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Financial Misconduct, Ethical Theory, and Regulatory Ethics—Promoting Accountability

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FINANCIAL MISCONDUCT, ETHICAL THEORY, AND REGULATORY ETHICS—PROMOTING ACCOUNTABILITY

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"There is evidence of deep-seated cultural and ethical failures at many large financial institutions. Whether this is due to size and complexity, bad incentives or some other issues is difficult to judge, but it is another critical problem that needs to be addressed."

~ William Dudley[1]

I. INTRODUCTION

Reports about misconduct in the financial sector are seemingly endless. Misconduct is wide-ranging and varied—from abusive practices in mortgage securities and commodities markets to manipulation of foreign exchange and interest rates.[2] Truly, the reports suggest an ethical crisis in finance. A major complaint is about the lack of serious efforts to hold to account executives that engaged in misconduct or were in leadership positions at the banks. The events call into question the adequacy of the current arrangements for ensuring integrity in the financial sector, at the institutional and individual levels.

This paper examines developments in the financial sector and identifies a role for regulatory ethics in promoting integrity and accountability. In this effort, the paper also explores theoretical perspectives in ethics and how they can shape business behavior. Specifically, the article proposes corporate codes of ethics, a mandatory requirement under the New York Stock Exchange Listing Rules, as instruments to promote morality in corporate conduct. Ethics codes, which are internally generated, must be tailored to reflect the experience and made more effective. They can be amplified to specify standards to govern the fiduciary duty of care applicable to executives, personal integrity and accountability. This method can be effective in shaping the moral climate in corporations and in checking misconduct.

Wrongful conduct reported against banks is wide-ranging and varied. Following are the major classes of misconduct:

- Mortgage-related issues, at both ends:
  - Practices adopted for selling mortgage securities to investors,[3] and
  - Foreclosure procedures in dealing with delinquent

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[1] William C. Dudley, President and Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Global Economic Policy Forum, New York: Ending Too Big to Fail (Nov. 7, 2013), http://www.newyorkfed.org/newsevents/speeches/2013/dud131107.html.

[2] *See infra* Parts II–V.

[3] *See infra* Section III.A.3

mortgages[4]

- ➢Transactions in non-financial markets—for example, commodities futures[5]
- ➢Interest rate manipulation (LIBOR)[6]
- ➢Manipulative practices in foreign exchange markets[7]
- ➢Questionable hiring practices in foreign jurisdictions[8]

Obviously, several factors shaped the trends. They included macroeconomic developments, mainly financial deregulation and switch to market-determined interest and exchange rates. The developments facilitated financial innovation, often questionable in content. In particular, deregulation enabled banks' entry into non-traditional fields including power and commodities. Banks were, quite understandably, natural players in the interest and exchange rate space. These activities became profit centers. Incentive systems were designed to boost business performance and results. For corporate actors who engaged in misconduct, personal gain linked to business results was often a major consideration. These realities inform the efforts made in this paper to interpret events in the financial sector in ethical terms.

The paper has four parts, including this Introduction. The next part examines some theories of business ethics and the different standards they prescribe for evaluating behavior.[9] The third part presents an ethical analysis of the major types of misconduct reported against banks, examining them against the standards advocated in ethical theory.[10] The fourth part reviews the outcomes faced by delinquent banks, which are mainly regulatory fines and sporadic disciplinary actions against individual executives involved in wrongdoing.[11] Government agencies have targeted the banks and procured financial settlements.[12] Put differently, the effort has mostly been restricted to accountability of banks, at the institutional level.[13] Action against executives

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[4] Nelson D. Schwartz & Sheila Dewan, *$26 Billion Deal Is Said to Be Set for Homeowners*, N.Y. TIMES, Feb. 9, 2012, at A1, http://www.nytimes.com/2012/02/09/business/statesnegotiate-25-billion-deal-for-homeowners.html?_r=0.

[5] *See infra* Section III.B.

[6] *See infra* Section III.C.

