Chapter 9
Ethics in Financial Services: Systems and Individuals

Some turn every quality or art into a means of getting wealth; this they conceive to be the end, and to the promotion of the end they think all things must contribute.

–Aristotle, Politics, Bk. 1, Ch. 9.1258a13-14

Introduction

Few, if any, major catastrophic events result from a single cause. This financial crisis is not different. The existence of multiple causes explains why various self-interested parties focus on causes that are unrelated to their own contribution to the crisis. In addition, certain parties receive blame for the crisis when the party is either innocent or its contribution is negligible. Let's try to sort this out. As we sort this out we will focus our attention on the ethical lapses that helped cause the crisis. We begin by mentioning a few factors in the crisis that may have contributed but the role played by these factors was not significant.

Some have faulted the federal government for a policy decision that encourages people to own their own homes. In other words government policy supports home ownership over renting. This is clearly seen in tax policy that permits interest and real estate tax deductions but provides for no deductions for rental costs. Although the policy may have been pursued overzealously, we see nothing morally wrong with the policy per se. It is a policy that has wide support among the American public. Many argue that home ownership contributes to family stability. Others argue that neighborhoods characterized by high levels of home ownership are more stable and less susceptible to social problems than neighborhoods with a high concentration of renters.

Another factor often cited is the dishonesty of mortgage applicants. It is true that some mortgage applicants lied on their applications. How large that number was is a

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matter of dispute. And getting an accurate count here is complicated by the fact that some-perhaps many- of the cases of dishonesty were actively encouraged by the lenders themselves. Blaming this crisis on mortgage applicants is downright silly. Stories abound of recently hired mortgage brokers working out of hotel rooms processing mortgage applications with no background checks. Let's stop blaming the victim.

In this Chapter, we begin with a discussion of the purpose of the financial system and then ask whether the financial services industry engaged in activities that undermined the purpose of the financial services industry. Engaging in such activity would itself be unethical. In discussing these activities we will do the following: (1) Investigate what the legitimate purpose of financial markets is; (2) Show how financial markets lost sight of their purpose; (3) Spell out more extensively the meaning of "corruption"; (4) Inquire to what extent greed played a role in the corruption; and (5) Consider the ethical role that individual financial services professionals play in the markets and their consequent role responsibility.

The Purpose of Financial Markets

The ultimate purpose of markets is the production and exchange of goods and services. For any market to succeed, there need to be sectors, which provide services necessary for the effective functioning of the market. There must be producers, consumers, traders and any number of other actors fulfilling the roles necessary to have a vibrant and healthy market. Corporations or sectors of the economy can only survive in the long run if they provide a good or service that is needed. For example, we no longer need firemen on trains with diesel engines. Not everything needs to be sustained. Things that fulfill no purpose should die out.

The needs of society determine the purposes of financial markets. People need capital, loans, and money with which to purchase necessary items. To fulfill these purposes society has invented banks, insurance companies, stock markets and any number of other agents, as well as financial instruments that are developed and sold by various actors in the financial markets. When the various sectors of the financial markets forget they are in business to provide those goods and services for clients, and concentrate solely on income generation, they fail to live up to their responsibility and become corrupted.

It is important to note that different sectors of the financial markets fulfill different needs. The responsibility of those in these sectors is to perform their role in such a way that they fulfill the specific needs of the clients. Let's examine a few.

One of the purposes of banks is to loan money. Banks make money doing that, but making money is not their purpose. Making money is the incentive to perform the business of servicing clients and customers well. For banks to persist they need to evaluate risk. It is unfair to their depositors to lend (depositors') money to those who are not credit-worthy. Certified public accountants exist to help give accurate and useful pictures of the financial holdings of companies. Rating agencies exist to give evaluations of the soundness of companies. It is unfair to the investing public for certified public accountants to be swayed by the fact that the companies that they audit pay for the audit. It is also unfair to the investing public for the rating agencies

to be swayed by the fact that companies pay fees to these very same agencies. Could you help but notice how fast rating agencies lower the scores of political entities like the United States and several European countries but failed to notice the financial issues that surrounded the mortgage companies and the major banks and insurance companies before the financial crisis hit?

The fundamental goods in the financial services market are financial instruments. But instruments are things that are useful for other purposes. What is their basic purpose? What are they used for? Life insurance policies, annuities, securities, mutual funds, CDs and other instruments are used to manage risk and provide financial security. The purpose of the hedge fund is to "hedge" or balance the risk of an investment when one's investments seem to be too extended. These financial instruments do not exist to be manipulated and arbitraged for the simple purpose of making more money for advisers or companies.

According to Robert Schenk,

> … the primary purpose of financial markets is to allocate available savings to the most productive use. A well-functioning financial sector increases economic growth. If an economy does not allocate savings to the most productive uses, it will grow more slowly than it can grow.[1]

Joseph Stiglitz maintains that there are three important functions the financial markets serve[2]: to allocate scarce capital more efficiently to benefit the rest of the economy; to manage risk; and to direct resources to the activities with the highest returns (i.e. run the payment mechanism at low transaction costs). For Stiglitz, the stock market, as one area of the financial market place, is "first and foremost, a forum in which individuals can exchange risks. It affects the ability to raise capital (although it may also contribute to management's shortsightedness.) However, Stiglitz laments what it has become for "in the end, it is perhaps more a gambling casino than a venue in which funds are being raised to finance new ventures and expand existing activities… new ventures typically must look elsewhere."

In summary, the financial system is the complex array of financial markets, securities, and institutions that interact in facilitating the movement of capital among savers and borrowers. That financial system is also used for mediation of risk among parties. In the best possible model, this is all accomplished in a very efficient and hopefully ethical manner. But underlying all this is the belief that the other party can be trusted in the exchange. Once trust is gone, the market will not operate.

