higher personal income rate.)

As Thomas Donaldson notes in Chapter 13, “Hedge Funds,” the main ethical issue is the opaqueness or lack of transparency, which is defended as essential to protect the proprietary nature of a fund's strategy. Donaldson argues that attempts by government to regulate hedge funds, given their opaqueness, run into two limits, which he calls *regulatory recalcitrance*, namely the cost of collecting and interpreting the data in a timely manner, and the impact that regulation would have on the use of innovative investment strategies. He does not conclude that no regulation should be imposed but recommends that it take the form of industry self-regulation in order to circumvent the problems of regulatory recalcitrance. Industry self-regulation involves, in Donaldson's view, the development of norms—which he calls *microsocial* norms—that solve collective action problems for hedge funds and serve to protect the impact on third-party stakeholders.

Sovereign wealth funds (SWFs), which are investment funds owned and controlled by nation states, usually funded by trade surpluses, raise many fears about their impact on financial markets, in part because of their size but mainly due to their control by a foreign government. The basic concern is that decisions by SWFs may be influenced less by standard financial or market considerations and more by national interests. Colleen Baker, in Chapter 14, “Sovereign Wealth Funds,” argues that the ethical objections to such funds can be grouped under the single label of *corruption*: “corruption of national security, corruption of market processes, corruption of information integrity, corruption of the rule of law, and corruption of domestic industry competitiveness.” Although these matters are serious, the potential problems are not insurmountable. Like hedge funds, SWFs do not appear to have played a disruptive role in the current financial crisis, and, indeed, they may have played a constructive role by providing American banks with much-needed

capital infusions. Moreover, the influence of SWFs may have peaked. Baker notes that several codes or guidelines have been developed, including the International Working Group of Sovereign Wealth Funds' *Sovereign Wealth Funds Generally Accepted Principles and Practices* (the Santiago Principles) and the Organisation for Economic Co-operation and Development's *Guidance on Sovereign Wealth* (OECD Guidance). She believes that these documents provide a workable blueprint for responsible conduct on the part of SWFs.

## FINANCIAL SERVICES

Financial services firms—which include banks, insurance companies, brokerage firms, mutual and pension funds, and financial planners—provide a vast array of financial services to individuals, businesses, and governments, as well as to each other. In so doing, these firms act primarily as financial *intermediaries*, by enabling their clients to consummate transactions through third parties rather than by themselves. This intermediary role utilizes the specialized knowledge and skill of finance professionals, as well as the unique capabilities of large financial institutions. For example, an individual might be able to manage a personal portfolio without expert advice and service, but only a bank can turn the savings of individual depositors into home mortgages, and only an insurance company can pool the risks of fire to home owners.

In acting as intermediaries, financial services firms typically become *agents* or *fiduciaries*. These roles have morally and legally defined obligations or duties, which are different from the ethics of market participants in arm's-length economic transactions. Much of the activity of financial services firms, as well as of markets generally, consists in the formation of *contracts*, which also create morally and legally binding obligations or duties, such as the duty to make loan payments, to settle insurance claims, or to honor derivative contracts. Indeed, agency and fiduciary relationships can be understood as the result of specialized kinds of contracts. In addition to the obligations or duties created by financial contracts of all kinds, financial services providers are also bound by the ethics of the marketplace to avoid fraud, violations of rights, and various kinds of unfair advantage taking.

Financial services firms operate as businesses, and like any business, they have the ethical obligation, as well as a legal duty, to observe accepted standards of business conduct. Thus, in their sales practices, firms should avoid deception, provide adequate information, ensure that products are suitable for customers and clients, and avoid abusive sales practices. Financial firms also have many of the other obligations for businesses generally—for example, to respect privacy rights, to avoid discrimination, to manage conflicts of interest, and not to participate in bribery and corruption. Banks have a particular role to play in preventing money laundering and tax evasion. Banks and other financial institutions also have social impacts that need to be managed according to best practices of social responsibility, and some institutions go further by facilitating socially responsible investing and providing credit to the very poor in less developed countries in a process known as *microlending* or *microfinance*.

