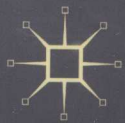




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ETHICS IN INVESTMENT BANKING

JOHN N. REYNOLDS
WITH EDMUND NEWELL



Ethics in Investment Banking

John N. Reynolds

with

Edmund Newell



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Preface

The love of money is the root of all evil

The First Letter of Paul to Timothy, chapter 6, verse 10

We have written this book primarily to assist investment bankers, stakeholders such as regulators and politicians, and those interested in starting an investment banking career in understanding how ethics can be applied in investment banking.

Since 2007, as the financial crisis has played out, there has been much criticism of investment banking and calls for more ethical behaviour by investment banks and investment bankers. At the same time, much of the commentary from outside the sector has been vague (such as trying to apply ethical principles without understanding what happens in an investment bank on a day-to-day basis), or it has been polemical (such as criticism of “speculation” without defining what is being criticised, and detailing what is wrong with it).

The financial crisis has shown that ethical failures can have profound consequences on the value of an investment bank and its reputation, and in our view investment banks have not taken ethics sufficiently seriously. Investment bankers typically have compulsory annual training in legal and regulatory compliance, but not in ethics; and although every major investment bank has a Code of Ethics, which sets requirements for ethical behaviour, these are of limited scope and have proved to be of little practical use.

This book does not focus on legislation, regulation and compliance (although all three are covered briefly where relevant). Our subject is ethics – and it needs to be stated clearly from the outset that, while ethics and compliance relate to one another, they are not the same.

Compliance, by definition, is concerned with complying with existing laws and regulations, and every investment bank has an established Compliance Department and sophisticated processes to ensure this happens. Ethics is broader, and is fundamentally about discerning what is right in a given situation – and acting on it.

There is naturally some blurring between the two: both compliance and ethics (when applied to business) are concerned with standards in doing business. However, whereas compliance is primarily concerned with a finite body of regulation and legislation and its applicability in business, ethics

deals with the underlying nature, intention and result of a situation or action.

The reason for focusing on ethics is simple: every situation and action in investment banking (and in business as a whole) has ethical connotations, but many are outside areas governed by compliance. As a result, much business activity takes place without moral scrutiny. In practice, it is perfectly possible for an investment banker to structure a non-compliant deal to avoid a specific compliance problem, and in the process ignore any significant ethical questions that the deal raises. The financial crisis has exposed the dangers of this approach. Ethics, therefore, involves going beyond the legal requirements and rules imposed by regulatory bodies to determine what is right when making a business decision.

In *Ethics in Investment Banking* we set out a method for thinking about ethics in the industry, assess the ethical issues associated with areas of concern that have arisen from the financial crisis and are found more generally in investment banking, and look at the day-to-day ethical issues that investment bankers might face. Although the financial crisis has brought attention to bear on capital market activities, which is our main focus, we also cover advisory activities, making this book applicable both to integrated investment banks and to specialist firms.

At the end of each chapter we highlight what we believe are the main ethical issues facing investment banks, provide a chapter summary and pose a key question, which we hope will assist interested readers in honing their skills in applying ethical thinking. Towards the end of the book we provide a Quick Reference Guide for investment bankers to review contentious issues and their ethical implications. We conclude with a proposed framework for ethical conduct in investment banking, including proposing a new approach to producing a Code of Ethics and a recommendation for ethical self-regulation across the industry.

We are very grateful for the help and advice we have been given in producing this book. Our own ethical thinking has been sharpened by being members of the Church of England's Ethical Investment Advisory Group, and we would like to thank Deborah Sabalot for her insights into regulatory law, and Mark Bygraves, Sabina Alkire and Nigel Biggar for their comments on different aspects of the text.

Glossary

2 and 20: fee structure typically used by hedge funds whereby a 2 per cent base fee is levied on funds under management and 20 per cent of the upside or profit is paid

Abrahamic faiths: collective term for Judaism, Christianity and Islam, relating to their historic and theological origins

Adviser: an investment banking or financial adviser giving advice primarily related to valuation, assisting with negotiation, co-ordinating due diligence and project management

Agent: an investment bank trading in the market on behalf of a client and typically receiving a commission

AGM: the annual general meeting of a company

Arranger: individual or group, usually an investment bank, charged with arranging finance for a transaction. Arranging finance would consist of preparing presentations to potential funders and securing financing (normally debt, but this can also include additional sources of equity finance)