Losing Sight of the Purpose of Financial Markets

We take it as a fundamental ethical principle that: Any social system is legitimated only if it serves the common good. We would argue that from society's point of view the fundamental purpose of business is not to maximize profit, but to create goods

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[1] Schenk, Robert. htpp://ingrimayne.com/econ/Financial/Overview%ma.html

[2] All three Stiglitz quotations in this paragraph are from Stiglitz, Joseph E. (1993). "The Role of the State in Financial Markets," *Proceedings of the World Bank Annual Conference on Development Economics*, 21.

and services, i.e. value.[3] Since financial services and financial markets are a subset of business activity, they must serve business' ultimate purpose, or else the tail will wag the dog. But, recently, financial markets have had a tendency to become independent entities of their own and subvert the common good.

In an important 2003 book, *Infectious Greed*,[4] Frank Partnoy gives a host of stunning examples, which eerily remind us of the situation today, where fundamental purposes were forgotten, and hence the balance required by justice was lost. As far back as 1987 at Banker's Trust, Andy Krieger was successful in using currency options to manipulate unregulated currency markets with over the counter transactions. Krieger's success at Banker's Trust lead Charles Sanford, the CEO, to encourage traders to speculate with the bank's capital. Why did he speculate in that way? He did it for the sake of ever increasing profits. What began as an investment that exploited inefficiencies in the market lead to speculation once the inefficiencies were discovered and eliminated, In other words the inefficiencies effectively dried up and the speculation ensued. Speculation is never the primary business of a bank and engagement in it can lead to the downfall of a bank, as it did in the case of Banker's Trust. In that case, as Partnoy points out, "Investment positions (were) even hidden from investors at Banker's Trust…(but) there was nothing illegal about it."[5]

Another example is Gibson's Greetings, Inc. a company that produced and sold greeting cards. Gibson's Greetings got involved in interest-rate swaps on their loans, which at the time, in early 1992, yielded a profit of $260,000. The swaps were used to hedge debt and became, for a short time, profit generators. That is until interest rates went up. In 1993 Gibson got involved in $96 million worth of swaps. According to Partnoy, Banker's Trust, which took no risk, "made about $13 million from the swaps with Gibson, all of which supposedly began as an effort to find a low-cost hedge for a simple fixed-rate debt."[6] Gibson, instead of concentrating on the production of greeting cards, the purpose of its company, became an outright gambler for the sake of easy profits. Banker's Trust, instead of looking out for the interest of its client, Gibson, looked to its own bottom line.

Jaime Jaramillo, was prescient, when he observed in 1994, long before the financial market melt-down, that:

> Today's financial economy is nothing more than a "great big fantasy," where promises made by people, firms, or even computers are taken so seriously that they are regarded as wealth. This fantasy eases economic transactions and enhances efficiency only to the extent that the instruments used in it are trusted by economic agents, and the entire system ceases to function when faith in these instruments collapses. The state's role in financial markets is necessary because of the "fiat" nature of monetary and financial instruments.[7]

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[3] Duska, Ronald. (2007). "The Why's of Business Revisited" in *Contemporary Reflections on Business Ethics.* Dordrecht: Springer.

[4] Partnoy, Frank. (2003). *Infectious Greed*. New York: Henry Holt and Co., 184.

[5] Ibid., 19, ft nt. 24.

[6] Ibid., 53.

[7] Jaramillo-Vallejo, Jaime. (1993). Comment on "The Role of the State in Financial Markets," By Stiglitz, *Proceedings of the World Bank Annual Conference on Development*: *Economics Supplement* (Washington, DC) Downloaded from http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1994/03/01/000009265_3970702134931/Rendered/INDEX/multi_page.txt, February 25, 2012.

To claim that the financial economy is a "great big fantasy" is to say the least a strong claim. But consider. A large portion of the earnings of hedge fund managers was made from dealing with Credit Default Swaps, Collateralized Debt Obligations and other exotic financial instruments in the sub-prime mortgage market, and in some cases from shorting the very financial packages these hedge firms assembled for others.

It is an interesting and related fact, that in December 2007, the Bank for International Settlements reported derivative trades tallying in at $681 trillion—ten times the gross domestic product of all the countries in the world combined. As the author said, "Somebody is obviously bluffing about the money being brought to the game, and that realization has made for some very jittery markets".[8]

Let us examine certain elements of this fantasy and see how these elements run contrary to the primary purpose of financial institutions. The basic responsibility to serve the ends and purposes of the good of society was undermined by individuals in financial institutions pursuing self-interest without constraints or regard for fulfilling their professional purpose. Ultimately, there seemed to be little concern for the good of the whole. In short, the pursuit of self-interest turned into selfishness which is the unconstrained pursuit of self-interest at the expense of and without concern for others.

One might then propose the thesis that the problem with financial markets is that they have turned into gambling casinos where wealth accumulation is the be all and end all of their activity, and hence they are not fulfilling their purpose. This is detrimental to the economies of the world, because while financial markets create no goods, 40 % of all profits are made in the financial sector. This straying from the basic purpose creates an opportunity for simply creating the fantasy world of financial instruments that Jaramillo warned about; where there is no "there" there.