Part IV on financial services begins with Chapter 15, "Marketing of Financial Services," by George G. Brenkert, who has written widely on marketing ethics. After developing an ethical framework for marketing ethics generally—which

includes identifying the relevant values and determining how they apply in practice—Brenkert focuses on three areas of marketing financial products to individuals that are subject to the greatest controversy. These are home mortgages, credit cards, and so-called payday loans. The first is controversial recently for the role that subprime mortgages played in the housing bubble, the wave of mortgage defaults and home foreclosures, and the subsequent collapse of the mortgage-backed securities market and the resulting credit squeeze; the second, for alleged abusive practices involving excessive fees and high interest rates; and the third, for the possibly usurious interest rates on such loans and the cycle of indebtedness that sometimes results when these short-term loans are rolled over. Although many of the ethical issues surrounding credit cards have been addressed in the United States by the Credit Card Accountability, Responsibility, and Disclosure Act of 2009, Brenkert observes that the other two sources of controversy are currently subjects of much proposed regulation.

The regulation of the marketing and delivery of financial services is achieved both by externally imposed government regulation and by a significant amount of internal self-regulation by professions, industries, and individual firms. The motivation for this self-regulation is not only to avoid more onerous government regulation but also to meet public expectations and to instill public confidence. In particular, finance practitioners in many areas seek to attain the status of professionals, which requires a certain amount of self-regulation and also a commitment to service in the public interest. All of these aims are achieved by the promulgation of a code of ethics. Chapter 16, “Financial Codes of Ethics,” by Julie A. Ragatz and Ronald F. Duska, examines the major codes of ethics that have been adopted by various professional organizations of financial services practitioners, including bankers, accountants, financial analysts, and financial planners and advisers. They find in the codes seven basic principles, namely integrity, objectivity, competence, fairness, confidentiality, professionalism, and diligence. Although these principles are easily recognized, the effectiveness of the codes depends on the interpretation of these principles and the manner in which they become embedded in practice. It is easy to be skeptical about the effectiveness of these codes and to suspect that they are mere “window dressing.” Accordingly, Ragatz and Duska conclude with an assessment of code effectiveness.

Banking is the financial service that touches the life of the most people, whether through checking and savings accounts, credit cards, consumer loans, home mortgages, or trust administration. In addition to providing essential services to customers, commercial banks serve the important economic function of aggregating people’s savings and making the funds available to individuals and businesses that need them. The economic health of any community depends on the soundness and the competence of its banks, especially in their money management and lending practices. In addition, investment banks provide some of these services as well as advisory, underwriting, and financing services for corporations that seek new capital or are engaging in a merger or acquisition. Investment banks can also engage in proprietary trading for their own account. All of these activities require not only strong technical skills but also an ability to address myriad ethical issues. These issues arise because of the important interests at stake in managing such large amounts of money and the conflicts that occur among different interests in typical bank dealings.

Chapter 17, "Banking," by Christopher J. Cowton, describes the activities and functions, mainly of commercial banks, and identifies the main ethical issues banks face. The ethical challenges to banks are grouped in the chapter under the twin heads of *integrity*, which is essential for generating the trust that banking requires, and *responsibility* in carrying out the activities and functions of banking effectively. In addition, Cowton explores a third area of *affinity*, which is a possibility that banks have only lightly exploited to bring together groups with similar interests in social causes. Affinity in banking shares similarities with socially responsible investing and microfinance, which are covered in other chapters of this volume.

Chapter 18, "Mutual Funds," by D. Bruce Johnsen, examines the ethical issues in two forms of mutual funds brokerage commission rebates: soft dollars and directed brokerage. Both practices are common in the mutual fund industry despite persistent criticism from academics and practitioners, who consider them to be ethically suspect. Soft dollars are credits that a brokerage firm provides to a mutual fund to pay for research and other fund expenses, and directed brokerage is a commitment by a brokerage firm to market a fund's shares. Both are means that brokerage firms use to compensate mutual funds for selecting them to execute their trades. Although they may appear to be a kind of kickback or bribe, Johnsen argues that, contrary to appearances, both practices may be efficient arrangements that benefit investors. The argument is that these arrangements effectively solve, at relatively low cost, a major problem for mutual fund managers, namely how to monitor the performance of a broker when the quality of the execution is difficult to assess. Although a fund manager may want high-quality execution, the manager will be unwilling to pay for it unless he or she can be assured of getting the (hard to detect) high quality. Soft dollars and directed brokerage may thus be a way for a broker to provide a bond to guarantee the quality of the execution. Although these two forms of commission rebates may be efficient, it does not follow that they are ethical. Johnsen completes the argument by using integrative social contracts theory, developed by Thomas Donaldson and Thomas Dunfee (1999), to show that such efficient arrangements are also ethical in virtue of being in accord with legitimate microsocial norms, as postulated in that theory.

