Chapter One

Finance Ethics: An Overview

Some cynics jokingly deny that there is any ethics in finance, especially on Wall Street. This view is expressed in a thin volume, *The Complete Book of Wall Street Ethics*, which claims to fill "an empty space on financial bookshelves where a consideration of ethics should be."[1] Of course, the pages are all blank! However, a moment's reflection reveals that finance would be impossible without ethics. The very act of placing our assets in the hands of other people requires immense trust. An untrustworthy stockbroker or insurance agent, like an untrustworthy physician or attorney, finds few takers for the services offered. Financial scandals shock us precisely because they involve individuals and institutions that we should be able to trust.

Trust is essential in finance, but finance ethics is about far more than trust. Finance consists of an array of activities that involve the handling of financial assets—usually those of other people. Not only does the welfare of everyone depend on the safeguarding and deployment of these assets, but billions of financial transactions take place each day with a high level of integrity. With this large volume of financial activities, there are ample opportunities for some people to gain at other's expense. Simply put, finance concerns other people's money (OPM), and OPM invites misconduct. Individuals in the financial services industry, such as stockbrokers, bankers, financial advisers, mutual fund and pension managers, and insurance agents, have a responsibility to the customers and clients they serve. Financial managers in corporations, government, and other organizations have an obligation to manage the financial assets of these institutions well. It is important that everyone else involved in

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finance, in whatever role, conduct themselves with the utmost attention to ethics.

The ethics of an occupation or a profession is best understood not by examining the worst conduct of its members but by attending to the conduct that is commonly expected and generally found. In finance, as in other areas of life, three questions of ethics are critical: What are our ethical *obligations* or *duties*? What *rights* are at stake? And what is *fair* or *just*? Beyond these more specific questions lies the ultimate ethical question: How should we live? In the case of finance, this question goes to the heart of the purpose of financial activity: What role should finance play in our individual lives and in the development of a good society?[2] These four fundamental questions are not easily answered, but an attempt to answer them—or at least the first three—is the main task of this book.

This chapter lays the groundwork for the ones that follow by providing an overview of the need for ethics in finance and the main areas of finance ethics. A comprehensive treatment of ethics in finance is, of necessity, long and involved because of the diversity of financial activities and the range of ethical issues they raise. However, there is little that is unique to finance ethics. The ethics of finance has counterparts in other areas of business and in the professions, such as medicine and law. Thus, our discussion of ethics in finance can be facilitated by drawing on the well-developed fields of business and professional ethics.

The Need for Ethics in Finance

Although the need for ethics in finance should be obvious, it is useful to understand both the misconduct that occurs all too frequently and its causes. Most people in finance are decent, dedicated individuals, but, unlike the professions, which involve a strong commitment to service, finance relies mainly on the search for gain, which can easily become greed. Moreover, individuals operate within and through organizations, institutions, and systems, including markets, which may be faulty. Consequently, scandals may occur that were part of no one person's intentions and for which no one bears responsibility. Many scandals result not from deliberate misconduct—doing what one knows to be wrong—but from rational actors following incentives in situations with complex interactions. Ethical misconduct is not always a matter of bad people doing bad things, but often of good people who stumble unwittingly into wrongdoing. This section describes some of the scandals of recent years, which have created an image of finance as an activity devoid of ethics, and it also explores some of the causes for these scandals.

Financial scandals

Wall Street was shaken in the late 1980s by the insider trading and market manipulation of Dennis Levine, Martin Siegel, Ivan Boesky, Michael Milken, and others. In 1990, Mr Milken pleaded guilty to six felonies and was sentenced to 10 years in prison. Previously, his firm, Drexel Burnham Lambert, collapsed after admitting to six felonies and agreeing to pay $650 million. James B. Stewart, the author of *Den of Thieves*, calls their activities "the greatest criminal conspiracy the financial world has ever known."[3] Insider trading continues to be not only a frequent occurrence but also a source of controversy. Although the domestic maven Martha Stewart was convicted in 2004 for lying to investigators about a suspicious transaction, questions remain about whether she had actually committed insider trading. However, the investigation of Raj Rajaratnam, head of the Galleon Group—who was convicted of insider trading in 2011 and sentenced to 11 years in prison—also ensnared many members of the circle of informants that he had built over many years, including a respected director of Goldman Sachs and Procter & Gamble. This conviction exposed the extent to which insider trading had become organized in the hedge fund world through so-called expert networks.

The investment bank Salomon Brothers was nearly destroyed in 1991 by charges that traders in the government securities division had attempted to execute a "squeeze" by rigging several auctions of US Treasury notes. The total cost of this scandal—including legal expenses and lost business, on top of a $290 million fine—has been estimated at $1 billion. The firm dismissed the people responsible for the bid-rigging, as well as CEO John Gutfreund, who was unaware of the activity at the time. (Gutfreund's offense was that he sat on the news for more than three months before reporting it to the Treasury Department.) Also ensnared in this scandal was vice-chairman John Meriwether, who went on to head Long-Term Capital Management, a hedge fund that collapsed at great loss in 1998. The name of this venerable firm, founded in 1910, was eventually abandoned in 2003, after a new owner, Citigroup, was itself involved in a series of scandals. At that time, the reputational value of the Salomon Brothers franchise was apparently deemed to be worth little.

After losing $1.6 billion on derivative transactions in 1994, Orange County in California sued its financial adviser Merrill Lynch for concealing the amount of risk that was involved in its investments. In 1998, Merrill Lynch settled the suit for more than $400 million. In 1996, Procter & Gamble (P&G) settled with Bankers Trust after the bank agreed to forgive $200 million that P&G owed on failed derivative transactions. P&G's charge that Bankers Trust had

misrepresented the investments was bolstered by damaging audio tapes, including some in which bank employees were recorded using the acronym ROF for "rip-off factor" to describe one method for fleecing customers. Although derivative securities continue to be a source of considerable abuse, efforts to regulate them have been largely unsuccessful. Both Merrill Lynch and Bankers Trust were eventually saved from collapse by absorption into larger banks (Bank of America and Deutsche Bank respectively).