Numerous critics have zeroed in on problems created by derivatives

> "Derivatives" are complex bank creations that are very hard to understand, but the basic idea is that you can insure an investment you want to go up by betting it will go down. The simplest form of derivative is a short sale: you can place a bet that some asset you own will go down, so that you are covered whichever way the asset moves[9]

Derivatives are useful hedging instruments and are widely used in the financial services industry. However, they are somewhat complex and can be misused and be misunderstood even by people who are relatively sophisticated about financial matters. The use of derivatives became fairly common around 1978. The first blow-up occurred in Orange County California. In 1991 the Orange County treasurer had invested over $14 billion in derivative contracts- primarily contracts issued by Merrill Lynch. When the Federal Reserve began to raise interest rates in 1994, Orange County lost $1.5 billion of its investment, could not pay back a loan and was forced to declare bankruptcy. At the end of a string of lawsuits, Merrill Lynch made

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[8] Bank for International Settlements BIS 77th Annual Report June 2007. Downloaded from http://www.bis.org/publ/arpdf/ar2007e.htm, February 25, 2012.

[9] Brown, Dr. Ellen "Credit Default Swaps: Evolving Financial Meltdown and Derivative Disaster Du Jour," *Global Research* April 11, 2008 Downloaded from http://www.globalresearch.ca/index.php?context=va&aid=8634, February 25, 2012.

$70 million in payments to Orange County and in fines to the SEC. The Orange County treasure went to jail.

Even Proctor and Gamble, a company that is hardly a novice in the financial markets owed Bankers Trust $195.5 million more than predicted on derivative contracts when interest rates rose. How did Bankers Trust handle the issue? They convinced Proctor and Gamble to purchase more derivatives. Proctor and Gamble sued and in the end Bankers Trust forgave most of the $200 million that Proctor and Gamble owed the bank. No wonder Warren Buffett called them "financial instruments of mass destruction."[10]

Short sales can increase the efficiency in markets because they signal that there are individuals who believe the economic value of a firm will go down in the future. An increase in short sales can serve as a warning to managers to improve performance or at a minimum to improve communication. However, in the financial crisis short sales exacerbated the extent and speed of the crisis. Markets were flooded with sellers and there were few buyers. In a short sale, the law technically requires that you own the stock you are selling. In practice that rarely happened. In market terms the short sales were "naked." During the height of the crisis short sales were banned and the debate about the role of short sales and how extensively short sales should be regulated continues.

It may be the case that complex financial instruments make the market more like a casino than a model of efficiency. We are not experts in these matters and so we leave the controversy to the experts. But if we did have a casino, did we have a corrupt casino as well? Did the mob take over the casino?

What Is Corruption?

Corruption can be viewed, as a state of affairs, which occurs when an individual, entity or system does not perform as it was intended to perform, i.e. does not fulfill its purpose. According to Aristotle, all things aim at some good. Entities and activities come into existence for a reason. They have some purpose or use. Since goals energize and keep entities and activities alive and animated, not fulfilling that original purpose leads to a loss of vitality or the animating principle, which derives from the Latin word *animus*, which means "soul". Now, any living entity, (be it a system, institution or individual) which fails to fulfill its purpose or function becomes corrupt and eventually dies away. That's why we associate the word "corruption" with rot and putrefaction. The recent market crisis shows the corruption in both government and financial markets.[11]

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[10] Buffett, Warren. (2002). *Berkshire Hathaway Annual Report*.

[11] We would suggest that in this matter we can see similarities between the twentieth century philosopher Ludwig Wittgenstein and Aristotle. Two central claims for which Wittgenstein is famous are the claim that "The meaning is the use" and the claim that there are "forms of life" which constitute sociological relationships. According to Wittgenstein, we know what something is by knowing

This corruption of markets, though, is not easy to recognize because it is abetted by a misconception of the true purpose of markets. Too often people think that the purpose of markets is to make profits for individuals. That view is not new. Markets do help people gain wealth, but that is not their societal purpose. While it is clearly the case that gaining wealth is an incentive to produce and exchange, incentives are not the same as purposes. The father of capitalism, Adam Smith, rightly noted, that we would not get much market activity if there were no appeal to self-interest. He writes, “It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own interest.”[12]

While Smith points out the obvious fact that self-interest is a great motivating factor and shows that self-interest is a great incentive to get people engaged in market activity, we should not confuse that incentive with the real purpose of the market. To confuse incentives with purposes is similar to confusing the engine of a plane with the destination of a plane. The engine is what drives you to your goal. It is not the goal. Accumulating wealth is what drives the market, but it is not the ultimate goal of markets. It is only a means to other more essential goals.

Becoming overleveraged, through buying short and long, is not the purpose of markets—it is out and out gambling. If the solitary quest for profit in these sectors deflects the market from fulfilling those functions, it is corruption.

Given the above, it should be clear that there was rampant corruption leading to the economic crisis of 2008. Rating agencies failed in performing their tasks. Lending institutions failed by giving out loans to non-credit worthy individuals, thereby jeopardizing other clients. Accountants and auditors failed in their duty to make sure financial statements reflected the worth of the companies they were reporting on or auditing. Investment advisers like Bernie Madoff failed to fulfill their fiduciary duty. One’s duty is not simply to be clever in doing something. One’s duty is to fulfill one’s role, which means fulfilling the purposes of that role. A clever financier can game the market and use his clients. An ethical financier will perform his or her function for the sake of the clients and public he or she serves.

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its use—what it is for, and that use constitutes a “form of life”. Max Weber, in *Christianity and the Spirit of Capitalism*, talks about the spirit of capitalism as being an ever renewed search for profit. To tie these notions of Weber and Wittgenstein together, let us suggest that such a spirit (Geist) as Weber refers to constitutes for Wittgenstein a “form of life”. The identification of form (formal cause) and purpose (final cause) is not only manifested in amorphous social organizations, it is also manifested in individual human beings. A person’s purpose or ends are, in a sense, his or her soul, since those ends define what the person is. A person’s mission (a collection of his or her ends) is the result of the person’s commitments to particular projects and ideas. The mission one chooses defines their identity in a more meaningful manner than a description of their aggregate physical characteristics.

