WORLDQUANT UNIVERSITY

Compiled Notes Module 7

MScFE 660

Case Studies in Risk Management

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Module 7: Ethics and Regulations

Module 7 discusses the theory of business ethics and regulation that have existed throughout history and highlights why they may fail when applied to the market. The module begins by defining ethics following the major schools of philosophical thoughts and how it has been applied to business through the history and depending on the context. The module continues by describing fairness as it applies to business and concludes with an overview on types of principal-agent relationship to preserve morality and act following ethical principles.

Unit 1: Keeping Your Eye on the Money

The vast and chaotic nature of the global financial market has necessitated the creation of some kind of ethical code. Market behaviors, especially as seen in the Flash Crash, are not necessarily grounded in any kind of moral code. Still, governments, individuals, and financial institutions have only had mixed success in trying to impose at least some moral order on the market. These efforts to institute some sense of ethics to the financial marketplace are certainly worthwhile, but first we should consider a philosophical perspective on ethics.

The basis to ethical behavior

Ethics is a series of theoretical and practical ideals that govern what is right and what is wrong, much like the conception of evil and good in literature and theology. Principles of ethics commonly devise a situation where a decision is made or forced that creates a negative outcome or a positive outcome based on action and reaction. Thereby, a negative outcome comes from a negative ethical decision, and must receive a negative reaction. The opposite, positive choices and actions, would require a positive reaction. Ethics and morality within human society have been interrelated for centuries and pave a way for how governments craft and execute their laws, with the entire process placed within an integral value system. Certain values – like honesty, integrity and transparency – are espoused by people who follow the pre-determined ethical code. Other values – deceit, greed and jealousy – are against the shared ethical code and are actions that are largely seen to disturb the greater morality of society.

The religious connotations are obvious to this kind of philosophical discourse, but that is not the sole focus of a moral or ethical code. What is critical when looking at the basics of ethics and the use of **applied ethics** – the study of situations or areas where a person is bound by ethical codes or frameworks that help define the ethical outcomes of their decisions – is that these systems come from early social conceptions of morality and that they evolve as morality and society changes and challenges itself. A time of rapid or drastic change – like a social revolution or a major conflict – naturally changes and challenges the moral code of society, and with it, the ethical agreements change. This change itself is assessed and reviewed for the moral codes it upholds and the ethical condemnations it suggests. It is critical to view this very clearly, as it will best inform how to explore business ethics and the application of moral code to financial investment practices.

The building blocks

When taking the study of applied ethics into the arena of business ethics, it is first important to view the way outcomes are viewed. Three large groups of moral consideration are key to the study of applied business ethics and will help frame the discussion around it. First, deontological philosophy suggests that the outcome is ultimately ethical even if it is not morally good, provided that the decisions leading up to the outcome have been 'right' or 'just'. This bases the entire ethical weighting on the decision to make the action, without any consideration of the action. The inverse of this is the second philosophical theory, which suggests that the outcome is the most important, as the decisions leading up to an outcome can possibly shift between various understandings of morality and the outcome is all that matters. This theory, utilitarianism, takes its main moral direction from its name: utility, or how the decisions made must create the best outcome for all involved. The third and arguably oldest theory of applied ethics looks towards how morally good people or groups act and how there is a belief that these people will ultimately make the decisions that create the best moral outcomes.

This overlap of moral assessment and ethical decision is tricky to navigate. The best solution offered by modern applied ethics is that there can be a principled approach to 'bad' motivations (like personal, unfettered greed, for example), 'bad' actions (like the tampering with the stock exchange program trading systems in the 2010 Flash Crash) and 'bad' outcomes (like the Great Depression of the 1930s). These examples are principally similar: a motivation enacts an action that produces an outcome that will cause harm. The case-by-case assessment of each motivation, action and outcome will best help view the moral or ethical discrepancy that will help reform the moral code of the day. This way, the biases of the present cannot attempt to create a revisionist approach to history but will rather view the entire 'story' of the decisions made and the ways in which they could have been prevented or changed.

