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Winner: Postgraduate Category

Does the Fact the Financial Sector is Heavily Regulated Leave Any Place for Ethics?

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Introduction

Financials: the size and scope

The financial sector encompasses several industries; banking, real estate, insurance and securities to name a few. And within these industries are a number of sub categories. It is the largest sector tracked by Standard & Poor's representing more than 20% of the global economy. (Standard & Poor's, 2013). Nearly everyone, especially in the developed world, has a relationship with a financial firm. Thus, the trustworthiness of these businesses is of vital importance. However, even as people need to trust financial firms, trust is wanting. According to the *2013 Trust Barometer*, an annual global survey on business trust by the public relations firm Edelman, respondents say they trust the financial services industry to do what is right 46% of the time. (Edelman, 2013). This places financial services last in trustworthiness among eighteen business areas tracked by the survey. These findings are symptomatic of numerous highly publicized scandals emanating from financial firms over the years highlighting ethical lapses which, at least anecdotally, supports my position that although they are heavily regulated this fact does not negate the need for ethics.

Before defending this assertion I will offer some insight into what regulation of the financial sector entails and then touch on the nature of ethics with a focus on the securities industry in particular. I will argue that despite heavy regulation financial firms sometimes fall short of their ethical obligations; first because they operate under a misguided sense of purpose weakening the ethical fabric which in turn leads to actions that can harm society. Added to this is a second problem, namely that it is unrealistic to expect to have a sufficiently comprehensive set of regulations to cover every contingency. (Paine, 1994).

The nature of financial regulation

Regulations are intended to support ethical behavior. They provide governing rules – the standards by which firms must operate. The number of regulations applying to the financial sector are too numerous to accurately count without herculean effort. Nevertheless, one can come to understand the weight of financial regulations by reviewing examples of their impact. For this purpose we look at regulation as it relates to the securities industry.

In the U.S. the securities industry is regulated by the Financial Industry Regulatory Authority (FINRA). FINRA is an independent, non-profit organization authorized by Congress with oversight by the Securities and Exchange Commission (SEC). FINRA promulgates regulations, provides surveillance over securities activities - monitoring 6 billion share trades every day. (FINRA, 2014). They also have the power to enforce their regulations. In 2012, for example, FINRA brought 1,541 disciplinary actions against registered brokers and firms; levied more than $68 million in fines, ordered $34 million in restitution to harmed investors, and referred 692 fraud and insider trading cases to the SEC and other agencies for litigation and/or prosecution. (FINRA, 2014).

If brokers run afoul of the rules, FINRA has the power to fine, suspend or bar them from the industry. And in 2012 FINRA expelled 30 firms from the industry, suspended 549 brokers and barred 294 brokers from doing business. (FINRA, 2014). The foregoing data suggests that financial firms are, indeed, heavily regulated. It is also clear from even this brief enforcement history that breaching regulations can result in serious consequences. Yet, as I will argue, regulations alone are insufficient and that ethics are essential.

The nature of ethics in financial firms

To understand what ethics means for the financial industry a logical place to start is to examine codes of ethics and their impact on firms. Only as early as 2004[1] did the SEC promulgate a rule requiring registered advisers to adopt codes of ethics. Regulations require each firm's code to address specific areas and standards of conduct expected of advisers. (SEC, 2004). An anonymized table of contents from one such investment adviser code is offered for reference. While use of a table of contents alone is grounds to complain of oversimplification, it nonetheless suffices in illustrating in a general sense what codes of ethics contribute to the industry. I offer it because it is a typical example of a financial firm code of ethics:

Investment Advisor Code of Ethics

Included herein are sections on:

A. Standard of Conduct and Compliance with Laws, Rules and Regulations

B. Protection of Material Non-Public Information

C. Personal Securities Trading

1. Level 1 Access Person Requirements

2. Level 1 (a) Access Persons - ETF Pre-Clearance Requirement

3. Level 1(b) Access Persons Requirements

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[1] Two points stand out. It is interesting that the requirement to have a code of ethics is as recent as it is. Second and more importantly, is that this requirement does not extend to the majority of those engaged in providing investment advice to the public. This rule applies only to those who are Registered Investment Advisors (RIA's). RIA's are also required to act as fiduciaries whereas the vast majority of advisors in the U.S. are neither required to have a code of ethics nor to act as fiduciaries. These non-RIA's are held to a much weaker suitability standard of care.