[12] Smith, Adam, *An Enquiry into the Nature and Causes of The Wealth of Nations*, I, ii, 2. Hereinafter referred to as WN.

Is Greed a Factor in the Corruption?

The present crisis has been aptly described as the perfect storm-too easy credit, too much leveraging, not enough information, over optimistic ratings, easy money and the desire on the public to acquire without the requisite thrift. But was the cause of all that simply greed or avariciousness or are the causes more subtle?

Let us investigate the ethical claim that greed was the cause. Greed may have been one of the causes, but we think that the claim that greed is the cause is too simple. To make our case we need to be more precise in defining "greed". First, it is important that greed not be confused with self-interest.

As we noted above, Adam Smith recognized the power of self-interest in his famous quote:

> It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own interest… (Thus in economic matters) …. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.[13]

It is this addressing of people's advantages that makes capitalism so successful. But by addressing people's self-love, are we promoting greed? Not necessarily. Smith's point is that self-love or self-interest can work for the benefit of the public good. However, when self-interest becomes so paramount that it is expressed at the expense of the public good, then self-interest can be transformed into greed. We believe this is what happened in the financial crisis. The meltdown was the consequence of the promotion and adoption of an acquisitive form of life across all sectors of the economy. Human nature is what it is. Human beings look out for their own advantage. But in the financial crisis the ethic that constrained that pursuit of self-interest was moribund.

If one looks at Max Weber, we can see that in many ways the recent collapse of the markets can be attributed to what he, in his classic work *The Protestant Ethic and the Spirit of Capitalism*, identified as the spirit of capitalism, a spirit that looks awfully much like greed. For Weber, capitalism is involved in "the single minded pursuit of profit and forever renewed profit."[14] According to Weber, such a pursuit is what gives the capitalist society its shape or form of life. For him any business operating in a wholly capitalistic society, which does not always take advantage of opportunities for profit making, is doomed to extinction. But, we would argue that such single-mindedness is monomaniacal and that such an unchecked pursuit of profit as a goal is an extreme, leading one to corruption.

Aristotle, the always temperate philosopher, would assert that virtue is always a golden mean and a vice is always an extreme. Oftentimes, in financial market transactions the unfettered pursuit of wealth for its own sake is paramount. How else can one explain, not the millions, but the billions of dollars of profit? Aristotle describes

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[13] Smith, ibid.

[14] Weber, Max. (1958). *The Protestant Ethic and the Spirit of Capitalism.* New York: Scribners, 17.

the practice of accumulating wealth for the sake of accumulating wealth, as greed. He deems greed unnatural and inordinate (out of order) in the sense that it is against the purpose of human beings, because the purpose of human beings is to live well, and the single-minded quest for wealth cannot be sufficient for living well. Rather, it corrupts the human being. Aristotle took note of those who "…turn every quality or art into a means of getting wealth; this they conceive to be the end, and to the promotion of that end they think all things must contribute." Clearly for Aristotle, this is a picture of someone corrupt. Like Midas, those who accumulate wealth for its own sake are, "intent upon living only, and not upon living well."[15]

This would be analogous to the for-profit corporations if the sole purpose of existence of a corporation is the ever increasing reach for more and more profit. In that case, the corporation loses its main purpose—the reason society allows it to flourish and exist—which is produce goods and/or services. The pursuit of profit overrides concerns for those for whom the good or service is provided. This explains clearly what happened at places like Enron, and perhaps at some of the large commercial banks.

Thus we can see that in some respects greed certainly was a cause of the financial crisis. Business ethicists by and large have been highly critical of the current level of executive compensation. It is not uncommon for those looking to apportion blame for our current financial predicament to point to "greedy CEOs" and corporate "fatcats" as the culprits who place our nation in the bind that it currently finds itself. It is interesting to note who the top income earners were before the collapse of the financial markets in 2008. According to *The New York Times*, reporting on an *Alpha Magazine* study of hedge fund managers, that distinction would go to John Paulson who earned an estimated $3.7 billion in 2007 and $2 billion in 2008. The second highest earner was James Simons of Renaissance Technologies with estimated 2008 earnings of $2.5 billion and estimated 2007 earnings of $2.8 billion. George Soros of Soros Fund Management had estimated 2008 earnings of $1.1 billion and estimated 2007 earnings: $2.9 billion. John D. Arnold of Centarus Energy made an estimated $1.98 billion in 2007 and 2008, while Ray Dalio of Bridgewater Associates made a mere $1 billion in those 2 years.[16]

What's more, *The Financial Times* pointed out that the 10 best-paid hedge fund managers in 2007 earned more than the combined GDP of Afghanistan and Mongolia. "John Paulson, who topped the list with $3Bn, could have purchased Bear Stearns almost three-times over out of his gross earnings that year! Forget that $100 m or so Goldman CEO Lloyd Blankfein is said to have earned in 2006- these guys wouldn't get out of bed for that."[17]

At the time of the financial collapse many were complaining about the unfairness of CEO's salaries. It was thought they were being overcompensated. Yet, if we compare Paulson's $3 billion income to the income of Goldman Sach's CEO,

[15] Aristotle, Politics, Book I, Ch. 9, 1258a.

[16] http://www.nytimes.com/2009/03/25/business/25hedge.html

[17] http://news.hereisthecity.com/2008/04/08/and_the_billy_big_bonus_of_200/

Lloyd Blankenfein, we see that Paulson made 30 times more money in 2007 than Blankenfein's comparatively measly $100 million. Clearly, if there is something inordinate about CEO's salaries, there is certainly something inordinate about the earnings of some hedge fun managers.