Bait and switch: investment banking practice of marketing a (senior) team of bankers to a client and then replacing them with more junior bankers once a mandate has been awarded

Big cap: a quoted company with a large market capitalisation or share value

Business ethics: an ethical understanding of business, applying moral philosophical principles to commerce

Capital markets: collective term for debt and equity markets; reference to the businesses within an investment bank that manage activity in the capital markets

Casino capitalism: term used to describe high-risk investment banking activities with an asymmetric risk profile

Categorical imperative: the concept, developed by Immanuel Kant, of absolute moral rules

CDS: credit default swap, a form of financial insurance against the risk of default of a named corporation

CEO: chief executive officer, the most senior executive officer in a corporation

Church Investors' Group (CIG): a group of the investment arms of a number of church denominations, mainly from the UK and Ireland

Code of Ethics: an investment bank's statement of its requirements for ethical behaviour on the part of its employees

Compensation: investment bankers' remuneration or pay

Compliance: structures within an investment bank to ensure adherence to applicable regulation and legislation

Conflict of interest: situation where an investment bank has conflicting duties or incentives

Corporate debt: loan made to a company

Credit rating: an assessment of the creditworthiness of a corporation or legal entity given by a credit rating agency

CSR: Corporate Social Responsibility

DCF: discounted cash flow

Debtor in Possession finance (DIP finance): secured loan facility made to a company protected from its creditors under chapter 11 of the US bankruptcy code

Derivative: a security created out of an underlying security (such as an equity or a bond), which can then be traded separately

Dharma: personal religious duty, in Hinduism and Buddhism

Discounted cash flow valuation: the sum of:

- the net present value (NPV) of the cash flows of a company over a defined timescale (normally 10 years);
- the NPV of the terminal value of the company (which may be the price at which it could be sold after 10 years); and
- the existing net debt of the company

Distribution: the marketing of securities

Dodd-Frank Act: the Dodd-Frank Wall Street Reform and Consumer Protection Act

Downgrade: a reduction in the recommended action to take with regard to an equity; or a reduction in the credit rating of a corporation

Duty-based ethics: ethical values based on deontological concepts

EBITDA: Earnings Before Interest Tax Depreciation and Amortisation

EIAG: the Ethical Investment Advisory Group of the Church of England

Encyclical: official letter from the Pope to bishops, priests, lay people and people of goodwill

Enterprise value (EV): value of an enterprise derived from the sum of its financing, including equity, debt and any other invested capital, which should equate to its DCF value

ERM: the European Exchange Rate Mechanism, an EU currency system predating the introduction of the euro

ETR: effective tax rate

EV:EBITDA: ratio used to value a company

Exit: sale of an investment

Free-ride: economic term for gaining a benefit from another's actions

Financial adviser: see Adviser

Glass-Steagall: the 1933 Act that required a separation of investment and retail banking in the US

Golden Rule: do to others as you would have them do to you

Hedge fund: an investment fund with a specific investment mandate and an incentivised fee structure (see 2 and 20)

High yield bond: debt sold to institutional investors that is not secured (on the company's assets or cash-flows)

HMRC: Her Majesty's Revenue and Customs, the UK's authority for collecting taxes

Hold-out value: value derived from the contractual right to be able to agree or veto changes

Ijara: Shariah finance structure for project finance

Implicit Government guarantee: belief that a company or sector benefits from the likelihood of Government intervention in the event of crisis, despite the fact that no formal arrangements are in place

Initial Public Offering (IPO): the initial sale of equity securities of a company to public market investors

Insider dealing: trading in shares in order to profit from possessing confidential information

Insider trading: see Insider dealing

Integrated bank: a bank offering both commercial and investment banking services

Integrated investment bank: an investment bank that is both active in capital markets and provides advisory services

Internal rate of return (IRR): the annualised return on equity invested. Calculated as the discount rate that makes the net present value of all future cash flows zero

Investment banking: providing specialist investment banking services, including capital markets activities and M&A advice, to large clients (corporations and institutional investors)