For most individuals, their pension is the single most valuable asset they possess. However, much of the control over this asset is in the hands of pension managers, who have a fiduciary duty to manage a fund in the interest of the beneficiaries. Because of this third-party control, pension holders are at considerable risk from the mismanagement of their funds. In addition, the design of pension plans, and especially the choice between defined benefit and defined contribution plans, involves questions of how risk is to be shared by employees and employers. In Chapter 19, "Pension Funds," David Hess sets out the ethical issues for both private and public pension plans. In view of the risk involved, he writes, "What fiduciary duties require of individuals is at the heart of many of the ethical issues for pensions." Although the fiduciary duty of pension fund managers is imposed by law, the law itself does not resolve all questions about the meaning and application of this duty. In addition to exploring some of the gray areas of fiduciary duty in pension fund management, Hess also discusses the ethics of shareholder activism and social investing, especially by public pension plans.

Although insurance raises many ethical issues, especially about sales practices and product quality, Chapter 20, "Insurance," by Julie A. Ragatz and Ronald F.

Duska, focuses mainly on the social role of insurance and the challenges the industry faces in meeting the expectations of society. Insurance serves an essential role by pooling risks and sharing the burden of misfortune, but fulfilling this role requires an immense amount of trust that the resources will be available when misfortune strikes. After noting that some ethical problems, such as moral hazard and adverse selection, are present in all kinds of insurance, the authors explore the issues specific to three major types of insurance, namely life insurance, property and casualty insurance, and health insurance. Some of these issues, such as those involved in attempting to insure against major catastrophes like Hurricane Katrina and to provide health insurance for everyone, are among the most difficult faced by society today. They rightly conclude that the resolution of these ethical issues is, at bottom, “a question of economic justice.”

When people think about ethics in finance, the socially responsible investing movement (SRI) often comes to mind. SRI is certainly an area of financial activity in which ethical concerns are most consciously considered. Céline Louche and Steven Lydenberg, who are, respectively, an academic and an industry professional, bring their separate perspectives to a study of the movement. In Chapter 21, “Responsible Investing,” they observe that SRI is both an investment *product* bought by individual investors and a *practice* on the part of fund managers to engage with companies to improve their socially responsible activities. After presenting the history of SRI, which stretches back to the eighteenth century, Louche and Lydenberg describe how SRI is carried out in practice, how the industry itself is organized, and what challenges confront the industry. They note that the financial crisis of 2008–2009 poses both a challenge and an opportunity. SRI stands in opposition to modern portfolio theory, which has led, to some extent, to the financial crisis; and although the crisis creates an opportunity for a different approach to investing, it can be seized only if SRI advocates can successfully develop an alternative theoretical framework for this investment approach.

Another area of finance that visibly involves ethics is microfinance, which is widely praised as an effective means for alleviating poverty and empowering women in less developed countries. This practice gained global recognition in 2006 when Muhammad Yunus and the Grameen Bank, which he founded, were awarded the Nobel Peace Prize. Chapter 22, “Microfinance,” by Antonio Argandoña, examines the ethical issues involving this practice. Despite its noble aims and achievements, microfinance is open to criticism for such features as the high interest rates charged and the social pressures used to enforce loan collections. Argandoña observes that much of the criticism both inside and outside the movement results from an unresolved tension between the social mission of microfinance and the need for financial viability. This tension has become more acute as commercial banks have entered this market with a greater profit orientation than the Grameen Bank.

## FINANCIAL MANAGEMENT

Financial management is a function within a corporation, usually assigned to a chief financial officer (CFO), that is concerned with raising and deploying capital. In a sense, a CFO is making investment decisions and managing a portfolio, but these decisions are not about which securities to hold but about what business

opportunities to pursue and especially how they are financed. Every corporation must have a financial structure in which capital is divided between equity, debt, and other types of obligations. All of these decisions are guided by the objective of maximizing shareholder wealth. In the United States, the Sarbanes-Oxley Act assigns the CFO a responsibility to personally attest to the accuracy of financial statements, and the act also requires that corporations have a code of ethics for their top financial managers.

