John R. Boatright Finance EthicsJohn R. Boatright teaches at Loyola University in Chicago.• Financial markets are vulnerable to unfair trading practices (fraud and manipulation), unfair conditions (an unlevel playing field), and contractual difficulties (forming,interpreting,and enforcing contracts). The main aim of fed-eral securities laws and the self-regulation of exchanges is expressed in the phrase “fair and orderly” markets, which reflects the need infinancial markets to balance the twin goals of fairness and efficiency.• Many individuals and institutions serve as fi-nancialintermediaries, providing financialservices on behalf of others. Financial inter-mediaries commonly make decisions as agents for principals in an agency relation, and they often become fiduciaries with fiduciary duties. Agents and fiduciaries have an obligation to act solely in the interests of other parties and, espe-cially, to avoid conflicts of interest. Although financial services providers are often merely sellers in a buyer–seller relation, they still have the obligations of any seller to avoid deceptive and abusive sales practices.• Financial Management: Business firms are legally structured as the financial instruments of shareholders, and officers and directors are agents of firms, and have a fiduciary duty to manage the firms with the objective of maxi-mizing shareholder wealth. Ethical issues in financial management concern the actions that violate the duties of financial managers and the discretion of financial managers to serve the interests of nonshareholder groups, commonly called “stakeholders.”All financial activity takes place in a larger eco-nomic, political, and social setting and so ethical issues arise about the overall impact of financial ac-tivity. Although financial decision making is gener-ally limited to the financial factors of risk and return over time, ethics includes a consideration of the ethi-cal treatment of everyone affected by a decision, and the consequences for the whole of society.FINANCIAL MARKETSThe fundamental ethical requirement of financial mar-kets is that they be fair. Fairness may be defined either substantively (when the price of a security reflects the actual value) or procedurally (when buyers are enabled to determine the actual value of a security). In the USA, some state securities laws aim at substantive fairness by requiring expert evaluation of new securities (so-called “blue-sky” laws), but the federal Securities Act of 1933 and the Securities Exchange Act of 1934 at-tempt to secure fairness procedurally by requiring adequate disclosure. The rationale for mandatory dis-closure is that securities transactions are more likely to be fair when material information must be disclosed and investors have easy access to information.Unfair Trading PracticesFraud, manipulation, and other unfair trading prac-tices lead not only to unfair treatment in securitiestransactions but to a loss of investor confidence in the integrity of financial markets. Speculative ac-tivity also produces excess volatility, which was blamed for the stock market crashes of 1929 and Oc-tober 1987. Both fraud and manipulation are defined broadly.Section 17(a) of the 1933 Securities Act and Section 10(b) of the 1934 Securities Exchange Act prohibit anyone involved in the issue or exchange of securi-ties to make a false statement of a material fact, to omit a fact that makes a statement of material facts misleading, or to engage in any practice or scheme that would serve to defraud. Whereas fraud generally involves the disclosure or concealment of informa-tion that bears on the value of a security, manipula-tion consists of trading for the purpose of creating a misleading impression about a security’s value. Fraud is obviously committed by an initial stockoffering that inflates the assets of a firm or fails to disclose some of its liabilities. Insider trading has been prosecuted as a fraud on the grounds that non-public material information ought to be disclosed before trading. In the 1920s, the stock market was manipulated by traders who bid up the price of stock in order to sell at the peak to unwary investors. In recent years, concern has been expressed about a form of program trading known as index arbitrage, in which traders are able to create volatility in differ-ent markets, solely for the purpose of trading on the resulting price differences.Fair ConditionsFairness in financial markets is often expressed by the concept of a level playing field. A playing field may be unlevel because of inequalities in informa-tion, bargaining power, resources, processing ability, and special vulnerabilities. Unequal information, or information asymme-try, may refer either to the fact that all parties to a transaction do not possess the same information or that they do not have the same access to information. The possession of different information is a perva-sive nature of markets that is not always ethically ob-jectionable. Indeed, investors who invest resources in acquiring superior information are entitled to exploit this advantage. And they perform a service by making markets more efficient. The unequal possession of information is unfair only when the information has not been legitimately acquired or when its use violates some right or obligation. Other arguments against insider trading, for example, are that the information has not been acquired legiti-mately but has been misappropriated from the right-ful owner (the “misappropriation theory”) and that an insider who trades on information that has been acquired in a fiduciary relation violates