- Investment banking adviser:** see Adviser
- Islamic banking:** banking structured to comply with Shariah (Islamic) law
- Junior debt:** debt that is subordinated or has a lower priority than other debt
- Junk bond:** see High yield bond
- Lenders:** providers of debt finance
- Leverage:** debt
- Leveraged acquisition:** acquisition of a company using high levels of debt to finance the acquisition
- LIBOR:** London Inter-Bank Offered Rate, the rate at which banks borrow from other banks
- Liquidity:** capital required to enable trading in capital markets
- M&A:** mergers and acquisitions; typically the major advisory department in an investment bank
- Market abuse:** activities that undermine efficient markets and are proscribed under legislation
- Market capitalism:** a system of free trade in which prices are set by supply and demand (and not by the Government)
- Market maker:** a market participant who offers prices at which it will buy and sell securities
- Mis-selling:** inaccurately describing securities (or other products) that are being sold
- Moral hazard:** the risk that an action will result in another party behaving recklessly
- Moral relativism:** the concept that morals and ethics are not absolute, and can vary between individuals
- Multi-notch downgrade:** a significant downgrade in rating or recommendation (by a rating agency)
- Natural law:** the concept that there is a universal moral code
- Net assets:** calculated as total assets minus total liabilities
- Net present value (NPV):** sum of a series of cash inflows and outflows discounted by the return that could have been earned on them had they been invested today
- NYSE:** New York Stock Exchange
- Operating profit:** calculated as revenue from operations minus costs from operations
- P:E:** ratio used to value a company where P (Price) is share price and E (Earnings) is earnings per share
- Price tension:** an increase in sales price of an asset, securities or a business resulting from a competitive situation in an auction

- Principal:** equity investor in a transaction
- Principal investment:** proprietary investment
- Private equity:** equity investment in a private company
- Private equity fund:** investment funds that invest in private companies
- Proprietary investment:** an investment bank's investment of its own capital in a transaction or in securities
- Qualifying instruments:** securities covered by legislation
- Qualifying markets:** capital markets covered by legislation
- Quantitative easing:** Government putting money into the banking system to increase reserves
- Regulation:** legal governance framework imposed by legislation
- Restructuring:** investment banking advice on the financial restructuring of a company unable to meet its (financial) liabilities
- Returns:** profits
- Rights-based ethics:** ethical values based on the rights of an individual, or an organisation
- SEC:** the Securities and Exchange Commission, a US regulatory authority
- Sarbanes–Oxley:** the US “Company Accounting Reform and Investor Protection Act”
- Senior debt:** debt that takes priority over all other debt and that must be paid back first in the event of a bankruptcy
- Shariah finance:** financing structured in accordance with Shariah or Islamic law
- Sovereign debt:** debt issued by a Government
- Speculation:** investment that resembles gambling; alternatively, very short-term investment without seeking to gain management control
- Socially responsible investing (SRI):** an approach to investment that aims to reflect and/or promote ethical principles
- Spread:** the difference between the purchase (bid) and selling (offer) price of a security
- Subordinated debt:** see Junior debt
- Syndicate:** group of banks or investment banks participating in a securities issue
- Syndication:** the process of a group of banks or investment banks selling a securities issue
- Takeover Panel:** UK authority overseeing acquisitions of UK public companies
- Too big to fail:** the concept that some companies or sectors are too large for the Government to allow them to become insolvent

Unauthorised trading: trading on behalf of an investment bank or other investor without proper authorisation

Universal bank: an integrated bank

Utilitarian: ethical values based on the end result of actions, also referred to as consequentialist

Volcker Rule: part of the Dodd–Frank Act, restricting the proprietary investment activities of deposit-taking institutions

Write-off: reduction in the value of an investment or loan

Zakat: charitable giving, one of the five pillars of Islam

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1

Introduction: Learning from Failure

There has been significant criticism of the ethics of the investment banking sector following the financial crisis. This book aims to provide a framework for the investment banking sector to consider ethical issues and move beyond the current regulatory and compliance thinking that has dominated debates of “ethics” in investment banking.

Scrutiny of investment banking’s role in the financial crisis has led to real questions being asked about the ethical basis of investment banking and the ethics of the capital markets on which much investment banking is based.

“Ethics” in moral philosophy, the sense in which we use it in this book, is the study of what actions and thoughts are right and wrong. Actions that are perfectly legal, but nonetheless unethical, can have profound implications for an investment bank, including severe reputational damage. The meaning of “ethics” is therefore wider than that of specific regulatory and legal codes relating to investment banking. Ethics in this broad sense is important to investment banking in the wake of the financial crisis. High levels of political and public concern about the sector will influence the level of independence and freedom that is politically acceptable, and will therefore affect profits and remuneration. As beneficiaries of enormous sums from Government intervention to support specific banks and therefore the capital markets as a whole, investment banks are now expected by politicians and the public to behave not only legally, but ethically – for it becomes a problem for investment banks if their expectations of ethical behaviour do not match those of politicians and the public.