As an example, we could look at the ethical problems with the 1929 Crash and the subsequent Great Depression. Though we cannot account for the individual motivations and decisions by every individual based in the eventual decline of the world's economy, individuals can be placed under the lens of a moralistic or ethical philosophy. For starters, the greed of many in Western stock exchanges cannot be doubted. The excesses of many in the urban elite were a clear indication of their desire to continue reaping rewards from the stock exchange, which was unquestionably selfish. Morality suggests that greed can create a situation of utter self-interest that will cause an individual to forsake their cares for their fellow human. This is a particularly difficult ethical area that doesn't favor the urban wealthy elite, manifested in the example by the greed of Clarence Hatry.

Further to this example, it is important to assess the lacklustre approach to economic revitalization and control that should, arguably, have been enacted by the Hoover administration before the Crash of 1929. As the custodians of one of the fastest growing nations on earth, the American government had the responsibility to ensure that there was no major decline in their economy or the stability of the state. It took another government to be elected for a resourceful approach to the problem, making the inaction of the Hoover administration seem ethically unsound if we apply a moralistic understanding of the inaction. Though it can be argued that they were not as aware, a government's responsibility, however big or small, is to protect its people and ensure stability is achieved.

It is critical to take from this set of notes that the application of ethics requires a contextual and principled approach to every kind of moral area and ethical code. In the instance raised – the 1929 Crash – there is a clear need to be aware of the conditions that informed moral decisions and the actions that generated outcomes, while also being aware of how to respond and interact with the problems created by the outcomes.

Unit 2: Points of Departure

Taking applied ethics into the context of business ethics, it becomes a series of practices, rules and theories that inform regulations that help create moral circumstances in the professional working environment. The role of business ethics in businesses and individuals within the workplace is a multi-layered approach that needs to be set out properly to explain how the creation of regulatory principles during the crashes and crises discussed in this course were attempts at a moral framework.

The guiding principles

The term 'business ethics', as a subset of ethics, must be understood in the context in which it is enacted and reformed. What was considered ethical a century ago may not be ethical right now, as there a shifting moral compass that guides and governs human society. Though it only became a formalized study during the 20th century, it can be argued that business ethics go as far back as the formalization of human trade and early mercantilism several centuries ago. As a branch of the philosophy of business, business ethics seek to define the practices and people within a commercial, mercantile, financial or business sector, and in doing so, govern the actions that a person or group in this sector can take. This begins with the application of a 'day-to-day' moral code that can be both formal or informal. An example of this would be the creation of notarized, legitimate contractual obligations between people. A contract between people or groups is a creation of a fair exchange of goods or services that must be upheld by all parties concerned. If it is not carried out, then compensation or recourse must be followed to ensure there is a fairness amongst all involved, making it a morally sound situation. This is the foundation to contract law, a study of the contractual obligations and guidelines that exist between people, groups and institutions.

There are more nuances to this relationship between morality, ethics and the law, but the principles of any legal publication or piece of legislation that seeks to intervene or participate in the economy will have some principle of business ethics involved in its creation and execution. The same applies to the political policy that is created and touted by political leadership in electoral and partisan competition. For example, the political ideology of a party that revolves around financial market regulation is influenced by their business ethics, as this will in some way define the norms around how stock exchanges, investment firms and solo investors can behave. Contextually, in the case of Module 2 (The 1987 Crash and Regulatory Implications) we saw two leading Western governments willingly remove regulations in the belief that the market would regulate itself as per the neoliberal take on business ethics. There is an undeniable connection between the political arena and the business sector – both are charted by a moral and ethical code and can easily break or bend that code. While there is a pressing social responsibility for business executives and members of the commercial or mercantile sector not to crash the economy because of greed, we have countless historical examples of damaging situations – like asset bubbles, trade wars and egregiously greedy practices that include slavery and poaching – that are as a result of the moral code being ignored. Similarly, we have seen in the cases within this course of how market crises have created circumstances for economic and social disorder.