But the greed of individuals themselves was not the only cause of the corruption of the markets. There were systemic factors at work which lead to widespread conflicts of interest, conflicts of interest that incentivized selfish behavior either on the part of individuals or companies. Thus along with greed, there were systemic ethical lapses within financial institutions. And regrettably these systemic ethical lapses were incentivized by the widespread existence of conflicts of interest.

A conflict of interest can be either actual or apparent. One has a conflict of interest when one has an interest of his own or another that may conflict with the interest of the institution or person (s) for whom he is an agent. When faced with an actual conflict of interest, one invariably acts on behalf of his own interest or the interest of another at the expense of the interest of an institution or person(s) for whom he is an agent. For example, a stock broker has a conflict of interest when he recommends a stock initial public offering (IPO) to the public where his bank is the financial institution doing the IPO deal. That conflict goes from being perceived to being actual if the broker recommends the stock to the public while believing that it is not an attractive investment for the general public. That is precisely what Jack Grubman did. The Enron scandal of 2001 exhibited a number of conflicts of interest. Arthur Andersen was the auditor of Enron and had a duty to the investing public to make an objective assessment of Enron's financial statements. However, Arthur Andersen took in much more revenue selling consulting services to Enron than it did in getting paid for auditing them. Arthur Andersen had a personal interest that interfered with their duty to the public and since they acted on that interest Arthur Andersen was guilty of an actual conflict of interest. (Professor Bowie has argued that the auditing function of CPA's rests on at least a perceived conflict of interest because the auditors are paid by the firms they audit. However, most of these conflicts of interest are perceived rather than actual After all most audits of publicly held firms are legitimate even though the firm that is audited pays for the audit so the conflict of interest involved is most often perceived rather than actual.) With Arthur Andersen's auditing of Enron, the perceived conflict of interest became actual. Auditors who are certified public accountants have a strong obligation to the public to certify that the accounts they are auditing are trustworthy (comply with generally accepted accounting practices) In the Enron case, Arthur Andersen's interest in serving the client that paid it-Enron-interfered with and overrode its duty to the public to provide an accurate audit. In addition some Andersen personnel worked for Andersen as Andersen accountants, which again is a clear conflict of interest. You cannot work for the company you audit. In that case even perceived conflicts of interest are not acceptable.

When we look at the financial crisis the entire system was riddled with conflicts of interest. The rating agencies are paid by the companies they regulate. Thus they have an interest that can and, in the financial crisis, did conflict with their duty to the public to provide accurate objective evaluations of the credit-worthiness of these

mortgage security tranches. The employees of the mortgage companies had their income determined by the number of mortgages they processed regardless of quality. Thus mortgage brokers had a personal interest in maximizing their income that interfered with their obligation to only grant mortgage approval to those who could afford the mortgages and to make sure that each person had the mortgage that was appropriate for him or her. Five year adjustable ARM's with a balloon payment are not appropriate for most borrowers.

Some of the most egregious conflicts of interest involved Goldman Sachs and Company. One article by the *New York Times* focused on conflict of interests at Goldman Sachs.[18] Among the incidents cited in the *New York Times* article were the following:

1. Goldman Sachs was selling the public mortgage related securities issued by its client Washington Mutual. At the same time Goldman Sachs believed that Washington Mutual was engaged in activities that put it at risk and actively bet against (shorted) Washington Mutual stock.
2. Goldman Sachs took out bets against longstanding clients of Goldman Sachs. It wagered against Bear Stearns and Countrywide Financial as well as American International Group (AIG). AIG was the insurer of Goldman Sachs mortgage bonds. Documents show that Goldman was buying protection against a possible default by AIG even as Goldman Sachs pressured AIG to put up more cash as collateral. Goldman Sachs also bet against National City, a Cleveland bank the firm had advised. In the Bear Stearns case, Bear Stearns was encouraged to buy a portion of a one billion dollar package of mortgage related securities called Timberwolf. At the same time Goldman Sachs was betting against Bear Stearns shares. Bear Stearns was merged into JPMorgan Chase to avoid bankruptcy. If Bear Stearns had gone bankrupt as Goldman Sachs hoped the profits for Goldman Sachs would have been 33 million dollars.
3. The State of New Jersey had Goldman Sachs as one of its main investment bankers. To its chagrin New Jersey discovered that Goldman Sachs was encouraging speculators to bet against New Jersey's debt in the derivatives market.
4. Goldman Sachs has a best practices statement to which it is supposed to adhere. Principle 1 says "Our clients' interest always come first." As item 2 above shows, that principle was not observed. Principle 14 says "Integrity and honesty are at the heart of our business." Hardly.
5. Goldman Sachs encouraged rather than discouraged conflicts of interest. Some former employees of Goldman Sachs report that there was a 15th best practice principle. "If you are not embracing conflicts, you are not being aggressive enough in generating business."

In commenting on these details, *The New York Times* said, "…potential conflicts of interest inherent in Wall Street's business model are at the core of many of the

[18] Morgenson, Gretchen and Louise Story. (2010). "Clients Worried About Goldman's Dueling Goals," *New York Times*, May 18.

investigations that state and federal authorities are conducting." But the situation at Goldman Sachs involves more than conflict of interest.

