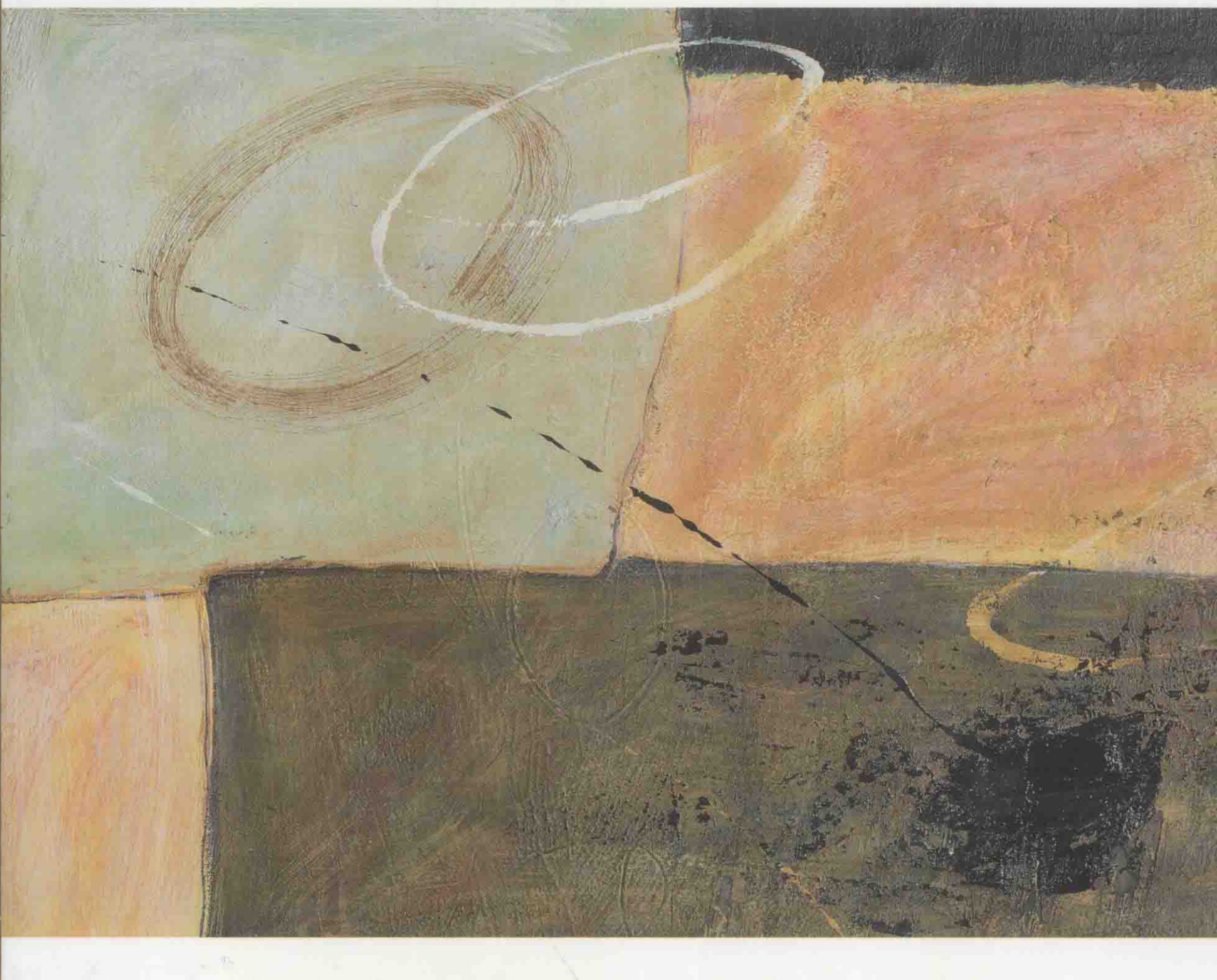
FINANCE ETHICS

Critical Issues in Theory and Practice



John R. Boatright, Editor

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Essential Perspectives

FINANCE ETHICS

Critical Issues in Theory and Practice

John R. Boatright

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The *Robert W. Kolb Series in Finance* series provides a comprehensive view of the field of finance in all of its variety and complexity. The series is projected to include approximately 65 volumes covering all major topics and specializations in finance, ranging from investments, to corporate finance, to financial institutions. Each volume in the *Kolb Series in Finance* consists of new articles especially written for the volume.

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The essays in each volume are intended for practicing finance professionals, graduate students, and advanced undergraduate students. The goal of each volume is to encapsulate the current state of knowledge in a particular area of finance so that the reader can quickly achieve a mastery of that special area of finance.

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CHAPTER 1

Ethics in Finance*

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INTRODUCTION

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

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

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

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

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

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

FINANCE THEORY

Finance as an academic field is an area of applied economics that is scarcely more than half a century old. Prior to 1950, the main concerns of modern finance theory—namely, the functioning of credit markets and the pricing of assets—were largely ignored or dismissed by economists as unsuitable topics for economic analysis. Financial markets were viewed by economists such as John Maynard Keynes as mere "casinos" or "beauty contests," in which assets were not priced in any rational way that could be described by economic laws. Before the development of finance theory, practicing traders operated by gut feelings or rules of thumb derived from experience, which they thought enabled them to take advantage of underlying trends that could be detected and charted but whose sources remained mysterious.

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

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

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

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

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

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

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

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

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

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

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

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

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

FINANCIAL MARKETS

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

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

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

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

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

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

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