The financial aspect

Making this specifically about the ethical considerations of the financial sector, there is a lot to be said on the basis of state-implemented regulations that attempt to create a set of moral considerations. The behavior of a financial sector is not purely a study in economics, statistics or commerce; it also becomes a lesson in politics, sociology, philosophy and human psychology. This is apparent in the series of notes in the historical contextualization of this course: there is a historical, political or social condition that informs how a series of people behave under dire circumstances, and how their decisions affect the trajectory of the crisis at hand. The ethics of these decisions would first take view of these conditions and assess them, as we have done previously in this module. The morality of the currency attacks in the Asian Crises is questionable, as it threatened several developing economies as a result of currency traders in developed states and was largely an action of greed that saw a gap in the market. However, it can also be argued that more moral considerations should have been made by the respective South East Asian governments to reduce corruption and make more sensible long-term macroeconomic policy decisions.

The other side to the application of business ethics in the financial sector involves the more specific details to how decisions affect elements like credit, debt, liquidity, profit and dividend growth or decline. The specific financial indicators of how a financial market is faring – like the proportion of national debt to gross domestic product – help inform the decisions that could be made, like austerity measures that involve cutting essential welfare spending. The moral trigger in a financial sector, and the site of analysis in the case of business ethics, would be the collection of relevant conditions to inform a decision-making procedure when a crisis arises. The moral assessment would then fall to the judgement of the decisions and outcomes produced from a response to a crisis, and how each contributed towards a net greater ‘good’ or ‘bad’. What is important to take from these considerations is that the creation of regulations is based on these judgements and its intersection with the political arena. The moral code of the social environment that voted in or supported a political regime is one that will inform the sorts of decisions taken by the financial sector and by the policies governing financial decisions.

Unit 3: Prediction at Play

The fundamental ethical requirement of financial markets is fairness. While we may debate the importance and impact of fairness and its motivation, many would agree that participation in financial markets is largely reliant on fairness as an important foundational principle. The most common concern over fairness in markets is around the practice of insider trading. In recent years, the definition of insider trading has shifted in both the U.S. and in Europe to a definition which encompasses insider-trading as a misappropriation of material non-public information for the trading of any stock, as opposed to just a competitor or the company the information directly pertains to.

While those in ethics may adopt a boarder motivation for the ethical concerns over insider trading, researchers in finance and economics tend to explore a more utility-based motivation for the concerns over insider-trading and other moral quandaries. This has led to debate over the impact and morality of insider trading in financial markets. If insider trading is beneficial to markets, is it then moral and ethical for financial professionals to engage in it? Clearly, this question lies at the heart of our debate over utilitarian and deontological ethical frameworks and their relevance in finance.

The economist Henry Manne has argued that insider trading could, in fact, be a benefit for financial markets. This view may seem strange, but if information reduces uncertainty over the price and value of a company, and uncertainty presents a risk for investors which must be compensated, then access to insider information could improve the efficiency on asset pricing and reduce any premium required by investors based on the uncertainty of private information and its effect on the company. Milton Friedman supported a similar view on insider-trading. Friedman saw insider trading as beneficial to financial markets, improving the efficiency by which information is incorporated into price – improving the stability of financial markets and the process of price discovery. The question is then: is efficiency enough?

The major issue of insider-trading is the concern over asymmetric information. For markets, this presents three concerns for efficiency and fairness:

1. Theft
2. Speculation
3. Participation

While we may discuss these effects separately, they are also strongly linked as theft and speculation may drive participation in the market.

Theft

If we consider the notion of theft, we look at the theft of economic rents to traders without insider information. If the counter-party to your trade possesses material non-public information, we may settle on different intrinsic prices for a company when considering the trade. While non-public information does not always become public, we can imagine that for this information to be material, it must present some effect on price going into the future. By trading on material non-public information, we can imagine that this information allows a counter-party to essentially rob market participants of future economic rents, as, without this trade, participants would likely experience and profit off these future price movements. If participants are unaware of future price movements, they do not benefit from the information which informs them and only then incur the cost of information-uncertainty, rather than the profits and losses.