[7] *See id.*

[8] Ben Protess & Jessica Silver-Greenberg, *Bank Tracked Business Linked to China Hiring*, N.Y. TIMES, Dec. 8, 2013, at A1, http://dealbook.nytimes.com/2013/12/07/bank-tabulated-business-linked-to-china-hiring/.

[9] *See infra* Part II.

[10] *See infra* Part III.

[11] *Id.*

[12] *Id.*

[13] *Id.*

who engaged in wrongful conduct has been limited.[14]

Finally, the fifth part advocates the strengthening of corporate codes of ethics to promote business integrity and accountability.[15] Ethical codes are now a regulatory requirement and they provide a ready vehicle for codifying the norms to govern executive behavior.[16] Thomas Donaldson argued that internally developed norms can be effective in promoting an ethical culture in corporations and in avoiding the shortcomings of regulation, such as recalcitrance.[17]

II. FINANCIAL MISCONDUCT—AN ETHICAL EVALUATION

As pointed out, interpreting some varieties of financial misconduct in ethical terms can be problematic. This is about the business purposes that inspired the questionable behavior. For instance, the hiring decisions at JPMorgan Chase were made, obviously, to please powerful interests in a large overseas market.[18] Is the ethical argument weaker because the decision was made ostensibly for corporate benefit? Can business advantage be an appropriate measure? There can be similar difficulties in dealing with banks' derivatives business. A common refrain is that there was insufficient understanding of the risks in credit derivatives. Is there an ethical aspect to the decision to take up business in credit derivatives without adequate knowledge and awareness? Was there an ethical failure when executives, through their actions, imposed on the banks risks they did not fully appreciate?

The apparent ethical tension makes it necessary to flesh out more clearly the boundaries of legitimate business conduct and possible transgressions. The definitional issue is a necessary first step in applying the yardstick of ethics. This part consists of two sections. The first reviews some of the standards that have been prescribed in ethical theory and the second attempts to identify an equilibrium standard for business conduct.

A. Ethical Standards and Their Different Shades

The ethical standards that have been prescribed by theorists vary significantly in degree. On the one hand, there is the conventional "honesty is

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[14] *Id.*

[15] *See infra* Part IV.

[16] *Id.*

[17] Thomas Donaldson, *Hedge Fund Ethics*, 18 BUS. ETHICS Q. 405 (2008).

[18] Protess & Silver-Greenberg, *supra* note 8.

the best policy" standard.[19] This approach eschews idealism, more or less, and views ethics largely as instrumental in promoting business. On the other, there are more absolute standards that present ethical behavior as intrinsically good.[20] John Dobson stressed "virtue ethics" and was not overly concerned with the business outcomes of moral conduct.[21] Then there is the middle ground that avoids strict formulations.[22] This is the "moral free space" for business corporations that Donaldson and Dunfee identified.[23] These differing perspectives, examined below, point towards the need to identify an optimal standard.

1. *Instrumental Ethics*

In general, financial theory of recent decades perceives ethical elements—for example, trust and reputation—as market-generated and driven by the motive of wealth maximization.[24] Diamond noted similar profit-seeking behavior in debt markets in nurturing trust among participants.[25] The idea is that the wealth maximization motive can inspire proper business conduct.[26] This mode of thinking was carried even further in the law-and-economics movement that was influential in the 1980s and 1990s.[27] For example, Easterbrook and Fischel argued that issues such as social responsibility must be left to the financial markets.[28] Investors will have the freedom to choose between companies that were socially responsible and those that were not. In this approach, wealth maximization trumped ethical concerns.

The instrumental view of ethics is aligned to a bias against regulation. A rather extreme anti-regulation argument came from Alan Greenspan, then chair

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[19] *See generally* Gabriel Abend, THE MORAL BACKGROUND: AN INQUIRY INTO THE HISTORY OF BUSINESS ETHICS (2014).

[20] *See, e.g.*, John Dobson, *Ethics in Finance II*, 53 FIN. ANALYSTS J. 15 (1997).

[21] *Id.*

[22] Thomas Donaldson & Thomas W. Dunfee, *Ties that Bind in Business Ethics: Social Contracts and Why They Matter*, 26 J. BANKING & FIN. 1853 (2002).