One of the most controversial collateral debt obligations issued by Goldman Sachs was the Abacus 2007-ACI deal. That deal looks fraudulent. According to a Wharton study, "Goldman Sachs and Abacus 2007-AC1: A Look Beyond the Numbers," investors lost one billion dollars in the deal but the deal produced one billion dollars in profits for a Goldman collaborator the hedge fund Paulson and Company that was betting that the housing bubble would collapse. Investors in Abacus knew nothing of the relationship that Goldman Sachs had with Paulson and Company. They lacked the following information. Goldman Sachs sold a Mortgage Collatorized Debt Obligation (CDO) to customers, the development of which was heavily influenced by John Paulson. However, in the marketing materials used to promote the transaction to investors, Goldman Sachs failed to disclose that Paulson had played a role in the portfolio selection process and also failed to disclose that Paulson had adverse economic interests. As a matter of fact, knowing it was largely "junk" Paulson shorted the CDO he helped put together.[19]

At that point we have a clear conflict of interest and the possibility of fraud. Larry Kudlow of CNBC in musing about the case said the following.

> All this… raises the key question of whether Goldman Sachs' decision not to disclose Paulson's involvement was a correct judgment, or whether it was a material omission. It just seems to me that Goldman Sachs should have named Paulson in the offering circular for the CDO. They didn't. Is it because they didn't want investors to understand that this was a bear-market, short-the-bond CDO?[20]

It has been argued that the Abacus CDO was created to unravel quickly. It has been pointed out that this CDO constructed by Goldman Sachs lacked sufficient cash; its covenants were weak; and it afforded less investor protection than usual in order to provide higher yields. Needless to say this is troubling since, it appears that the CDO was designed to fail and that those marketing the CDO knew that. To market such a product in those circumstances seems to involve deliberate fraud although no one involved has been criminally charged nor are they likely to be. Creating something that's designed to fail? What kind of brokerage service is this?

This is not mere carping by two business ethicists. The SEC charged Goldman Sachs with misconduct and Goldman paid a record $550 million to settle the charges. In paying the fine Goldman made the following statement:

> Goldman acknowledges that the marketing materials for the ABACUS 2007-AC1 transaction contained incomplete information. In particular, it was a mistake for the Goldman marketing materials to state that the reference portfolio was "selected by" ACA Management LLC without disclosing the role of Paulson & Co. Inc. in the portfolio selection process and that Paulson's economic interests were adverse to CDO investors. Goldman regrets that the marketing materials did not contain that disclosure.[21]

[19] http://www.scribd.com/doc/30032645/Goldman-Sachs-complaint, April 16, 2010 11:22 EDT. For more on this we recommend three books: *The Big Short*, by Michael Lewis; *Reckless Endangerment*, by Gretchen Morgenson and Joshua Rosner; and *Money and Power*, by William D. Cohan, among others.

[20] http://kudlowsmoneypolitics.blogspot.com/2010/04/case-against-goldman-sachs.html

[21] http://www.sec.gov/news/press/2010/2010-123.htm

Tying It All Together

Many commentators on the financial crisis who focus on the causes of the crisis begin and end with greed. We agree that greed is certainly an important element in understanding the financial crisis. But ending the analysis by citing greed as **the** cause is too simplistic. The fact that people refused to recognize and in some cases even seemed to endorse conflicts of interest is especially troubling. Even more troubling is the fact that some people and some financial institutions abused information asymmetry and deliberately sold products to an unsuspecting public-products that they had reason to believe would fail. Thus we moved from greed-a vice- to conflict of interest, deception and fraud that are unethical and illegal. How did this happen? Our larger thesis is that this happened because people forgot that self–interest must be constrained and it happened because these individuals and institutions lost sight of the larger purpose of business in general and of financial institutions in particular.

Let's return to our earlier discussion of Aristotle and Adam Smith. As we saw, with Aristotle, where greed rules, there are no limits. What begins as a necessary service in a financial world became corrupted by forgetting what the service was about and what it was for. If the only goal is to maximize wealth or profit, by definition there is no end–no place to stop. To maximize means there is never enough.

And counter to the belief of many, Adam Smith never promoted self-interest without any limits. He asserted that the pursuit of self-advantage is indeed a good thing, so that

> Every man,…, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or order of men.

But he puts a limit on that: "as long as he does not violate the laws of justice."[22]

If we take justice to mean everyone gets his or her due, or if justice is balance, then one achieves the balance by doing what is to one's advantage, but always keeping in mind and being constrained by the purpose of one's pursuit.

It is just this balance that was lost and it was lost because many of the players in the financial markets lost sight of the purpose of one's pursuit. Forgetting the major purpose of financial markets, financial market players took on projects simply to accumulate wealth—for the company and the executives. This forgetting led to inordinate greed, which led to the corruption of many financial institutions.

At this point it is important to re-emphasize the purpose of business in general and of financial institutions in particular. Commercial pursuits are necessarily societal. They involve others and the purpose of working for others. What does a lender owe the borrower? What is a mortgage company for? Is giving someone a mortgage they cannot afford, giving them their due? Is providing someone who is non credit worthy with credit giving them or the other stakeholders their due? Is failing to appraise securities properly giving those who trust the ratings their due? What is a

[22] WN, IV, ix, 51.

bank for? What is a rating agency for? What are financial markets for? Is helping to destroy trust by failing to disclose crucial information including possible conflicts of interest giving society its due?

The crucial question at this point is this. Are Aristotle's and Smith's views of limited pursuits of self-interest constrained by societal purposes to be the defining ethical principle of markets or is Weber right in his judgment of capitalism that we quoted earlier correct? Is the collapse into greed a necessary aspect of the free market system? One would hope not, and the constant notion that certain behavior is scandalous, underlies the fact that there is still an ethos that seeks human fulfillment, and recognizes that it won't be achieved by the pursuit of wealth for its own sake.