4. Level 2 Access Persons Requirements

5. Holdings Reports

6. Transactions Reports (Account Statements)

7. Review of Transactions

D. Compliance Certification

E. Consequences for Failure to Comply and Reporting Certain Conduct

F. Recordkeeping

In glancing at the code one readily observes that while expressing that which it must in order to be in compliance with SEC regulations there is little that inspires ethical behavior. To the contrary it serves largely as fair warning against misconduct. Such a representation of ethics *may* deter bad behavior. Yet I suspect many who read it do so as a condition of employment and as a perfunctory exercise. This dynamic of having a code that is read but not necessarily taken to heart is surely less than optimal.

The purpose in having a code of ethics is to inform employees and other interested parties of the behavior expectations the company has of employees. Therefore one expects to encounter proscriptions against certain behaviors as well as references to requirements to perform various duties. And the fact that the SEC requires specific information to be contained in advisors' codes of ethics accounts for the stiff, legalese style. Though in my naiveté I hope for a code of ethics which also seeks to illuminate what the firm stands for- its noble purpose and how employees fit with this vision. In addition to the "thou shall and thou shall not" language, a code of ethics can and should make an attempt to inspire right behavior and to provoke further thought about the importance of the work employees do and the gratification that flows from doing the right thing not just doing things right. It should be noted that the SEC requirements do not preclude inclusion of more aspirational language, the rule merely details what, at a minimum, must be included. Thus I feel there is a missed opportunity in limiting the scope of such codes to the minimum requirements of the law.

Paine rightly takes issue with companies where expectations of ethical behavior are conveyed with a heavy emphasis on compliance. She states, "Even in the best cases, legal compliance is unlikely to unleash much moral imagination or commitment. The law does not generally seek to inspire human excellence or distinction. It is no guide for exemplary behavior – or even good practice. Those managers who define ethics as legal compliance are implicitly endorsing a code of moral mediocrity for their organizations." (Paine, 1994). My purpose in sharing this example is to demonstrate that even though ethics is critical such legalistic codes do little to support a culture of ethics. The relevance to our question is that sound ethics establishes trust and trust is a necessary condition upon which society grants the moral license for businesses to operate in the first place. And compliance centered codes do little to engender that trust.

Ethics, trust, license to operate, and purpose

I mentioned earlier that a mistaken sense of purpose leads to weakened ethics. But to understand what purpose businesses are meant to serve we must first know what gives businesses the right to operate in the first place. Businesses are at their root a social construct which derive power to conduct their activities from society. Therefore businesses have a responsibility to discharge their activities in such a way that seeks to benefit society while avoiding doing harm. (Cowton, 2007), (Dunfee, 2007).

In arguing that businesses have a responsibility to society Duska, with whom I agree states, "… It stands to reason that the purpose of any societally constructed system or institution has to do with an end that is compatible with some social good … which may or may not be compatible with any specific individual's interest. … Hence business is instituted to be beneficial to society." This is important inasmuch as financial firms do not place enough weight on their responsibility to society. This is because they are mistaken about their main purpose. And this mistaken purpose has led to ethical lapses.

What is the purpose?

Just as we must understand what gives financial firms the right to exist in the first place, we need to understand what fundamental purpose is served by them. For according to Duska, "if the fundamental purpose never gets questioned, the ethics never get questioned, because the fundamental purpose of something gives you the reason for its existence. It tells you whether you're doing it well or not. It's the ultimate ethical question: What's your purpose?" (Duska, 1997).

Because businesses have a responsibility to serve society they must have as their main purpose more than merely maximizing long-term owner value. The primary purpose of business must be first and foremost to produce quality products and services. (Duska, 1997). This is not to say that financial firms must be non-profit organizations, but the profit motive must be of secondary importance to the purpose which, in the case of financial services, is to provide quality financial products and services that help meet important needs of consumers such as helping achieve financial security during retirement years. In contrast, others argue that maximizing long-term owner value *is* the appropriate purpose of business. Yet when this is the focus businesses may lose sight of what is ethical.