Our definition of “investment banking” is based on the organisation and activities of investment banks, rather than on a strict regulatory or legal definition. By “investment banking”, we are referring to the activities

carried out by the bulge bracket banks and other “integrated” investment banks (carrying out both capital markets and advisory activities), the investment banking arms of “universal” banks (combining investment banking and commercial/retail banking) and the activities of specialist investment banks, who may carry out one or more of the investment banking activities of the bulge bracket and integrated investment banks. These include a range of capital markets activities (e.g., research, sales and trading), advisory services such as M&A (mergers and acquisitions) and other associated services, such as fundraising and “prime-brokerage” (raising funds for private equity and hedge funds). Investment banking typically also includes a range of specialised lending or investment activities, although investment banks’ freedom to invest is increasingly limited by regulation, notably the “Volcker Rule”. This definition may not coincide in all respects with regulatory definitions of investment banking as opposed to banking, but reflects what we believe to be the organisational structure of, and services provided by, investment banks.

In the past, investment banks have paid insufficient attention to ethical considerations, and it is unclear in the light of the financial crisis whether this will, or can, substantially change. However, should it do so there is uncertainty regarding where the focus should be. Debate about investment banking ethics can be characterised as a clash between proponents of a rights-based approach to investment banking ethics, and those who believe that investment banking ethics are based on a series of duties. On the one hand, an investment bank has a right to utilise its intellectual property, but on the other it has duties of care to stakeholders – notably its clients – and, as will be seen, these can conflict. We argue that investment banks should not subjugate ethical duties to ethical rights, and to do so specifically risks unethical behaviour.

Investment banks have been accused of major ethical failings, and the political and popular perception is that the investment banking industry is in need of reform but is unwilling and unable to reform itself. Investment banking has become subject to an unprecedented level of public and political opprobrium and scrutiny. Legislation has been enacted in many jurisdictions not only to increase regulation, but also to increase taxes on banks and other financial institutions and limit remuneration, especially that of directors and other senior management. Previous ethical failures by investment banks have proved to be costly: following the dotcom crash, investment banks paid \$1.4 billion in fines in the US, resulting from securities violations, including fraud in the handling of stock recommendations.

While investment banking may display attributes of “casino capitalism” (a term that will be considered later), it is nonetheless an intrinsic part of the modern economy, and provides essential services to Governments and corporations. Investment banks do not exist in a vacuum and therefore inevitably reflect ethical standards more generally prevalent in business. Investment banks have established client bases working with major companies, investment funds (such as private equity and hedge funds) and institutional investors, and also work closely with other professional services providers, notably lawyers.

Individual investment banks exist and succeed because (a) they offer services that are bought by clients, and/or (b) they trade effectively in the capital markets. In the case of all major investment banks, a significant proportion of their activities is, in some way, based on serving clients.

To some degree it is possible that in certain cases clients use investment banks because of, rather than in spite of, their ethical failings. For example, a client seeking to sell a business may wish to hire an investment bank that is prepared to break rules in order to conclude a deal on the best terms. Investment banking behaviour will inevitably reflect both wider prevailing standards of behaviour and also clients’ (both corporate clients and institutional investors) demands.

It is also important to bear in mind that other sectors of the economy have also been faced with ethical problems, including bribery in the defence industry, encouraging potentially harmful sales of alcohol and tobacco in the retailing sector and mis-selling in the retail financial services sector. Raising ethical standards in investment banking is therefore part of a bigger picture and should not be seen in isolation. Investment banks work so closely with institutional investors and major industrial companies, as well as law firms, that the ethics of the investment banking sector are almost inevitably aligned to some extent with the standards of commerce and industry generally. Ethical failures in investment banking therefore probably reflect wider ethical concerns in business.

Despite many recent adverse political statements and press comments in relation to the financial crisis, there is no reason to assume that investment banking is especially – or intrinsically – unethical. Given the size of the investment banking sector, the transactions and trades in which investment banks are instrumental, and the influence that the sector wields on commerce and Government, the investment banking sector can be a major force for good. Nevertheless, the criticisms levelled at investment banking as a result of the financial crisis are legitimate, and many of them raise profound ethical issues.