a fiduciary duty. Equal access to information is problematical because accessibility is not a feature of information itself but a function of the investment that is required to obtain information. To the objection that an inside trader is using information that is inherently inacces-sible, some reply that anyone can become an insider by devoting enough resources. Similarly, inequalities in bargaining power, processingresources, and ability—which arepervasive in financial markets—are ethically ob-jectionable only when they are used in violation of some right or obligation and especially when they are used coercively. The main ethical requirement is that people not use any advantage unfairly. For example, American stock markets permit relatively unsophisticated investors with modest resources and processing ability to buy stocks on fair terms, and some changes, such as increased use of program trading or private placements, are criticized for in-creasing the advantages of institutional investors. (The growth of mutual funds has served to reduce the adverse consequences of inequalities among in-vestors.) Vulnerabilities, such as impulsiveness or overconfidence, create opportunities for exploitation that can be countered by such measures as a “cooling off” period on purchases and loans, and the warning to request and read a prospectus before investing.Financial ContractingSome financial instruments, such as home mortgages and futures options, are contracts which commit the parties to a certain course of action, and many finan-cial relations, such as being a trustee or corporate officer, are contractual in nature. Contracts are oftenvague, ambiguous, or incomplete, with the result that disagreements arise about what is ethically and le-gally required. First, beyond the written words of express con-tracts lie innumerable tacit understandings that con-stitute implied contracts. Financial affairs would be impossible if every detail had to be made explicit. However, whatever is left implicit is subject to differ-ing interpretations, and insofar as implied contracts are not legally enforceable, they may be breached with impunity. Not only financial instruments but the relations of corporations with employees, cus-tomers, suppliers, and other stakeholders consist of implied contracts, from which each party receives some value. . . . Second, contracts are sometimes imperfect becauseof limitations in our cognitive ability, especially in-complete knowledge, bounded rationality, and future contingencies. In addition, some situations may be too complex and uncertain to permit careful plan-ning. As a result, the parties may fail to negotiate contracts that produce the maximum benefit for themselves. Disputes in contractual relations also arise over what constitutes a breach of contract and what is an appropriate remedy. Agency and fiduciary relations are one solutionfor the problems of imperfect contracting because they replace specific obligations with a general duty to act in another’s interests. In particular, the fiduciary relations of managers to shareholders has arisen because of the difficulties of writing contracts for this particular relation. Similarly, supplier rela-tions are not easily reduced to contractual terms. The term relational contracting has been coined to describe the building of working relations as an al-ternative to rigid contracts.FINANCIAL SERVICESThe financial services industry—which includes commercial banks, securities and investment firms, mutual and pension funds, insurance companies, and financial planners—provides a vast array of fi-nancial services to individuals, businesses, and gov-ernments. Financial services firms act primarily as financial intermediaries, which is to say that they use their capital to provide services rather than to trade on their own behalf. In providing financial ser-vices, these firms sometimes act as agents or fidu-ciaries with respect to clients; at other times, they act as sellers in a typical buyer–seller relation. Thus, a broker who is authorized to trade for a client’s ac-count is an agent, but a broker who makes a cold call to a prospect is merely a salesperson. Many ethical disputes result from misunderstandings about the nature of a financial service provider’s role.Fiduciaries and AgentsA fiduciary is a person who is entrusted to act in the interests of another. Fiduciary duties are the duties of a fiduciary to act in that other person’s interest without gaining any material benefit except with the knowledge and consent of that person. Simi-lar to the fiduciary relation is the relation of agent and principal, in which one person (the agent) is engaged to act on behalf of another (the principal). Whereas fiduciary relations arise when something of value is entrusted to another person, agency rela-tions are due to the need to rely on others for their specialized knowledge and skill. In both relations, the specific acts to be performed are not fully spec-ified in advance and fiduciaries and agents have wide latitude. A major source of unethical conduct by fiducia-ries and agents is conflict of interest, in which a per-sonal interest of the fiduciary or agent interferes with the ability of the person to act in the interest of the other person. Fiduciaries and agents are called upon to exercise judgment on behalf of others, and their judgment can be compromised if they stand to gain personally by a decision. For example, a conflict of interest is created when a brokerage firm offers a higher commission for selling in-house mutual funds. The conflict arises because the broker has