Maximizing long-term owner value is misguided

Milton Friedman argues that maximizing long-term owner value is the primary purpose of business. He states business executives have the "responsibility to … make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."(Friedman, 1970). Friedman argues that although it may be appropriate for individuals to expend personal resources on socially responsible issues it is immoral for business executives to devote company money for this purpose. As Friedman sees it, being socially responsible is a matter of personal choice. Business executives, according to Friedman, have a responsibility to owners to use business resources to maximize long-term owner value. To do otherwise is self-serving and a misuse of company money. Friedman further argues that it is hypocritical and tantamount to fraud when companies engage in socially responsible activities for the sake of appearances while in reality attempting to maximize long-term owner value. Finally, he argues that companies that engage in socially responsible activities, albeit sincerely, undermine democracy. His argument is that if a particular social action was so desirable or necessary then society should elect public officials who in turn would enact laws accordingly. Friedman questions why a company should do something for society that society itself doesn't seem to want. He figures that if society deemed a given social project necessary policymakers would pass a law. And isn't democracy undermined when a company takes unilateral social action, thus effectively by-passing the legislative process? (Friedman, 1970). Prima facie, much of what Friedman argues appears to have merit. It is when we get into practical application that short-comings are exposed.

One such drawback is that Friedman's approach creates a utilitarian puzzle for those who must consider what actions will, in fact, maximize long-term owner value. It is simply too difficult to consider every possible outcome and contingency, especially over the long-term in order to determine what action really will maximize utility, or long-term owner value. In his defense, Friedman notes the need to conform to the law and to ethical custom. The rub is that a concept such as ethical custom can encompass thorny questions open to wide interpretation and debate. One need only look at the well-worn case of the Ford Pinto as described by Michael Sandel to illustrate how the interests of long-term owner value can conflict with those of society:

During the 1970's, the Ford Pinto was one of the best-selling subcompact cars in the United States. Unfortunately, its fuel tank was prone to explode when another car collided with it from the rear. More than five hundred people died when their Pintos burst into flames, and many more suffered severe burn injuries. When one of the burn victims sued Ford Motor Company for the faulty design, it emerged that Ford engineers had been aware of the danger posed by the gas tank. But company executives had conducted a cost-benefit analysis and determined that the benefits of fixing it (in lives saved and injuries prevented) were not worth the eleven dollars per car it would have cost to equip each car with a device that would have made the gas tank safer. (Sandel, 2009). Further illuminating this point is the ethical mindset exposed by Ford's "Lee Iacocca who apparently was fond of saying 'Safety doesn't sell.'"(Dowie, 1977). When the purpose is maximizing long-term owner value ethical custom can take a backseat – right near the gas tank.

We have experienced similar instances of misplaced purpose with financial firms whose intent was to maximize long-term owner value by making home mortgage loans to people who could not afford them on a grand scale and then compound the error by packaging these loans into esoteric securities that later became known as toxic assets ultimately leading to a global financial crisis. (Taibbi, 2010). The latest "poster child" for ethical lapses among financial services firms is J.P. Morgan Chase. In spite of heavy regulation we witness a disturbingly long list of ethical infractions. During 2013 alone, J.P. Morgan Chase was fined by various regulators at least twelve times totaling more than $30 **b**illion. Putting this staggering amount into perspective, though, J.P. Morgan Chase reported revenue of $23.9

billion in the third quarter of 2013 alone. (Peralta, 2014). One wonders if, in spite of being heavily regulated, J.P. Morgan Chase isn't engaging in its own utilitarian cost-benefit analysis and determining that maximizing long-term owner value outweighs the interest society has in having a sound financial system.

John Taft, CEO of RBC Wealth Management, U.S. in Minneapolis and New York appears to be among those who recognize a problem with ethics in financial services exists and the importance of what is at stake. Taft states, "One of the major contributors to the financial crisis was that participants in financial markets lost sight of what their mission should be: to serve the needs of individual investors. … When we lost sight of that, we started to engage in behavior that got everybody in trouble. We can have all the rules and regulations that we want, but if we don't get the culture right, if we don't return to the right sense of stewardship, we will never restore the public trust and investor faith in the markets, and we will not have lasting reform of the financial system."(Taft, 2014). Clearly Taft recognizes the limitations of regulations. And it is refreshing that he acknowledges the importance of "stewardship and mission" which closely aligns with ethics and purpose in the context discussed here.