Unauthorized trading by individuals has caused great losses at several banks and trading firms. Nick Leeson, a 28-year-old trader in the Singapore office of Barings Bank, destroyed this venerable British firm in 1995 by losing more than $1 billion on futures contracts that bet the wrong way on the direction of the Japanese stock market. (The final blow to his precarious position came from an unpredictable event, the Kobe earthquake.) In 1996, the acknowledged king of copper trading was fired by Sumitomo Corporation for losing an estimated $2.6 billion, and Sumitomo also sued a number of banks for issuing derivative securities that enabled the trader to hide the losses. Between 2006 and 2008, Jérôme Kerviel, a trader at the French bank Société Générale, managed to lose 4.9 billion euros in unauthorized activity. UBS incurred losses of $2.3 billion in 2011 that had been hidden by a young trader named Kweku Adoboli. In most of these cases, the rogue traders exploited flaws in reporting systems and benefited from lax management supervision, which may have also been weakened by a reluctance to interfere in these traders' apparent money-making ability. Returns that are "too good to be true" often are, but who wants to point this out?

The usually staid mutual fund industry was roiled in 2003 when New York State attorney general Eliot Spitzer brought charges against a number of mutual fund sponsors, including Bank of America, Putnam Investments, Janus Funds, and Strong Capital Management. These companies had allowed favored traders to operate after the close of the business day and also to make rapid, market-timing trades. Late trading is illegal, and most funds discourage market timing with rules that prevent the practice by ordinary investors. In the case of Strong Capital Management, the founder, Richard S. Strong, not only permitted a favored investor, Canary Capital, to engage in market-timing trades but also engaged in the practice himself. He made 1400 quick trades between 1998 and 2003 in violation of a fiduciary duty that he, as the manager of the Strong family of funds, had to the funds' investors.

Also in 2003, 10 major investment firms paid $1.4 billion to settle charges that their analysis of securities had been slanted in order to curry favor with client companies. At the height of the Internet and telecommunications boom, the firms' securities analysts had issued favorable reports of companies such as WorldCom and Global Crossing that subsequently collapsed. These biased

reports induced thousands of people to invest millions of dollars, much of which was lost when the market bubble burst. The analysts were, in many cases, compensated for their ability to bring in investment banking business, which created a conflict of interest with their duty to offer objective evaluations of companies. Two analysts, Jack B. Grubman at Salomon Smith Barney, then a part of Citigroup, and Henry Blodget of Merrill Lynch, paid large fines and agreed to lifetime bans from the securities industry for their roles in pushing companies that they knew were troubled. William H. Donaldson, then chairman of the Securities and Exchange Commission, commented, "These cases reflect a sad chapter in the history of American business—a chapter in which those who reaped enormous benefits based on the trust of investors profoundly betrayed that trust."[4]

The fall of Enron in 2001 and WorldCom in 2002 involved many ethical lapses. An important part of the Enron story involved off-balance-sheet partnerships that generated phantom profits and concealed massive debts. These partnerships were formed by Enron's chief financial officer (CFO) Andrew Fastow. For Fastow to be both the CFO of the company and the general manager of the partnerships, and thus to negotiate for both sides in deals, constituted an enormous conflict of interest—a conflict that he used to reward himself handsomely. Shockingly, the Enron board of directors waived the prohibition on such conflicts in the company's code of ethics to allow Fastow's dual role. Aside from the fact that many of the partnerships violated accounting rules and should have been consolidated on the company's books, Enron guaranteed some of the partnerships against losses with a commitment to infuse them with more stock in the event they lost value. Because the partnerships were capitalized with Enron stock to begin with, a decline in the price of the stock triggered massive new debt obligations. The end for Enron came quickly when investors realized the extent of the company's indebtedness—and the faulty accounting that had hidden it.

By contrast, the accounting fraud at WorldCom was alarmingly simple: the company reported as revenue accruals that were supposed to be set aside for payments, and some large expenses were recorded as capital investments. Both kinds of entries are violations of generally accepted accounting principles (GAAP). WorldCom's end also came quickly when the head of internal auditing unraveled the fraud and courageously reported it to the board of directors. CEO Bernie Ebbers and CFO Scott Sullivan were convicted and sentenced to prison terms of 25 and 5 years respectively. The internal auditor, Cynthia Cooper, was later featured on the cover of *Time* as one of three women whistleblowers who were recognized with the magazine's 2002 Persons of the Year award. (Another awardee was Sherron Watkins, who blew the whistle on Enron's perilous financial structure.)

In the financial crisis that began in 2007, the most obvious target of ethical criticism was the mortgage origination process in which unsuitable loans were made without adequate determination and documentation of creditworthiness. Lax mortgage origination practices contributed, in part, to a bubble in housing prices, which precipitated the crisis and left many borrowers "under water," owing more on their mortgage than the house was worth. Mortgage originators were often heedless about suitability or creditworthiness because they could quickly sell the loans to major banks, which would combine many mortgages into securities that were sold to investors. Woefully inadequate documentation of mortgages (called "robo-signing") has also proven to be a serious problem as banks, which often lacked clear title to the property, sought to foreclose on borrowers, who, in some cases, did not owe the amounts charged.

Although the securitization of mortgages and other debt obligations has many benefits, the risks of default, which were increased by the housing bubble and uncreditworthy borrowers, tended to be overlooked by both the securitizers and investors. When the bubble burst, the banks that held many of the mortgage-backed securities and financed their holdings by short-term borrowing found themselves unable to obtain funding, and because of their high leverage and assets of questionable value, they faced the threat of insolvency. Since many of these banks were considered "too big to fail," their collapse threatened the whole economy, which prompted a vigorous government response. A failure on the part of rating agencies to accurately gauge the risk of the mortgage-backed securities and government policies supporting home ownership were also blamed for the crisis. In particular, the federally chartered, for-profit mortgage holders, Fannie Mae and Freddie Mac, were major factors in the financial crisis. Given the many factors in the crisis, controversy remains about which were more important and which of these involved distinctively ethical failings as opposed to poor judgment, failed systems, and plain bad luck.