an incentive to sell funds that may not be in a cli-ent’s best interests. Whether mutual fund managers should be permitted to trade for their own account is a controversial question because of the perceived conflict of interest. Fiduciaries and agents also have duties to preserve the confidentiality of informationand not to use the information for their own ben-efit. Thus, “piggyback” trading in which a broker copies the trades of a savvy client, is a breach of confidentiality. Agency relations are subject to some well-known difficulties that arise from the inability of principals to monitor agents closely. These diffi-culties are opportunism, moral hazard, and adverse selection. Opportunism, or shirking, occurs because of the tendency of agents to advance their own in-terests despite the commitment to act on behalf of another. In agency theory, which is the study of agency relations, whatever in principal loses from opportunism is known as agency loss. The total of the agency loss and expenditures to reduce it are called agency costs. Moral hazard arises when the cost (or risk) of an activity is borne by others, as when a person seeks more medical care because of insurance. Moral hazard can be reduced in insurance by requiring deductibles and copayments, which provide an insured person with an incentive to lower costs. Insurance companies can also seek out better insurance prospects, but this leads to the problem of adverse selection. Adverse selection is the tendency, in insurance, of less suitable prospects to seek more insurance, which increases the risk for insurers who cannot easily identify good and bad insurance pros-pects. More generally, principals are not always able to judge the suitability of agents, and agents have an incentive to misrepresent themselves. Many ethical problems, ranging from churning ofclient accounts by stockbrokers to the empire-building tendencies of CEOs, result from the difficulties inher-ent in agency relations. These problems can be ad-dressed by closer monitoring and by changes in the structure of the relation. For example, the incentive for brokers to churn could be reduced by basing compen-sation more on the performance of clients’ portfolios and less on the volume of trades. In addition, com-pensating executives with stock options aligns their interests more closely with those of the shareholders and thus prevents empire building. The most effective solutions for ethical problems in agency relations are twofold: first, there must be a strong sense of profes-sionalism accompanied by professional organizations with codes of ethics; second, a high degree of trust must be present. Trust is essential in the financial services industry, and companies generally pay a heavy price for violating the public’s confidence.Sales PracticesFinancial products are susceptible to abusive sales practices, such as “twisting,” in which an insurance agent persuades a client to replace an existing policy merely for the commission, and “flipping,” which is the practice of replacing one loan with another in order to generate additional fees. The poor are fre-quent targets of abuses by loan providers who offer high-interest loans and add on various “options” of little value. Finally, financial products should meet certain standards of integrity. Just as automobiles and houses can be shoddily made, so too are there shoddy financial products. The sale of limited part-nerships, for example, has been criticized in recent years for dubious valuation of assets and question-able practices by developers. Victims of fraud or abuse by financial servicesfirms generally have recourse to the courts, but the securities industry in the USA requires most custom-ers (and employees) to sign a predispute arbitration agreement (PDAA) that commits them to binding arbitration of disputes. Mandatory arbitration is spreading to the holders of credit cards, insurance policies, and other financial products. Although ar-bitration has many advantages over litigation, crit-ics charge that the process is often unfair and denies investors adequate protection. The controversy over compulsory arbitration in the securities industry fo-cuses on three issues: the requirement that investors sign a PDAA as a condition of opening an account, the alleged industry bias of arbitration panels, and the permissibility of punitive damages. In addition, the requirement that employees submit complaints about such matters as discrimination and harassment to arbitration denies them of the right to sue in court, a right that employees outside the securities industry take for granted.Financial Services FirmsFinancial services firms are themselves businesses, and the management of such a business raisessome ethical issues, especially in the treatment of institutional clients. For example, underwriters of municipal bonds have been criticized for making political contributions in city elections in order to gain access. Firms as well as individuals encounter conflicts of interest, such as the reluctance of bro-kerage firms to issue a negative analysis of a client company’s stock. In recent years, rogue traders have caused great losses at some firms, including the col-lapse of a major bank. The managers of large investment portfolios formutual funds, insurance companies, pension funds, and private endowments face two important ethical questions.1. Should they consider social factors in making decisions, such as how a corporation treats its employees or its record on the environment?2. Should they vote the stock that they hold, and if so, what criteria should they use to