Aristotle pointed out that there are more things necessary to living well than the solitary pursuit of wealth. Businesses which discover the importance of serving their stakeholders will not only flourish as outstanding corporate citizens, they will provide a model of integrity for all to follow and be the foundation of trust that is necessary for markets to operate efficiently for the benefit of society. However, given the propensity of human beings to look out for their own advantage, we need to set up incentives that reward responsible behavior with worthwhile goals.

To summarize: Financial markets have a role and purpose in society, but when that purpose is distorted because of greed and the proper role is abandoned for the sake of profit, the entire system gets corrupted. What has happened over and over again is that the markets have been manipulated and financial instruments misused. There are legitimate uses and purposes for hedges, SPE's, derivatives, and Swaps, such as to handle risk management. But, when accumulation is pursued and rewarded for its own sake, those purposes are forgotten.

Financial Services Professionals

Up to this point we have looked at the corruption of the system of financial markets. In spite of the systemic risks and corrupt practices, there are groups of financial services professionals who sell the various financial instruments and products. We will complete this Chapter by looking briefly at their ethical responsibilities. Clearly, if Goldman's Mortgage CDO was defective and a broker knew that, he should not have sold it.

There are various types of micro behavior within the market system that need to be examined. Generally there is agreement that a number of practices such as fraud, stock manipulation and churning are unethical. However, there are also practices in financial dealings where it is unclear whether and how those practices are unethical. Questions can be raised about the following sorts of practices such as: insider trading, tax shelters, income smoothing, some appearances of conflict of interest, independence, de-mutualization, confidentiality and privacy, conflicting loyalties between clients and companies, and the responsibilities of professionalism among others.

Is insider trading really wrong? If so, what exactly is wrong with it? How much disclosure is necessary in sales of financial instruments? How much disclosure is

necessary in financial statements that show the financial strengths and weaknesses of a company? Should mutual fund managers put themselves in unwarranted conflict of interest situations by engaging in private purchases of stocks their company trades in? Should banks be able to sell insurance and investment products, and does such a capability create unnecessary conflicts of interest for them? Should one demutualize? What should the limits of privacy be in the credit industry? What climate should be created so that the interests of the broker do not conflict with those of his client? Do we need fee based advising only, or is commissioned based selling with an agent's responsibility to give a client the best possible advice? Are financial service personnel professionals or simply sales people, and what are their responsibilities as such?

Once again, the needs of society determine the purposes of the financial markets. Not everything needs to be sustained. Things that fulfill no purpose should die out. The ethical rules in the market place, even in the market place of money, that individuals should follow are fairly straightforward. Market transactions between individuals ought to be carried on without using others and without engaging in deception or fraud in accordance with one's role. However, human beings, being what they are, will for a variety of reasons fall short of fulfilling their responsibilities (in the worst cases, greedily and selfishly use others for their own gain). What follows is a list of ethically problematic ways of behaving in the financial services industry.

Perhaps the easiest form of being unethical is by lacking integrity. Ways of being deceitful or dishonest in the financial services industry include misrepresenting the financial product, including deceptive illustrations of possible returns, concealing of risk factors, withholding full disclosure, misrepresenting one's ability, and other activities. Fraud is a legal concept and has specific meanings in specific instances, but generally involves "intentional misrepresentation, concealment, or omission of the truth for the purpose of deception or manipulation to the detriment of a person or organization."[23] Beyond deception and fraud, there are other ways of using a client, particularly in exchange situations, but possibly elsewhere, which involve coercing or manipulating the client, by fear mongering or other means.

As we have already shown. a central concern in financial services arises from conflicts of interest. There is conflicting interest when either the broker or agent's interest is served by selling a product the client does not need or is inferior to another product, typically a product that provides less remuneration to the sales person. There is also conflict when an agent has two clients, and service to one will be detrimental to the other. If the interests in conflict are the interests of the agent against those of the client, professionalism demands that the agent subordinate his or her interests to those of the client. When the interests in conflict are those of two parties, both of whom the agent serves, solutions are more complex.

There are particularly difficult conflict of interest situations for accounting firms arising from providing external audit function for a publicly held firm while simultaneously selling consulting services to the same firm. Also, the audit function

[23] Downes, John and Jordan Elliot Goodman. (1985). *Dictionary of Finance and Investment Terms* (Barron's Finance and Investment Handbook). Woodbury: Barron's, 148.

has inherent conflicts balancing confidentiality to the client and their duty to inform the public of possible illegal practices. The SEC has historically been concerned about the latter problem, but it is the mixing of auditing and consulting that concerns the SEC even more.

Financial planners routinely run into conflicts between the interests of their clients and the structure of fees for their services. There is an interesting juxtaposition in the field between fee only planners and planners that sell a product. A fee only planner charges for their advice, but receives no commission from the client's implementation of that advice. Most planners are not fee only. They do not overtly charge for their advice, but are remunerated through a commission on the implementation of that advice. This creates an interesting dilemma—does my advice purely service the needs of the client or do I shade my advice depending on the structure of a commission schedule?

In money management and investment banking, there are numerous examples of potential unethical practices. For example, money managers who trade personally in the securities their firms hold in portfolio. A manager with large holdings in a security can easily influence the price of that security as they buy and sell; therefore why not enter the market for a personal transaction before placing the firm's transaction? Investment bankers have ample opportunities to engage in practices that are either clearly a conflict of interest, and often illegal, or border on a conflict of interest. Free riding and withholding securities from the public in an initial public offering is illegal, but the temptation to compromise this rule is powerful when the issue is "hot"; that is everyone knows the price will increase once the security begins to trade in the secondary market. In December 2000 the SEC commenced an investigation against three prominent investment banking firms for selectively providing shares of "hot" IPOs to certain clients. The investigation centered on a "quid pro quo" arrangement where the client is charged higher fees for other services in exchange for IPO shares that will surely rise in value.