Related reasons for ethical lapses

While maximizing long-term owner value relates specifically to owners and business executives. This misguided purpose infuses ethical decisions throughout an organization, including front-line managers and employees. To illuminate further, Duska theorizes that there are 5 reasons why ethical lapses occur. (Federwisch, 2006). 1) Self-interest sometimes morphs into greed and selfishness, which is unchecked self-interest at the expense of someone else. 2) Some people suffer from stunted moral development. 3) Some people equate moral behavior with legal behavior, disregarding the fact that even though an action may not be illegal, it still may not be moral. 4) Individual responsibility can wither under the demands of the client. 5) Professional duty can conflict with company demands. For example, a faulty reward system can induce unethical behavior. (Duska as cited in Federwisch, 2006).

I add to the forgoing by noting; what business leaders *do* is more important than what they or the regulations *say*. And when ethical dilemmas must be resolved employees will make decisions in the context of what they believe will be most acceptable within the framework of the culture of the firm, even when there are regulations that would suggest a different decision. To illustrate this point we now examine a true but anonymized case:

Mack likes making his own investing decisions and enjoys the low cost commissions offered by a securities firms' online trading facility. The trading platform is user-friendly, and reliable. There are, however, rare occurrences when the trading system may not work properly. When this happens the firm determines if an investor has been adversely affected and, if so, will compensate investors accordingly.

One day Mack entered an order to buy shares of stock but really meant to sell them. Buying instead of selling caused him to lose $10,000. Mack contacts Joe, a local manager, to let him know that he bought instead of sold by accident. During the conversation Mack tells Joe he is considering depositing additional assets but his decision will hinge on whether or not Joe "corrects" his order. After all, as Mack states, "This online stuff is rather new and confusing sometimes, especially for people who have not had a lot of experience using a computer for placing trades." If the firm makes the adjustment Mack will have a profit rather than a loss. Mack further let it be known that if the firm was unwilling to accommodate him he might transfer his sizable account to a competitor.

Joe authorized the "correction" rationalizing, "It was an honest mistake - an accident after all. Mack is a nice guy who I have known for many years. I think Mack learned from his experience and will not make the same mistake again." Mack was pleased and eventually moved more assets to the online brokerage as he had indicated he might.

Bear in mind Joe's performance evaluation and compensation were based on factors which, without going into details, would have been negatively impacted had he refused to adjust the trade because of the firms' emphasis on keeping customers happy.

There are regulations designed to prevent favoring large investors. The firm also has policies that apply to customer disputes such as described in this case. The problem is that while there are regulations and policies which forbid favoritism and unfair trade adjustments, regulations also allow for taking into consideration times when firms are presented with unique circumstances and thus permit them to interpret the facts as they deem appropriate. Hence ethical dilemmas may arise which require critical thinking skills. Thus, in spite of heavy regulation, ethics must play a part.

Worth noting is that had Joe been objective he might have regarded Mack's plan to deposit more assets as a quasi-bribe. Or perhaps Mack's threat to move his assets to a competitor could be viewed as a mild form of extortion. More to the point though is that despite the existence of regulations designed to address such disputes an ethical lapse occurred and for reasons noted by Duska earlier.

Duska's reasons apply in this way: First, Joe's *self-interest* to retain and win a greater share of Mack's business influenced the resolution. Second, it may be that had Joe possessed a more *developed sense of morals* he might have made a different decision. Third, it is true Joe had the leeway within the regulations to decide as he did, but this was an example of *equating moral behavior with legal behavior*. Fourth, this case illustrates how it may be possible for *one's individual responsibility to wither under the demands of the client*. Finally, the case offers a glaring example of how *professional duty can conflict with company demands*. In this case a well-intended but faulty reward system induced unethical behavior.

Conclusion

Having first looked at the nature of regulation and ethics in financial firms we discussed how ethical behavior leads to trust. And it is through trust that society grants businesses the right to operate. This is why the purpose of business is to serve society by producing quality products and services rather than merely maximizing long-term owner value. The culture of the firm will be informed by the purpose of the organization. The wrong purpose engenders wrong behavior. Clearly, regulations alone are no substitute for ethics and the ability to think critically through ethical dilemmas.

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