evaluate the issues that are submitted to a vote?Some large institutional investors take a hands-off approach, while others are becoming actively in-volved as shareholders in a movement known as re-lationship investing.FINANCIAL MANAGEMENTFinancial managers have the task of actively de-ploying assets rather than investing them. Unlike a portfolio manager who merely buys stocks of corpo-rations for a client, a corporate financial manager is involved in the running of a corporation. Investment decisions in a corporation are concerned not with which securities to hold but with what business op-portunities to pursue. These decisions are still made using standard financial criteria, however. Finance theory can be applied to the operation of a corpora-tion by viewing the various components of a busi-ness as a portfolio with assets that can be bought and sold. Option pricing theory, in particular, sug-gests that all of the possibilities for a firm can be regarded as options to buy and sell assets. Bank-ruptcy, for example, is exercising an option to “sell” the corporation to the debtholders. (However, one critic has called this a “thoroughly immoral view of finance.”) The ethical issues in financial management aretwofold.• Financial managers, as agents and fiduciaries, have an obligation to manage assets prudently and especially to avoid the use of assets for per-sonal benefit. Thus, managers, who have prefer-ential access to information, should not engage in insider trading or self-dealing. For example, management buyouts, in which a group of man-agers take a public corporation private, raise the question of whether people who are paid to mind the store should seek to buy it.• Financial managers are called upon to make decisions that impact many different groups, and they have an obligation in their decision making to balance some competing interests. For example, should the decision to close a plant be made solely with the shareholders’ in-terests in mind or should the interests of the employees and the local community be taken into account?Balancing Competing InterestsIn finance theory, the objective of the firm is share-holder wealth maximization (SWM). This objective is reflected in corporate law, according to which officers and directors of corporations are agents of the corporation and have a fiduciary duty to operate the corporation in the interests of the shareholders. Despite the seemingly unequivocal guide of SWM, financial managers still face the need, in some situations, to balance competing interests. In partic-ular, decisions about levels of risk and hostile take-overs reveal some difficulties in the pursuit of SWM.The Level of RiskMaximizing shareholder wealth cannot be done with-out assuming some risk. A critical, often overlooked, task of financial management is determining the appro-priate level of risk. Leveraging, for example, increases the riskiness of a firm. The capital asset pricing model suggests that, for properly diversified shareholders, the level of risk for any given firm, called unique risk, is irrelevant and that only market or systemic risk is im-portant. Finance theory treats bankruptcy as merely an event risk that is worth courting if the returns arehigh enough. If a firm is in distress, then a high risk, “bet-the-farm” strategy is especially beneficial to shareholders, because they will reap all the gains of success, while everyone will share the losses of failure (the moral hazard problem). Consequently, a financial manager should seek the highest return adjusted for risk, no matter the actual consequences. However, a high-risk strategy poses dangers forbondholders, employees, suppliers, and managers themselves, all of whom place a high value on the continued operation of the firm. Employees, in partic-ular, are more vulnerable than shareholders to unique, as opposed to systemic, risk because of their inability to diversify. Is it ethical for financial managers to in-crease risk in a firm so as to benefit shareholders, at the expense of other corporate constituencies? Does the firm, as an ongoing entity, have value that should be considered in financial decision making? Some have argued that managing purely by financial cri-teria, without regard for the level of risk, is immoral.Hostile TakeoversHostile takeovers are often epic battles with winners and losers. For this reason, the rules for acquiring controlling interest should be fair to all parties in-volved. Managers of target companies feel entitled to a fair chance to defend their jobs; shareholders who sell their shares, and those who do not, have a right to make a decision in a fair and orderly manner; bondholders often lose in takeovers because of the increased debt; and employees and residents of local communities, who usually have no say in the deci-sion, are generally the groups most harmed. . . . The directors of a target company, whose approvalis often necessary for a successful takeover, have a fiduciary duty to act in the best interests of the firm itself, which may not be identical with the interests of either the preexisting shareholders or those who seekcontrol. A majority of states have adopted so-called “other constituency statutes” that permit boards of directors to consider other constituencies, such as em-ployees, suppliers, customers, and local communities, in evaluating a takeover bid. Many other laws govern the conduct of raiders and defenders alike, so that the market for corporate control is scarcely a pure market. In general, courts and legislatures have created rules for takeovers that seek both fairness and efficiency.