Since the financial crisis, questions of ethics have been raised in such cases as the collapse of MF Global, in which about $1 billion in clients' money disappeared in a frantic effort to meet the firm's own obligations after the failure of risky bets on European sovereign debt. MF Global violated a fundamental requirement in their business of derivative trading to segregate client funds from those of the firm. The "flash crash" of May 6, 2010, and the $440 million loss at Knight Capital Group in 2012, both due to malfunctioning software programs, have focused attention on the dangers of high-frequency trading, which some charge is a predatory practice that provides little benefit to investors. Confidence in financial institutions was further imperiled by charges that major banks had intentionally manipulated the widely used

London Interbank Offered Rate (LIBOR) by submitting false information to the rate-setting organization. Banks have also been under investigation for aiding in illegal tax evasion and for deliberately circumventing rules to prevent money laundering for clients in countries under international sanctions, such as Iran.

These scandals not only undermine the public's confidence in financial markets, financial institutions, and indeed the whole financial system but also fuel popular perceptions of the financial world as one of personal greed without any concern by finance people for the impact of their activities on others. A 2011 Harris poll revealed that 67 percent of respondents agreed that "Most people on Wall Street would be willing to break the law if they believed they could make a lot of money and get away with it."[5] In addition, 70 percent believed that people on Wall Street are not as "honest and moral as other people." Only 31 percent of people agreed with the statements "In general, what is good for Wall Street is good for the country" and "Most successful people on Wall Street deserve to make the kind of money they earn." In 2006, 60 percent of respondents polled believed that "Wall Street only cares about making money and absolutely nothing else." These results are virtually unchanged from polls conducted annually by Harris since 1996.

The public's dim view of ethics in finance is shared by industry insiders. A 2012 survey of 500 financial services professionals in both the United States and the United Kingdom found that 26 percent of Wall Street and Fleet Street professionals had personally witnessed unethical conduct in the workplace.[6] In addition, 24 percent of the respondents believed that getting ahead requires people to engage in unethical and illegal behavior. Only 41 percent of respondents were sure that no one in their firm had "definitely not" engaged in such behavior, while 12 percent thought that it was likely that people in their firm had done so. Thirty percent of respondents in the United States and the United Kingdom also agreed that the compensation system in their firms created pressure to violate ethical and legal standards.

This image of the financial world as mired in misconduct is not entirely undeserved, of course. Ivan Boesky delighted a commencement audience of business school students at the University of California at Berkeley with the assurance that greed is "all right." "I think greed is healthy," he said. "You can be greedy and still feel good about yourself."[7]

Causes of wrongdoing

Although scandals cannot be prevented entirely, it is important to understand why they occur and to undertake reasonable preventive measures. At the same time, we should aim not merely at the prevention of scandals but also at

achieving the highest possible level of exemplary ethical conduct. The goal should be not only to prevent the worst but also to achieve the best. Success in meeting this challenge depends on a complex interplay of the personal integrity of individuals, supportive organizations and institutions, and ethical leadership by people in positions of responsibility.

Pressure and culture

Some of the most difficult dilemmas of business life occur when individuals become aware of questionable behavior by others or are pressured to engage in it themselves. In a survey of 30 recent Harvard University MBA graduates, many of the young managers reported that they had received "explicit instructions from their middle-manager bosses or felt strong organizational pressures to do things that they believed were sleazy, unethical, or sometimes illegal."[8] A survey of more than one thousand graduates of the Columbia University business school revealed that more than 40 percent of the respondents had been rewarded for taking some action they considered to be "ethically troubling," and 31 percent of those who refused to act in ways they considered to be unethical believed that they were penalized for their choice, compared to less than 20 percent who felt they had been rewarded.[9] The Harvard graduates did not believe that their superiors or their organizations were corrupt. The cause is rather intense pressure to get a job done and to gain approval. Ethical and even legal restraints can get lost when the overriding message is "Just do it!"

Unethical behavior can also be fostered by the culture of an organization. In *Liar's Poker*, an amusing exposé of the author's brief stint as a trader at Salomon Brothers, Michael Lewis describes the coarse pranks of a group who occupied the back row of his training class.

> There was a single trait common to denizens of the back row, though I doubt it occurred to anyone. They sensed that they needed to shed whatever refinements of personality and intellect they had brought with them to Salomon Brothers. This was not a conscious act, more a reflex. They were the victims of the myth, especially popular at Salomon Brothers, that a trader is a savage, and a great trader is a great savage.[10]

In the culture that Lewis describes, ethical behavior is not readily fostered. He continues, "As a Salomon Brothers trainee, of course, you didn't worry too much about ethics. You were just trying to stay alive. You felt flattered to be on the same team with the people who kicked everyone's ass all the time."[11]

Organizational factors

Although wrongdoing is sometimes attributable to a lone individual or rogue employee, some of the most common misdeeds are committed by organiza-

tions in which many people contribute to an outcome that no one intends or even foresees. Wrongdoing also occurs in large organizations when responsibility is diffused among many individuals and no one person is "really" responsible. In some cases, it is difficult to identify any one person or decision as the source of an act, and the wrongdoing can be attributed only to the organization as a whole. Such organizational wrongdoing is often due to the fragmented nature of decision making in which a number of individuals make separate decisions about different matters, often on the basis of diverse, sometimes conflicting, information. Typically, these decisions are not made all at once but incrementally over a long period of time in a series of small steps, so that their full scope is not readily apparent.

Virtually all organizations seek to direct and motivate members by means of incentives, which may produce unintended outcomes. Poorly designed incentive plans may either move people in the wrong direction (when incentives are misdirected) or too far in the right direction (when incentives are simply too strong). Perverted or overly powerful incentives are the root cause of many financial scandals. Another kind of incentive problem develops when individuals or organizations acquire interests that interfere with their ability to serve the interests of others when they have a duty to do so. When a broker, for example, is obligated to recommend only suitable investments for a client but is compensated more for some investments than others, a personal interest in more pay may lead the broker to fail in the duty to serve the client. The very existence of such an incentive to violate an obligation to serve the interest of another is a wrong that is known as a *conflict of interest*. Conflict of interest is a particularly prominent incentive problem in all areas of finance ethics.