[23] *Id.*

[24] *See, e.g.*, Hayne E. Leland & David H. Pyle, Informational Asymmetries, Financial Structure, and Financial Intermediation, 32 J. FIN. 371 (1977).

[25] Douglas W. Diamond, *Reputation Acquisition in Debt Markets*, 97 J. POL. ECON. 828 (1989).

[26] *Id.*

[27] *See, e.g.*, *id*.

[28] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

of the Federal Reserve.[29] Greenspan called for abolishing the statute against fraud. Brooksley Born, former head of the Commodity Futures Trading Commission (CFTC), stated: "[Alan Greenspan] explained there wasn't a need for a law against fraud because if a floor broker was committing fraud, the customer would figure it out and stop doing business with him."[30]

To be clear, market practices can be effective in checking misconduct. This is true, but the argument is probably more valid when the times are "normal." The range and volume of misconduct recently seen in banks suggest that the times were quite far from normal. When the culture and climate are in reasonable order with no major patterns of lax conduct, markets can internalize ethics. This can be so even if the driving considerations are amoral and the incentive is financial gain, rather than virtue.

The limits of market as the source of ethical behavior are evident in the saga of the financial sector. Patterns of wrongful behavior prevailed across banks and in a range of activities—a veritable epidemic.[31] These suggest a significant change in market culture. There was greater tolerance of wrongful behavior, evident, for example, from collusive practices among executives across banks in LIBOR manipulation.[32] The experience underscores the need for more robust and nuanced frameworks that are not entirely dependent on current moods in markets.

2. *Virtue Ethics*

Another school argues for a stronger, absolute version of ethics. It perceives ethical behavior as an end in itself, more or less. John Dobson advocated this more robust version and termed the concept virtue ethics. In the context of creative accounting practices, he argued for traveling beyond external criteria, such as expectations of the users of financial statements or the utilitarian goal of generating overall benefit. According to Dobson, these considerations are no more than constraints on behavior and they hardly promote virtue.[33] Earlier in 1993, Dobson treated ethical behavior as an inner issue for individuals,[34] tracing it to older traditions that date back to David

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[29] Manuel Roig-Franiza, *Brooksley Born, the Cassandra of the Derivatives Crisis*, WASH. POST (May 26, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html.

[30] *Id.* Born had sounded early warnings about the risks in derivatives. *Id.*

[31] *See id.*

[32] *See id.*

[33] Dobson, *supra* note 20.

[34] John Dobson, *The Role of Ethics*, 49 FIN. ANALYSTS J. 57 (1993).

Hume (1711–1776)[35] and Adam Smith (1723–1790)[36].

For virtue ethics, an important point of distinction from instrumental ethics is the concern in virtue ethics with the "internal" aspect.[37] Even before Dobson, the internal dimension had been emphasized by MacIntyre.[38] In virtue ethics, rectitude is inspired by inner needs and urges of individuals, rather than external factors, such as quest for wealth or recognition.[39] To put it differently, instrumental ethics relies on sensory attractions and worldly incentives to guide behavior.[40] In contrast, virtue ethics understands morality as an inner quality, driven by higher spiritual needs rather than acquisitive and possessive qualities, dictated by sensory attractions.[41]

Virtue ethics sets a lofty bar. Given the imperfections in human character and personality, there can be challenges in implementing virtue ethics, without denying its value as an ideal. It would probably be easier for individuals to practice virtue ethics, but it would be more challenging at the collective or corporate level. We can only speculate how far the human species has evolved to a level where a large majority can rise above sensory attractions and sensual temptations and have the ability to do right, regardless of anything. Yet history shows the difference leadership can make. Moral exemplars, such as George Washington and Mahatma Gandhi, inspired large numbers of people to sacrifice immediate gain and accept hardship in pursuit of higher goals.[42]

However, moral exemplars and inspirational phases happen only sporadically. In the recent deluge of financial misconduct, the opposite was probably true. It was apparently one misdeed inspiring another and one wrongdoer leading another. Judge Hellerstein, in convicting Kareem Serageldin of Credit Suisse of inflating the value of securities to hide losses, described Serageldin's conduct as "a small piece of an overall evil climate

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[35] Maurice Cranston, *David Hume*, ENCYC. BRITTANICA, http://www.britannica.com/biography/David-Hume (last updated May 21, 2015).