The ethical issues in financial management fall into two broad categories: the ethical obligations or duties of financial managers of a corporation, and the ethical justification for organizing a corporation with shareholder control and the objective of shareholder wealth maximization. The former category bears on the decisions made by financial managers in fulfilling the finance function of a corporation, and involves the fiduciary duties of financial managers to a corporation and its shareholders. The latter is a matter largely for government in establishing the laws of corporate governance; it concerns more theoretical matters about property rights and social welfare.

The first chapter in Part V on financial management covers this latter category of the meaning and justification of shareholder wealth maximization (SWM) as the objective of the corporation, which finance theory posits as the touchstone of all corporate financial decisions. In Chapter 23, "Shareholder Wealth Maximization," the author, Duane Windsor, focuses primarily on the standard interpretation and justification of this objective in the finance literature, and on the criticism of this purely financial view from the perspectives of corporate law and business ethics, the latter of which encompasses the literatures of corporate social responsibility and stakeholder theory. These critiques are relevant to the assessment of SMW because, as Windsor writes, "the public corporation is simultaneously private property, a web or nexus of contracts, a governmentally licensed and traded securities registrant, a social benefits entity, and a locus of stakeholder relationships." He concludes that the financial view, which is based largely on property rights, may be inadequate both as a justification of the corporate objective in law and as a practical managerial guide.

Although a company's financial records are maintained by internal accountants and certified by external auditors, the CFO of a corporation has ultimate oversight over financial reporting and is responsible for the presentation of financial records to investors and the government. In carrying out this responsibility, CFOs may be tempted to present the records in the most favorable light in ways that may be described as *earnings management*. In Chapter 24, "Earnings Management," Leonard J. Brooks, an expert in accounting ethics, explores the large gray area between the permissible and impermissible in reporting a company's earnings and offers practical guidance to CFOs and investors about the acceptable limits of this widespread practice. Of particular usefulness is his discussion of the red flags that can alert users of financial statements to questionable or impermissible earnings management.

In addition to required financial reports, which may be subject to earnings management, most large corporations maintain an office, staffed by finance professionals, to communicate regularly with investors about all manner of financial information. This investor relations office is typically headed by an investment relations officer (IRO). Like earnings management, investor relations raises a host of ethical questions about what information to disclose and how to disclose it.



These questions are addressed by Cynthia Clark Williams and Lori Versteegen Ryan in Chapter 25, "Investor Relations." The answers to these questions, they argue, are determined, in part, by considerations of what rights investors have to certain information. In the United States, these questions have been given additional urgency by SEC Regulation FD on fair disclosure, which requires that information be disclosed to all investors and not merely a select few. In addition, many investor relations offices collect information about the corporations' own shareholders, thus raising additional issues about ethical information collection practices.

Risk is commonly applied in finance to the probability of the expected return on an investment, as explained in Chapter 26, "Risk Management," by Peter Young. In traditional discussions of risk and ethics, the main focus has been on the concept of moral hazard. However, the concept of risk can also refer to all of the factors that bear on the profitability and, indeed, the survival of a firm. These factors, which move beyond mere moral hazard, must be considered in some manner by the top managers of a corporation, including the CFO, and be reflected in the decisions they make. Although the management of specific risks has long been done on a piecemeal basis, a significant change in recent years has been the integration of these previously disconnected efforts into a coordinated function called enterprise risk management (ERM). Some firms have even created the position of chief risk officer to discharge this function. In this chapter, Young seeks to elucidate how this modern-day ERM is related to ethics. He finds the main link between ERM and ethics in the way in which risk management is necessarily connected to an organization's core values. Indeed, risk management is itself a value that must be deeply embedded in a corporation's culture for it to be practiced successfully. And when practiced well, he writes, "risk-based thinking serves to articulate an organization's values with respect to risk, uncertainty, complexity, and ambiguity, and to inform the decisions and actions that are taken."