These organizational factors are evident in the case of E.F. Hutton, a now-defunct brokerage firm, which was convicted in 1985 on 2000 counts of fraud for a check-kiting scheme. The firm obtained interest-free use of more than $1 billion over a 20-month period by systematically overdrafting checking accounts at more than 400 banks. This illegal scheme began as an attempt to squeeze a little more interest from the "float" that occurs when checks are written on one interest-bearing account and deposited in another. Until a check clears, the same dollars earn interest in two different accounts. No one person created or orchestrated the practice, and yet the firm, through the actions of many individuals, defrauded banks of millions. When the check-kiting scheme began, few people were aware of the extent of the activity, and it continued, no doubt, because anyone who intervened would have had to acknowledge the existence of the fraud and take responsibility for the loss of the extra income it generated. In addition, the participants could assure themselves that their own actions did no significant harm since each transaction seemed minor.

In another example, Marsh Inc., which called itself "the world's leading risk and insurance services firm," was accused in 2004 by the New York State attorney general of cheating its insurance brokerage clients by rigging bids and accepting undisclosed payments from insurance companies that it recommended. As an insurance broker, Marsh advises clients on the choice of insurance companies and policies. By accepting so-called contingency commissions—which are fees of 5 to 7.5 percent of the annual premium on top of a typical 15 percent standard commission—Marsh placed itself in a conflict of interest that potentially hampered its ability to offer its clients unbiased service. This added cost of companies' insurance policies, which is arguably exorbitant for the services provided, is passed along to the public in the form of higher prices. Although contingency commissions appear to be questionable, they have gone largely unquestioned by industry leaders. Jeffrey W. Greenberg, chairman and CEO of Marsh at the time, issued a statement calling them a "longstanding, common industry practice."[12] Nevertheless, Marsh paid $850 million in 2005 to settle the charges, agreed to forgo the payments permanently, and issued an apology for engaging in the practice. More ethically aware leadership might have recognized the inappropriateness of contingency commissions and ended their use much earlier.

Organizational factors are also impacted by leadership. Leaders of firms have a responsibility for the environment in which unethical conduct takes place. In a *Harvard Business Review* article, Lynn Sharp Paine writes:

> Rarely do the character flaws of a lone actor fully explain corporate misconduct. More typically, unethical business practice involves the tacit, if not explicit, cooperation of others and reflects the value, attitudes, beliefs, language, and behavioral patterns that define an organization's operating culture. . . . Managers who fail to provide proper leadership and to institute systems that facilitate ethical conduct share responsibility with those who conceive, execute, and knowingly benefit from corporate misdeeds.[13]

The bond-trading scandal at Salomon Brothers, for example, was not due merely to the willingness of the head of the government bond-trading department to violate Treasury auction rules. It resulted, in large measure, from the aggressive trading culture of the firm, from a poorly designed compensation system, and from a lack of internal controls. At Salomon Brothers, some units had negotiated compensation systems in which members shared a bonus pool equal to a percentage of the total profits, while managers in other units received lesser amounts that were based mostly on the overall performance of the firm. This system placed no cap on the bonuses of some traders and encouraged them to maximize profits without regard for the profitability of the whole firm.

In addition, there were few controls to detect irregular trading by the managers of the most profitable units. The task for the new leadership of Salomon Brothers included a thorough overhaul of the whole organization, which was led by major shareholder Warren Buffett, whose reputation for integrity was instrumental in regaining the trust of clients and regulators.

Leadership failures were abundant in the years leading to the financial crisis that began in 2007. The heads of large mortgage origination companies created a climate in which loan officers were actively encouraged, indeed forced, to abandon prudent standards in order to meet the insatiable demand from the packagers of mortgage-backed securities. Further, these companies created new types of mortgages with low teaser rates and generous repayment plans, such as interest-only and even negative amortization loans, in which unpaid interest was added to the principal. While praising these inventive mortgages in public, the founder of one of the largest origination companies, Countrywide, was more candid. About one of these products (a mortgage with no down payment), Angelo Mozilo wrote, "In all my years in the business, I have never seen a more toxic product."[14] Yet the sales went on.

Innovation

Although financial innovation has brought many benefits, its value has been questioned in the public mind and among some finance experts for the destructive consequences that sometimes follow. Economist and *New York Times* columnist Paul Krugman quipped that it is "hard to think of any major recent financial innovations that actually aided society, as opposed to being new, improved ways to blow bubbles, evade regulations and implement de facto Ponzi schemes."[15] Former Fed chairman Paul Volcker claimed that the only really useful recent innovation was the ATM machine.[16] Even good innovations, such as the credit card, have some socially destructive consequences. Robert Manning convincingly shows in *Credit Card Nation* that America's "addiction to credit," as he calls it, has brought misfortune to many.[17] The dangers of innovation are inevitable and may be inseparable from the benefits.

First, innovation creates new situations in which the rules for proper conduct, as well as for safe practice, are uncertain and slow to develop. In the changed world wrought by innovation, the old rules may no longer apply, and, eventually, new rules will be developed, but in the meantime, there are windows of opportunity for misconduct. For example, in the early days of the Internet, there was great uncertainty about how to value dot.com businesses and, in particular, about how to recognize income for start-ups that were not making any money but had great potential. Many investment decisions were made on the basis of pro forma statements that presented hypothetical future

income and expenses that, in many cases, turned out to be wildly optimistic. The result was the Internet or dot.com bubble.

Second, new situations sometimes involve a change of incentives and a shift of risk and responsibility. This was certainly true of mortgage lending during the current financial crisis. In the old originate-to-hold model of mortgage lending, issuing banks had an incentive, and the responsibility, to ascertain and verify the creditworthiness of potential borrowers, inasmuch as they held the loans on their books and hence bore the full risk of default. With the shift to an originate-to-distribute model, in which mortgages were securitized and sold to investors, neither the originating banks nor the ones packaging the securities (which were sometimes the same) had an incentive to ensure borrowers' creditworthiness. The responsibility for this function was shifted to the ultimate investors, who, in many cases, were ordinary people, who were utterly unaware of the risk shift taking place and, in any event, had neither the information nor the ability to assess the quality of the underlying mortgages.