Ethics and the financial crisis

The causes of the financial crisis are complex, but include ethical failings by investment banks (among others). The US Financial Crisis Inquiry Commission blamed failures in regulation; breakdowns in corporate governance, including financial firms acting recklessly; excessive borrowing and risk by households and Wall Street; policymakers ill-prepared for the crisis; and systematic breakdown in accountability and ethics.¹ The UK's Independent Commission on Banking cited factors including "global imbalances, loose monetary policy, light-touch regulation, declining under-writing standards, widespread mis-pricing of risk, a vast expansion of banks' balance sheets, rapid growth in securitized assets".²

The UK economist Roger Bootle diagnosed the crisis in a more straightforward way in his 2009 book *The Trouble with Markets*: "greedy bankers and naive borrowers, mistaken central banks and inept regulators, insatiable Western consumers and over-thrifty Chinese savers".³ Others have also directly cited bankers' greed. Gordon Brown, the UK Prime Minister at the time the financial crisis developed, in his book examining the financial crisis, *Beyond the Crash*, has blamed "excessive remuneration at the expense of adequate capitalisation" for the UK banking crisis.⁴

It is clear that incentives in the form of the high levels of pay received by investment bankers creating and trading seriously flawed products was a contributing factor to the financial crisis. The asymmetry of risk and reward in investment bankers' remuneration can incentivise risk-taking: there is an opportunity to be paid very well if a trade is profitable, but the investment banker does not actually lose money (in the form of cash – the value of any equity owned in the investment bank can reduce) if a trade is loss-making. However, despite the criticisms of investment bankers' "greed", we do not find it compelling to base the blame for the financial crisis on greed alone or as the major contributor to the crisis.

Many investment bankers would accept that a desire to personally make large amounts of money is one of their driving forces. However, this does not necessarily equate with "greed", which can be defined as the desire to acquire or consume something beyond the point of what is desirable or can be well used. While we cannot determine the motives behind an individual's pursuit of wealth, the high levels of remuneration in investment banking raise the question of whether there is such a thing as "institutional greed". In a highly competitive industry where long-term employment is not guaranteed and where, because of the heavy work demands, careers can be short, there is an incentive for investment bankers to make as

much money as quickly as possible. Whether or not that can be construed as greed or as a sensible strategy in terms of potential lifetime earnings is unclear.

One of the results of the financial crisis was that some investment bankers who had accumulated substantial equity holdings in their employers saw this wealth almost entirely obliterated. Many senior investment bankers (including the CEOs of Lehman and Bear Stearns, two of the high-profile investment banks to fail during the crisis) themselves lost considerable sums during the crisis. Were they the victims of their own – or institutional – greed? Opinions differ.

A consequence of greed is that it can cloud judgement and rational thinking. This is important in the context of the financial crisis as it has been argued that greed led to investment bankers taking undue risks. There is some validity in this, as it is unquestionably the case that risks were taken and investment bankers were incentivised by remuneration to take risky decisions. However, other factors were at play as well – including inaccurate credit ratings that greatly underestimated the risk associated with what proved to be “toxic” financial products.

Interestingly, among the proposed (and legislated) solutions to the financial crisis is a requirement for investment banking bonuses to be paid largely in equity (in the bankers’ employers). Ownership of equity by investment bankers is, however, a practice that has been common for a considerable time – it has been common for a proportion of bonuses to be paid in “deferred equity” (equity vested over a period of, say, three years, dependent on the employee still being employed at the date of vesting). Ownership of very substantial amounts of equity by investment bankers, including ultimate decision-makers at investment banks most affected by the crisis, does not appear to have made an impact on the behaviour leading to the crisis. This appears to contradict the assertion that the crisis was based mainly on greed. Even if it is difficult to accept greed as the main cause of the financial crisis, whichever approach to understanding the crisis is accepted, it is clear that a part of the cause relates to a failure in investment banking ethics.

Investment banks have received an economic free-ride, based on an implicit guarantee that financial markets will receive Government support, as well as practical intervention by the state. This may impose ethical “duties” on investment banks (we will go on to define what an “ethical duty” is). The question of the nature of the ethical duties imposed on an investment bank in return for implicit Government backing of both banks and investment banks has now become important, even though the