Bankruptcy raises an immense number of ethical issues not only for financial managers dealing with a financial crisis but also for legislators and judges who must craft and administer the Bankruptcy Code. For a corporation facing insolvency, the decision whether to file for bankruptcy protection and for which kind of protection deeply affects its financial operation and structure. Whether the choice is to liquidate or reorganize, the firm will have to work with its creditors to satisfy their claims. If the firm attempts to reorganize, it typically seeks debtor-in-possession financing to raise new capital. Even before a decision about bankruptcy, a corporation may make many financial decisions in an effort to avoid bankruptcy, some of which may benefit shareholders at the expense of bondholders and other creditors. And a solvent business may take advantage of the Bankruptcy Code to pursue strategic aims, such as reducing legal judgments or breaking contracts. In drafting a bankruptcy code, legislators must first overcome the traditional view that bankruptcy is a moral failing that should not be rewarded, and then draft a code that strikes the right balance between the rights and interests of debtors and creditors and between economic efficiency and social well-being. Chapter 27, "Bankruptcy," by Ben S. Branch and Jennifer S. Taub, explores these myriad ethical issues in both the historical and contemporary forms and also offers some illuminating cross-national comparisons.

Like bankruptcy, a merger, acquisition, or takeover is a corporate event that deeply affects a wide range of constituencies or stakeholder groups and thus raises

ethical concerns. Although the hostile takeovers of the 1980s, which were strongly criticized for their adverse effects on workers and communities, are now less frequent occurrences, the pace of friendly mergers and acquisitions has increased as companies struggle to remain competitive. A challenge for management in these sometimes wrenching transformations is to maintain the support of employees, customers, suppliers, and other groups that are critical to a company's competitiveness. As Anthony F. Buono and Roy A. Wiggins III observe in Chapter 28, "Acquisitions, Mergers, and Takeovers," making a merger or acquisition work often involves attention to such ethical considerations as fair treatment of all parties and the minimization of adverse impacts. They recommend that, in addition to the financial, strategic, and legal analyses that are typically undertaken, companies should also develop a plan for managing the conflicts that inevitably occur in acquisitions and mergers.

Perhaps no issue involving finance raises greater ethical concern than that of executive compensation. Outrage is the most common response, according to John J. McCall in Chapter 29 on this topic, "Executive Compensation." The fervency of this outrage is not matched, however, by a clear understanding of exactly what might be wrong. Is the ethical problem with the form of executive pay, which is largely in stock options? Is it with the absolute level of pay or with the way in which pay is set? Why are people outraged with the high compensation to some executives but not others? Emotion is no substitute for rigorous ethical analysis. Although McCall sides with the critics of executive compensation, he supports his view with a careful examination of the arguments in the academic literature that criticize and support the current system and attempt to answer the more specific questions.

Boards of directors are ultimately responsible not only for executive compensation but for all financial matters of a corporation from decisions about financial structure to capital expenditures. Boards are also critical in controlling a firm so as to avoid financial irregularities. Indeed, many provisions of the Sarbanes-Oxley Act, passed in 2002 in response to the collapse of Enron, address the composition and operation of boards, including the requirement that there be a majority of independent directors. This focus on boards reflects the judgment of Congress that the financial scandals of that period were due, in large measure, to a lack of director independence. The need for the independence of directors is dictated not only by long experience but also by theory, specifically agency theory, which is discussed in Chapter 7 as an important component of finance theory. According to this theory, director independence is essential to overcome the agent-principal problem inherent in the separation of ownership and control. If managers also serve as directors, then they are, in effect, monitoring themselves. This problem is especially acute when the CEO of a corporation also serves as the chairman of the board, so-called *duality*. However, CEO duality, which is prevalent in U.S. corporations, is dictated by organization theory generally and, in particular, by the idea of the *unity of command*. The result is identified by Dan R. Dalton and Catherine M. Dalton as "a collision of theories and a collapsing of application." In Chapter 30, "Boards of Directors," these management scholars examine the issues of director independence and CEO duality and the conflict between theories with a view to contributing to both theory and practice in corporate governance.

## CONCLUSION

Although finance ethics may lack recognition as a distinct field of study, the chapters in this volume show that the individual topics involved have long been examined from an ethical point of view and are rich in ethical content. No single volume could contain all the possibly relevant topics, and some readers may find a subject of interest omitted. This volume is an attempt, however, to bring together not only the major topics but also the key scholars in the nascent field of finance ethics to provide a foundation for further work. The rest is left to the readers of this volume with the hope that the field of finance ethics flourishes.

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