Third, innovation is inherently complex and opaque, and the dangers are difficult to perceive. Innovation takes place on the cutting edge of finance or any other domain and may be understood, at first, by only a few involved in the creative process, if at all. History is replete with examples of how inventions had profound and unexpected consequences. Moreover, some financial innovations are deliberately designed to be complex and opaque precisely in order to gain an advantage by deceiving or confusing others. In the recent financial crisis, the role of credit default swaps (CDSs) was a crucial factor inasmuch as many banks took greater risk in holding risky mortgage-backed securities, called collateralized debt obligation (CDOs), because they believed their positions were adequately hedged with the insurance-like credit default swaps. What they failed to see was that the insurers who issued these swaps would be unable to honor claims in a general crisis that would result from a collapse of the mortgage market. The two securities, CDOs and CDSs, turned out to be closely linked.

Fourth, given that the dangers of innovation are difficult to perceive, everyone is held captive to the least perceptive—or the most daring. 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. In *Fool's Gold*, Gillian Tett describes how the bankers at J.P. Morgan who developed the derivative called CDO squared (or synthetic CDO) foresaw the dangers of using their discovery to make bets on mortgage-backed securities.[18] In her account, the J.P. Morgan bankers looked on in horror as less cautious firms, who did not perceive the unique risks posed by using mortgages in these securities, proceeded to do exactly that. As long as a few banks and enough

investors failed to see the dangers, these securities would continue to be produced and purchased with the disastrous consequences that occurred. This dilemma was illustrated by Charles Prince, the CEO of Citigroup, who was aware of the dangers in financing long-term assets with short-term debt. Yet, he said, "But as long as the music is playing, you've got to get up and dance." This remark shows that his restraint would have had little effect unless all parties involved perceived the dangers and acted in concert to stop dancing to the music.

The causes of major scandals in finance involve more than individual conduct and range over many organizational and systemic factors. However, the field of finance ethics is concerned with more than these scandals, which are merely the most visible and troubling evidence of the need for ethics in finance. Ethics is probably most needed in the everyday activities that constitute the world of finance, in which individuals and firms work to spend, save, invest, produce, and, in general, secure our economic welfare. Scandals may be thought of as a malfunction in an otherwise smoothly operating machine, and ethics is not only the sand in these malfunctions but also the oil that maintains the machine's ordinarily smooth operation. Much of this book is concerned with specific ethical problems and issues in the financial sector—with securing a high level of ethical conduct in everyday financial activities—and not with the different challenge of preventing scandals.

The Field of Finance Ethics

Finance is concerned broadly with the generation, allocation, and management of monetary resources for any purpose. It includes *personal finance*, whereby individuals save, spend, invest, and borrow money in order to conduct their lives; *corporate finance*, whereby organizations, both businesses and not-for-profits, raise capital, mainly through loans or the issue of stocks and bonds, and manage it in order to engage in their activities; and *public finance*, whereby governments raise revenue by means of taxes and fees and spend it to provide services and other benefits for their citizens. This financial activity is facilitated by *financial markets*, in which money and financial instruments are traded, and by *financial institutions*, such as banks and other financial services providers, which facilitate financial transactions and offer various kinds of products and services. Both markets and institutions are also important means for managing risk, which is another important service needed by individuals, corporations, and governments. In addition, financial activity takes place within an economic *system*, which in most developed countries can be characterized as capitalism. Thus, financial markets and

institutions assume very different forms in socialist or planned economies with state-owned enterprises, as in China.

Defining the field

Ethics in finance consists of the moral norms that apply to financial activity broadly conceived. Moral norms, in this context, may be understood as prescribed guides for behavior or conduct about what is right or wrong or about what ought to be done, using such concepts as duty or obligation, rights, and fairness or justice. That finance be conducted according to moral norms is of great importance, not only because of the crucial role that financial activity plays in the personal, economic, political, and social realms but also because of the opportunities for large financial gains that may tempt people to act unethically.

Many of the moral norms in finance are embodied in laws and regulations, which are enforced by prosecutors and regulators. Ethics plays a vital role in these matters, however, first, by shaping laws and regulations and, second, by guiding conduct in areas not governed by laws and regulations. In countries with well-developed legal systems, much of what is unethical is also illegal, and the law is constantly expanding to align ethics and law more closely. Thus, ethics is a major factor in the development of existing legislation and regulation and also a major source of new legislation and regulation. That is, ethics explains why we have the laws and regulations we do and guides their creation. However, in finance and other areas of life, some matters are not suited to legal control, and there ethics alone holds sway.

The moral norms that apply to financial activities are diverse and vary to some extent among societies or cultures. This is most marked in the case of Islamic finance, the moral norms of which contrast sharply with those of the United States and Europe. These norms are expressed in Islamic law, known as Shariah, and derive from the Qur'an, the sacred text of Islam, and the sayings of Muhammad, the prophet. In the Islamic view, all economic activity should aim at human well-being, which includes justice, equality, harmony, moderation, and a balance of material and spiritual needs. The main principles of Islamic finance are that wealth should come from legitimate trade and investment activity that has some social benefit, so interest or *riba* is forbidden as an unproductive activity; all harmful activities (*haram*) should be avoided, so investment should not be made in such prohibited activities as drugs, gambling or pornography; and risk should be limited and fairly shared, which rules out speculation (which is also gambling) and one-sided, sure-bet trades based on superior information (which describes a lot of arbitrage). Because so many financial instruments, such as conventional loans, options, futures,

and other derivatives, are forbidden, Islamic finance requires the creation of inventive means of achieving the same ends. For example, the purchase of business equipment might be accomplished without an interest-bearing loan through *Ijara*, in which the bank owns the equipment and leases it back to the user at an agreed-upon mark-up, which substitutes for interest.

A complete account of financial activity is not possible in a few words. First, finance is not a distinct, identifiable occupation or profession. Like medicine, law, engineering, and accounting, finance involves a highly technical body of knowledge, but people who are trained in finance engage in a much wider range of activities. Accountants, by contrast, do much the same work in every setting, and the different accounting functions—public and management accounting or external and internal auditing—raise similar ethical problems that can be identified and addressed in a code of professional ethics. Thus, accounting ethics, like the ethics of medicine, law, and engineering, focuses on the ethical problems of a relatively uniform activity. Although codes of ethics exist for many specific fields in finance—such as financial advisers, financial analysts, actuaries, and insurance underwriters—the idea of a single code of ethics for everyone in finance is impractical since the range of activities is so diverse.