Another unethical practice which occurs in the financial services industry is the scalping of securities: for example an investment advisor who buys a security before recommending it, then selling out after the price has risen based on the recommendation. The most prominent case occurred in the 1980s involving the Wall Street Journal's "Heard on the Street" column. This column was widely read and carefully followed by investors. The articles were very specific and often listed companies and recommendations resulting in many to buy upon the written recommendations. The author was accused of tipping off certain individuals about the contents of articles before they were published.

Cornering the market is obviously unethical and often illegal, especially when it is in direct violation of government regulations, as was the well-publicized case against Salomon Brothers in 1991. Salomon was one of the major primary dealers in US government securities. These dealers bid in the auctions for Treasury bills, notes and bonds. The government has regulations concerning the percentage of successful bids that may go to individual firms, but firms may also bid for their customers. In one auction in early 1991 Salomon received over 80 % of the offering under the

pretense that a sizeable amount of the bids were for customers. In the subsequent investigation they were charged with illegal activity, but there was also evidence to suggest that Salomon had used agreements with customers that technically may not have been illegal, but surely bordered on the unethical given the intent of the government rules.

Companies can get involved in activities such as: illegal dividend payments, where "dividend payments come out of capital surplus or that make the company insolvent;"[24] incestuous share dealing- buying and selling of shares in each other's companies to create a tax or other financial advantage,[25] compensation design, where they set up alternative forms of payment to allow agents to avoid rebating violations; discrimination in hiring and promoting; misrepresentation to new hires; invasion of privacy ; and dubious claim settlement policies.

In insurance sales, there is needless replacement, and defective illustrations, which have been the basis of billion dollar lawsuits against Prudential, New York Life and Metropolitan Life among others. Brokers and agents get involved in churning accounts that benefit the agents at the expense of the clients. Some attempts have been made to counteract these unethical practices. For broker/dealers there is insistence on suitability rules, which demand you know and act in behalf of the best interests of the client you are selling to. There is the prohibition for financial planners and for those with control over clients' monies, either as trustees or brokers or advisers against commingling those funds with the financial service agents.

For those on the exchanges, there is insider trading, which is, as the name implies, engaging in trading on the basis of inside information. This practice is viewed as unfair to other traders who do not have the information as it makes for an unequal playing field. There is free riding, in the form of withholding a new securities issue to resell later at a higher price, or in the form of buying and selling in rapid order without putting up money for the sale.

Finally, there are prohibitions against schemes such as pyramiding that build on non-existing values, such as a Ponzi Scheme, rigging the market, manipulation, or running ahead i.e. an analyst buying a stock before making the recommendation to buy to his or her client.[26]

Most of these unethical practices have in common, if not downright deception, the use of one's customers or clients for the benefit of the firm, the officers of the firm or the financial services professional. This litany should help us begin to understand the tremendous range of possible conflicts of interest and out right possibilities of fraud in financial interaction. What can be done to avoid such problems?

[24] Ibid., 174.

[25] Ibid., 175.

[26] Ibid., 352.

Basic Ethical Principles: A Call to Reexamine Purpose

We have just provided a list of only some of the types of ethical misbehavior to occur in the financial services industry. Given the huge diversity of issues, what is the practical way to approach them? First, it would seem useful to come up with some general principles to follow. Second, it would be helpful to examine the various kinds of regulation governing financial services. Finally, it would seem helpful to examine how to make the environment more susceptible to ethical behavior. There is not time to deal adequately with the last issues, but we will briefly lay out some general principles.

Our experience show there are three valuable and overarching ethical principles that can be applied to the majority of issues in financial services: (1) avoid deception and fraud, and (2) honor your commitments. (3) fulfill the true purpose of your professional role. Note that the different sectors of the financial markets fulfill different needs. The responsibility of those in these sectors is to perform the role in such a way that it fulfills those needs.

One can use the knowledge of financial markets to make predictions about what instruments will do, and that knowledge is important for the financial adviser. However, that knowledge can be used for good or ill. Integrity demands that one fulfill one's purpose. It demands aligning the cleverness or skill of the professional with ends that serve those whom the professional is committed to serve. In the case of financial services professionals, that is the client. The primary purpose of the financial adviser is to give advice. That means determining and serving the needs of the advisee not the adviser. The adviser has a fiduciary responsibility to put the interests of the advisee first. Giving advice that is geared to enrich the adviser more than the advisee is not advice. It is corrupt behavior. It is the manipulation, by deceptive words, of the person for whose interests the adviser is supposed to look out.

It should be clear that there was rampant corruption leading to the economic crisis of 2008. Rating agencies failed in performing their tasks. Lending institutions failed by giving out loans to non-credit worthy individuals, thereby jeopardizing other clients. Accounting and auditing failed in their duty to make sure financial statements reflected the worth of the companies they were reporting on or auditing. Investment advisers like Madoff failed to fulfill their fiduciary duty. One's duty is not simply to be clever in doing something. One's duty is to fulfill one's role, which means fulfilling the purposes of that role. A clever financier can game the market and use his clients. An ethical financier will perform his or her function for the sake of the clients and public he or she serves.

That basic responsibility to serve the ends and purposes of the good of society was undermined by pursuing self-interest without constraints and without a concern for the good of the whole. In short, the pursuit of self-interest turned into selfishness, which is the unconstrained pursuit of self-interest at the expense of and without concern for others. That is the underlying corruption.