Speculation

The next concern over insider trading is speculation. While Friedman may argue that insider trading leads to greater market efficiency, this argument ignores the behavioral implications of insider trading on markets with a mix of insiders and ordinary participants. Given the asymmetric information, traders can be more influenced by momentum in the market or sudden price movements as they speculate over the presence of insider traders in the market and the decisions of those traders in particular instances. Bold financial trades come at a large risk to investors. If these trades are motivated by material non-public information, this risk is far less obvious and far more explainable to the broader market. Given large and extreme price movements, participants may be uncertain as to the motivation of these trades and may assume based on their risk that they are driven by insider information. If this is true, participants may choose to follow these trades, to avoid losses – introducing inefficiency into the market as participants are uncertain as the trades of insiders and ordinary investors. If this is the case, prices no longer abide by the traditional notion of the Efficient Market Hypothesis, since while information may be considered random, trading decisions may be based on the uncertainty of information and the speculation of possible insiders, rather than real information itself.

Participation

The final concern over insider trading may be the hardest to prove or deny. The broadly held view, echoed by researchers Bhattacharya & Daouk (2002), is that insider trading is seen to raise the cost of capital for securities issuers, decreasing overall economic growth. In their paper, "The World Price of Insider Trading", they discuss the effects of insider trading on market participation and market efficiency. While insider trading may improve or harm price discovery and market efficiency, it is difficult to argue the tensions it bears on many traditional and closely held views on fairness. While classical economics largely ignores the role of fairness on individual behavior, fairness is vitally important to people's decisions. Famous behavioral economists, Kahneman, Knetsch & Thaler (2018), in their paper "Fairness and the Assumptions of Economics", discuss the preferences that people have for being treated fairly and for treating others fairly. Many believe that not only do participants seek to treat others with fairness in financial markets, but they also expect fair treatment from others in order to participate. Most argue that if markets are unfair, many participants may leave the market, increasing concentration and decreasing liquidity. While price discovery may improve, many would agree on the harmful effect of liquidity on markets, as explored in the 2010 Flash Crash.

While many people are in favor of insider trading, a purely utilitarian-based motivation leaves a lot of room for uncertainty over many ethical obligation and practices when considering the behavioral and deontological considerations of insider trading. In order for markets to work, we need a cohesive set of moral standards to allow for a clear set of guidelines for financial professionals to ensure participation and market efficiency. Ethics is not just a tool for market efficiency, but also about ensuring a common social contract among investors around acceptable and known behavior. It is for this reason, that while the most commonly adopted means for ensuring fairness in markets is government regulation, a significant degree of industry regulation is also employed in finance.

Unit 4: The Right Way to Help

The morality of the firm

It is important in any discussion around business ethics, to note the foundation of economic theory and economic thinking. For early economists, discussions around the morality of commerce were critical in dissecting both the economy and its role in and relationship with society. It is for this reason that many of these early economists saw themselves as moral philosophers, and not as the economists we now label them as.

In Adam Smiths' famous extract from *The Wealth of Nations* on the invisible hand, Smith writes,

> "[...] and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. "

In this work, Adam Smith discusses the morality of commerce and the inherent tensions seen at the time between greed and competition, and the values of charity and social virtue. For economists like Smith that observed economies of scarcity, it was obvious that the market power of producers could easily dictate terms to consumers. For Smith, it was essential that business firms behave justly for the common good.

So far, we have considered only a one-dimensional view of the firm, considering only its incentives in maximizing-profits; however, the issue is far more complicated than this. To the economist Milton Friedman, profit-seeking was not only key, but a social responsibility to firms. Despite these views, Friedman also believed there exists a moral minimum which was to engage in free and open competition without deception or fraud. His views seemed to suggest that the identity of those that profited were unimportant, but that it was also important to examine not only the responsibility of social good, but also the duties of fiduciary in a company to serve some agent. Even under the lens of the confidence school, the question of whose discounted cash flows are being maximized is critical to understanding the ethical duties of individuals acting on behalf of the firm.