Second, the ethics of finance is concerned not solely with the ethical problems of individuals in a specific occupation or profession but also with problems in financial markets and financial institutions, as well as the financial function of corporations and governments. Because market regulation is concerned, in part, with fairness (orderliness and efficiency are the other main aims), financial ethics must address such questions as what is a fair trading practice or the fair treatment of customers or clients. Finance is also a function in every business enterprise and in most nonprofit organizations and governmental units. Corporate financial managers are responsible for myriad decisions, from how best to raise and invest capital to the planning of mergers and acquisitions. Nonprofit organizations typically raise money from donors and apply it to public service causes. Public finance, on the other hand, is concerned largely with raising and disbursing funds for governmental purposes. These tasks raise ethical dilemmas of personal conduct, as well as broad questions of organizational or institutional practice, especially when important financial decisions affect society.

Ethics and law

The close connection of ethics with law and regulation raises the question of why these more formal mechanisms are not enough. Why is ethics needed in finance *in addition to* legislation and regulation? Finance is perhaps the most

heavily regulated area of business. Not only is the basic framework of regulation established by major legislative enactments but legislatures on various levels have also created innumerable regulatory bodies with the power to create and enforce rules. The financial services industry in the US is now subject to oversight from the federal Consumer Financial Protection Bureau, and some parts of the industry engage in self-regulation through, for example, the Financial Industry Regulatory Authority (FINRA). Many questionable industry practices are challenged in court, so that the judiciary—which consists of prosecutors and judges—plays a prominent role in determining the boundaries of acceptable conduct. Most organized exchanges, such as the New York Stock Exchange and the Chicago Board of Trade, have their own private rule-setting and rule-enforcement bodies.

In view of this extensive body of law and regulation, people in finance might well assume that this is the only guide needed. Their motto might be: "If it's legal, then it's morally okay." However, this motto is inadequate for many reasons.

First, the law is a rather crude instrument that is not suited for regulating all aspects of financial activities, especially those that cannot be easily anticipated, reduced to precise rules, and enforced by appropriate and effective sanctions. The relationship between a broker and a client, for example, involves repeated interactions, and some of these are one-of-a-kind situations for which legal rules may not have been developed. In such situations, what constitutes fair treatment may be obvious, but a rule mandating a specific action may not be easy to formulate. Consequently, 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." Moreover, precise rules can often be "gamed" to produce results that may be considered unfair, and legal sanctions for violations of a rule may be difficult to devise and apply.

The example of conflicts of interest is illustrative. Because of the variety of conflicts, a law barring them would be difficult to draft, and such a law would be subject to difficulties of interpretation and enforcement. Conflicts of interest are often a matter of perception so that a strict legal definition would be elusive, and proving a conflict would be similarly difficult. Rules designed to prevent conflicts could be effective only if individuals obeyed the spirit as well as the letter of these rules. The difficulty of bringing legal action against some figures involved in the recent financial crisis also shows the limited use of the law in complex financial cases where it is difficult to prove individual culpability.

Second, the law often develops as a reaction to activities that are considered to be unethical. It would be perverse to encourage people in finance to do anything that they want until the law tells them otherwise. Besides, the law is

not always settled, and many people who thought that their actions were legal, though perhaps immoral, have ruefully discovered otherwise. For example, the law prohibits abusive tax shelters but offers no precise standards for judging such abuse. Consequently, some accounting firms have offered tax shelters that they believed to be within the law and that no court or tax ruling has declared to be illegal. Nevertheless, in 2005, one of these firms, KPMG, paid $456 million to settle charges of selling illegal tax shelters, and heavy fines and stiff prison sentences were imposed on two convicted KPMG partners and one lawyer. Their belief that the tax shelters were legal turned out to be grievously mistaken.

Third, merely obeying the law is insufficient for managing an organization or for conducting business because employees, customers, and other groups expect, indeed demand, ethical treatment. The law is a relatively low standard of a minimally acceptable level of conduct that is generally below not only public expectations but also the higher plane that companies themselves profess and practice. As a former Securities and Exchange (SEC) chairman observed, "It is not an adequate ethical standard to aspire to get through the day without being indicted."[19] The attitude that only the law applies to financial activities invites even more legislation, litigation, and regulatory attention. Self-regulation—by individuals, organizations, and markets—is not only a more effective means for securing ethical conduct on some matters but also a shrewd strategy for avoiding more onerous legal regulation. A certain amount of self-regulation is necessary, not only as a replacement for legal regulation but also as a supplement for areas that the law cannot easily reach.

Financial markets

Despite the complexity of finance ethics, an examination of this field can be organized in three broad areas: financial markets, financial services, and financial management. Financial markets involve transactions such as one-time trades that take place in organized exchanges, such as stock markets, commodities markets, futures or options markets, currency markets, and the like. Furthermore, financial activity includes long-term contractual relationships, which are also formed in markets and are a kind of exchange or transaction. Thus, a mortgage or an insurance policy, which are products bought and sold in markets, commits two parties to act in certain ways over an extended period of time. Financial markets, in which these exchanges or transactions take place, presuppose certain moral rules and expectations of moral behavior.

The first obligation or duty in any market exchange is to abide by the agreements made. Every transaction in a market is a kind of agreement or contract,

which creates an ethical obligation to act in certain ways. Market trades take the form "I will give you this in exchange for you giving me that." Markets could not work if the parties to an exchange did not perform as they have agreed or contracted to do. Simply put, a market transaction is a kind of promise, and we have a basic moral duty to keep all promises made. Failing to abide by an agreement made in a market exchange may also be described as a breach of contract, which, too, is a kind of failure to keep a promise.

Failures to abide by agreements or contracts in market exchanges are not always simple matters of nonperformance or breach. The required conduct may not be clear or may be understood differently by the two parties. Consequently, disagreements can arise about whether one or both of the parties has acted appropriately. The parties can also take advantage of any ambiguity or omission in an agreement or contract to advance their own interests. These kinds of abuse often end up in court where a judge must interpret a contract's meaning. Agreements also require monitoring to ensure that both parties abide by them, and since it may often be difficult to determine compliance, there are abundant opportunities in contracting to take advantage of any inability to monitor adequately. Such problems are described as cases of *information asymmetry*, in which one party knows more than the other about his or her performance, and the outcome is commonly described as *opportunism* or *shirking*, which is taking advantage of an opportunity to breach a contract without consequences or avoiding the need to comply with the terms.

Second, all market exchanges are governed by a general prohibition against force and fraud. The prohibition against force follows from the necessary assumption that all transactions in a market are entered into voluntarily. Giving up a wallet to a gunman in an alley in return for not being harmed is not a market exchange due to the wrongful threat. So any forced transfer is a kind of theft and, of course, theft is wrong. In market transactions, where each party gives up something in order to obtain something that is valued more, full information about what is given up and gained in return is critical. So a misrepresentation by one or other party affects the value created by the exchange. Thus, fraud, which is willful misrepresentation of some fact made with the intent to deceive the other party, interferes with the crucial feature of markets to make both parties to an exchange better off. In simple terms, fraud is a kind of lie, and, of course, lying is wrong. Manipulation, which is also a wrong in a market exchange, is a kind of fraud inasmuch as it misleads or deceives the other party about some relevant fact in the transaction.

Third, many of the rules and expectations for markets are concerned with fairness, which is often expressed as a level playing field. The playing field in financial markets can become "tilted" by many factors, including unequal information, bargaining power, and resources. Many market regulations aim

to correct various kinds of differences or asymmetries between the parties to an exchange that creates an unlevel playing field. In addition to making one-time economic exchanges, participants in markets also engage in financial contracting whereby they enter into long-term relationships. These contractual relationships typically involve the roles of agents and fiduciaries, which are subject to unethical conduct because of the possibility for opportunistic behavior to benefit at another's expense. Indeed, the roles of agent and fiduciary are ubiquitous in finance, and the responsibilities of these roles—that is, agency and fiduciary duties—constitute much of finance ethics.

Finally, market exchanges between two parties often have third-party effects, which is to say that they affect others who are not parties to a transaction. Third-party effects are especially common in investment decisions by corporations and financial institutions, which have wide-ranging consequences for people's welfare and the well-being of society. Many of these third-party effects are *externalities*, which are costs of production that are not borne by the producer but are passed along to others. Pollution is a common externality from manufacturing, but financial activities are also capable of producing externalities. Consider, for example, the impact that bank lending practices have on community development. Insofar as banks engage in *redlining*—the alleged practice of denying mortgages and home-improvement loans for properties in deteriorating neighborhoods, which are figuratively outlined in red on a map—they actively contribute to the process of urban decay (which becomes an externality). On an international scale, the lending practices of multinational banks and global financial institutions such as the World Bank have an enormous impact on less-developed countries and thus are subject to ethical evaluation.

Consequently, ethics in financial markets includes some consideration of the social impact of financial activity and the responsibility of financial decision makers to consider these impacts. The extent of this responsibility to consider social impacts, however, is open to question. If the primary obligation of a corporate finance officer, for example, is to serve the interests of shareholders, then should the fact that a decision will result in layoffs or plant closures be taken into account? It is tempting for financial managers to make purely financial judgments and leave the more difficult task of social impacts to others, but such a neat division of responsibility is not always possible. Furthermore, financial institutions serve many publics and wield immense power in our society. Shouldn't they use this power responsibly?

Although the moral rules that govern markets may be complex in their application, they may be expressed simply: don't steal, tell the truth, keep your promises, be fair, avoid harm, and be a faithful agent or fiduciary. The complexity lies in the details.

Financial services

The financial services industry is the most visible face of finance and the aspect that affects ordinary people most directly. This industry consists of major financial institutions, such as commercial banks, investment banks, savings and loan associations, credit unions, mutual funds and pension funds, financial planners, and insurance companies. Private partnerships, such as hedge funds, and publicly traded investment management firms, such as Warren Buffet's Berkshire Hathaway, further expand the definition of the financial services industry.

Financial services firms fulfill many useful, often essential, functions. They enable individuals, organizations, and governments to save and borrow, to invest for a return, to have access to capital, to insure against misfortune, and to effect major changes, such as mergers and acquisitions. These benefits are made possible by specialized services, such as the research of stock analysts, the guidance of investment planners, the risk assessment of actuaries, and the investment ability of a mutual fund, pension fund or hedge fund manager. The financial services industry also provides benefits through the creation of innovative products. Thus, insurance serves to reduce risk by pooling assets; money-market funds allow small investors to invest in large-denomination commercial paper; mutual stock funds enable people of limited means to hold a diversified portfolio; and home equity loans turn an otherwise illiquid asset into available funds. In recent years, securities that bundle or securitize a group of assets, such as a pool of mortgages, and derivatives, which are securities whose value is "derived" from some underlying asset, have created new opportunities, as well as some dangers. Thus, financial services are both diverse in form and critically important for individual and social well-being.

The financial products that firms offer should meet certain standards of integrity. These products should fit people's needs, be financially sound, and be marketed in a responsible manner. Not only should they be accurately represented—which is to say that firms should avoid false, misleading, or deceptive claims and disclose relevant information, including the level of risk—but they should also be fairly priced, offer good value, and be suitable for the buyer. In recent years, some mortgage originators acted irresponsibly by selling inappropriate mortgages using misleading tactics. In addition, financial services firms often act as a custodian of people's assets and an executor of their transactions. In serving these roles, a bank, for example, has a duty to safeguard customers' deposits and execute their payments faithfully. Further, financial services providers typically owe certain duties to clients that arise from offering to put special skills and knowledge to work for their benefit. The people who make such offers often become fiduciaries or agents who have a

duty to subordinate their own interests to those of the clients. Some financial services providers may even be characterized as professionals who have stringent professional duties like those of physicians and lawyers.

Agents and fiduciaries, as well as professionals, have opportunities to abuse the trust invested in them by pursuing their own interest, especially in cases known as *conflicts of interest*, where the agent, fiduciary or professional has an interest that may interfere in the ability to serve the other party faithfully. In finance, however, it is sometimes difficult to determine when an individual or a firm is acting as an agent or fiduciary and when that party is acting in a purely market capacity in which there is no duty or obligation to serve the other party's interest. For example, both Goldman Sachs and Citigroup have been accused of betraying customers by betting against securities that they had created and sold to them. Both banks argued, however, that the investors were merely trading partners or counterparties ("sophisticated investors") and not trusting clients to whom some duty was owed.