Principals and agents

As juristic persons, consisting of numerous stakeholders, companies are obviously subject to a range of agency concerns. The principal-agent relationship is an inherent relationship of vulnerability which comes with several moral duties and responsibilities on the part of the agent. This position of vulnerability is an ethical conundrum for agents who balance their moral duties to their principals with their personal interests. While we may debate the importance of these moral duties, in utilitarian or deontological frameworks, we can assume for now these duties to be generally accepted for our analysis.

The ability to instruct agents relies on a clear mandate on the preferences of the individuals who act as principals. These preferences can often materially depend on the individual and context where they find themselves and may vary over time. Without a definition of a principal or a set of preferences, it is difficult for an agent to consider or act in the best interests of a principal. For instance, the decision for a company to pay a dividend or issue a share buyback needs to be done in the best interests of the principal and can depend heavily on both the regulations and taxes in a country or the preferences of a particular group of shareholders such as pensioners. If an employee must perform some fiduciary duty for a principal, he or she must know who the shareholders are and their interests in order to best fulfil them.

So far, we have used the word principal and shareholder interchangeably, but the question of who should act as principal and the moral duties of that principal is much debated. Why should the shareholder be the only principal? Is it the fact that they have financially invested in the company? What about those who are deeply affected by the company and find themselves similarly vulnerable to shareholders – should they not get a say? While we may assume the narrowest view that shareholders serve as the only principal for companies, there exists an important moral debate to whether other interests or other stakeholders should be considered. Over time, several models have been considered for this principal-agent relationship on the moral duties of the firm. These are:

1. The Narrow View on Shareholder Supremacy
2. The Shareholder Primacy Model
3. The Stakeholder Model

1. The Narrow View

Under the Narrow View, profit-maximization is absolute. In this model, unlike the view of Friedman, no moral minimum exists on firms on maximizing shareholder wealth. To this school of thought, the idea of negative externalities like pollution, exploitation or even deception is all justifiable provided they maximize shareholder wealth. While this may seem extreme, that is not to say this model is not consistent with the discussions in previous parts of this module on the value of reputation. In this model, while no moral obligation exists, firms may still perform moral acts in the interest of shareholder wealth.

2. The Shareholder Primacy Model

While the Narrow View can be considered our most extreme case on the ethical responsibilities of the firm, the Shareholder Primacy Model is a tempered extension. Echoing the views of Friedman, the Shareholder Primacy Model states that while the primary duty of the firm is towards the wealth maximization of shareholders, firms are still subject to minimum ethical requirements. These minimum requirements often vary in their discussion but can range from respecting the laws of a particular country to ordinary decency, distributive justice and fairness.

3. The Stakeholder Model

Moving on from the Primacy Model, the final model for us to consider is the Stakeholder Model. In the Stakeholder Model, the legitimate interests of all stakeholders are considered. These stakeholders can include shareholders, employee, customers, suppliers and the broader society. In a global market featuring large trans-national corporations, those stakeholders are both numerous and widely dispersed. These interests can be both the well-being and moral interests of those individuals, and so extends well beyond the ethical minima of the Primacy Model. Keeping this model in mind, it is clear that risk-management for an individual firm is not the same as the risks that society as a whole must bare. As we have seen with crises like the Great Depression and housing market collapse, business can have a tremendous impact on larger society. Risk-management, perhaps, might be seen as a social goal rather than just an individual one.

While all three of these models come with some benefits, all have flaws in serving as cohesive and easily applied tools for taking ethical actions on behalf of a firm. While the Narrow View may be most consistent and easiest to analyze given its strong utilitarian framework, the Narrow View leaves much to be desired when faced with clear moral ills like exploitation. The Narrow View also fails to provide guidance on the relationships between the ethics of the agent and their responsibilities in performing unethical actions for the firm. While both the Shareholder Primacy and Stakeholder Models serve to amend the Narrow View to protect against clear moral ills, they are far harder to apply as they require one to balance and consider a range of views in their application.

Generally, in corporate governance, various forms of the Stakeholder Model are being widely adopted and codified. It is important to identify these models and understand their advantages and motivations to dissecting many ethical concerns in the area of finance.

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