In addition to offering financial products and services, which involves sometimes becoming agents or fiduciaries, financial services providers also serve as intermediaries for market transactions. These two roles of product provider and intermediary are often linked, as when, for example, a bank offers checking accounts (a product) and also serves as an intermediary in making payments and in linking savers with borrowers, thereby providing loans (another product) as well as in enabling savers to gain interest on their deposits. Similarly, an insurer is able to offer a product (an insurance policy) by acting as an intermediary in managing risk, whereby the policy holders essentially pool their premiums through an insurer to pay those with claims. (Thus, insurance is essentially a system by which policy holders agree to compensate each others' losses with the company acting merely as a facilitator or intermediary.) When an investment bank sells an option to a client—such as an interest-rate or currency swap—it not only provides a requested product (the swap) but may also take the other side of a bet on, say, interest rates or exchange rates and thus become a counterparty. An investment bank that underwrites a bond or stock offering may also invest in the same issue. Such dual roles are inherent in the investment banking business, and managing the conflicts is a necessity.

Some of the products that the financial services industry provides may not merely fit people's needs but may also contribute to important social goals, such as increasing the social responsibility of corporations and reducing poverty. Many mutual and pension funds practice *socially responsible investing*, in which securities are selected not only for their financial return but also on the basis of the company's social performance. Such funds originated from the demand of religious and socially concerned investors to avoid so-called

"sin stocks," but they now appeal to investors who take a long-term view of value creation that includes sustainability and social desirability. A creative example of using finance to address poverty in less-developed countries is *microfinance*, which consists of loans in very small amounts to people who are among the "unbankable." With these small amounts, poor people have an opportunity to start or expand a business that would be impossible within the traditional banking system. The contribution of microfinance to poverty alleviation was recognized by the awarding of the 2006 Nobel Peace Prize to Muhammad Yunus for his founding of the Grameen Bank in Bangladesh.

Financial management

Financial managers, especially chief financial officers, or CFOs, have the task of raising and allocating capital, managing a company's revenues, payments, and cash flows, and overseeing most financial reports and communications with investors. In a sense, a CFO is like an investment manager in making investment decisions and developing a portfolio, but these decisions are not about which securities to hold but about what business opportunities to pursue. Because these investment decisions are so closely linked to strategy, a CFO is typically involved in high-level management planning and is often an ex officio member of the board of directors. A CFO is also responsible for managing the risks of a corporation, although many large firms now have a separate chief risk officer (CRO).

In carrying out these tasks, financial managers are agents and fiduciaries with a duty to manage the assets of a corporation prudently, avoiding the use of these assets for personal benefit, and acting in all matters in the interest of the corporation and its shareholders. Specifically, this duty prohibits unauthorized self-dealing and conflicts of interest, as well as fraud and manipulation in connection with a company's financial reporting and securities transactions. In many recent scandals, most notably those at Enron and WorldCom, the CFO was convicted along with the CEO, since accounting fraud, which was central to these cases, generally requires the acquiescence, if not the active involvement, of individuals in the financial management function.

Every firm must have a capital structure in which its total capital is divided between equity, debt, and other types of obligations. Corporate finance is concerned mainly with determining the optimal capital structure and, if necessary, how best to raise additional capital. Most large corporations today have a very complex financial structure with on- and off-balance sheet entities and extensive holdings in derivatives. All of these decisions are guided by a single

corporate objective: to maximize shareholder wealth. This objective has been criticized by some who hold that it unjustly neglects the interests of other corporate constituencies. Therefore the ethics of financial management must address not only the obligations or duties of a financial manager but also the justification of shareholder wealth maximization as the objective of the firm.

The duties of financial managers are often the subject of special codes of ethics. The major exchanges, the New York Stock Exchange and NASDAQ, as well as the Securities and Exchange Commission (SEC), require publicly held companies to have a code of ethics for their senior financial officers. Section 406 of the 2002 Sarbanes–Oxley Act specifies that companies adopt a code of ethics for senior financial officers with standards that are "reasonably necessary to promote (1) honest and 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; and (3) compliance with applicable governmental rules and regulations."

Fraud, accurate accounting and reporting, conflict of interest, and insider trading are the main ethical (and legal) matters that arise for CFOs and other financial managers, but more specific and subtle problems occur in earnings management and in investor communications, which may involve no legal violation. Accountants have considerable leeway within the rules to report earnings, and many techniques exist for managing earnings that may violate the spirit, but not the letter, of these rules. Similarly, communications with investors may contain omissions and interpretations that give a misleading picture of a corporation's financial health. Both the flow and the content of information released to investors can powerfully affect investors' perceptions—and consequently a firm's stock price. One practice, the release of information to favored analysts, which served to encourage favorable analysis, is now illegal due to the SEC rule FD (for "fair disclosure"). Some major events in a corporation's life, such as bankruptcy and mergers and acquisitions, including hostile takeovers, confront CFOs with difficult ethical challenges.

Conclusion

Although the cynical view that there is no ethics in finance is easy to refute, the financial scandals that occur with depressing regularity impress upon us the challenge of maintaining—and restoring when necessary—the level of ethics needed for a functioning, flourishing financial system. Addressing this challenge requires not only doing what is right when this is known but also knowing what is the right conduct, which may be unclear. Financial activity,

which takes place in financial markets, financial services firms, and the financial management function of corporations, raises an immense number of difficult ethical issues. At bottom, these issues are about right and wrong, about what ought to be done, about obligations or duties, about the rights of various parties, and about fairness or justice. The remaining chapters in this book address these ethical issues in finance, first, by identifying them in finance practice and, then, by seeking to resolve these issues through an examination of the main positions that can be taken on them and the arguments for these positions. The ultimate aim of this book is to enable people in the world of finance, as well as everyone affected by this world—which is, indeed, all of us—to address the inevitable ethical issues in a reflective and effective manner.

Notes

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