[36] Robert L. Heilbroner, *Adam Smith*, ENCYC. BRITTANICA, http://www.britannica.com/biography/Adam-Smith (last updated Nov. 23, 2014).

[37] Dobson, *supra* note 20, at 16.

[38] ALASDAIR MACINTYRE, AFTER VIRTUE: A STUDY IN MORAL THEORY (2d ed. 1984).

[39] Dobson, *supra* note 20, at 16–17.

[40] *See id.* at 16.

[41] *See id.* at 16–17. The Indian spiritual classic, *Katha Upanishad*, states that the human face with its sensory openings focuses on the outer world; it is only the wise that turn their gaze inward. VALERIE J. ROEBUCK, THE UPANISHADS 327 (1st ed. 2000). In keeping with the democratic spirit of the present age and collective arrangements (such as governments and corporations) that dominate life, it is perhaps necessary to strive for greater diffusion of this variety of wisdom.

[42] *See* Dobson, *supra* note 20, at 17–18 (discussing the impact leaders have on the ethics of the entire organization).

inside that bank and many other banks."[43]

A greater problem in actualizing virtue ethics is the corporate stock market system in which executives function. Greenfield pointed out the difficulties for executives operating under a fiduciary duty to maximize shareholder wealth and an amoral climate that treats financial penalties for infractions as a part of the cost of doing business.[44] Yet the recent financial misconduct and the penalties banks have paid to settle with governments indicate the perils in adopting amoral approaches and striving towards wealth maximization with little regard for other factors.

3. Moral Free Space—A Middle Ground?

Between the poles of instrumental ethics and virtue ethics, Donaldson and Dunfee offer a more open and adaptive framework.[45] This is the Integrative Social Contracts Theory (ISCT).[46] This model eschews setting rigid standards for companies and is more sensitive to the dynamic environment in which businesses operate.[47] At the same time, a minimum standard of conduct is emphasized.[48] Donaldson and Dunfee explained that the "moral free space" in their construct permits "nations and other economic communities to shape their distinctive concepts of economic fairness, but it draws the line at flagrant neglect of core human values."[49] In this framework, morality would be conditional or situational.[50] Donaldson and Dunfee offered an illustration by referring to recent changes in the expectations framework in which corporations now function; in addition to competitive advantages, corporations must now pay attention to "a variety of issues involving fairness and quality of life."[51]

ISCT has at its core the notion that ethical standards evolve in societies according to the ideas and values of the time.[52] It reflects, somewhat, the

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[43] Rachel Abrams & Peter Lattman, *Ex-Credit Suisse Executive Sentenced in Mortgage Bond Case*, N.Y. TIMES, Nov. 23, 2013, at B3, http://dealbook.nytimes.com/2013/11/22/ex-credit-suisse-executive-sentenced-in-mortgage-case/?_r=0 (quoting J. Hellerstein).

[44] Kent Greenfield, *Corporate Ethics in a Devilish System*, 3 J. BUS. & TECH. L. 427, 428 (2008).

[45] *See* Donaldson & Dunfee, *supra* note 22, at 1859.

[46] *Id.* at 1854.

[47] *Id.* at 1859.

[48] *Id.*

[49] *Id.* at 1855.

[50] *Id.*

[51] *Id.*

[52] *Id.*

Hegelian concept of *zeitgeist*, or the spirit of the times.[53] This implies that the ethical standard is not static.[54] Rather it constantly evolves, as a product of broad societal consensus.[55] In essence, ISCT avoids the polar positions of instrumental ethics, which gives a freer rein to primeval instincts and virtue ethics, which operates at a more rarefied level.[56] ISCT is sensitive to the corporate or collective character of ethics in contemporary business, particularly in comparison with virtue ethics, which can be quite challenging at the collective level.[57] However, ISCT hesitates to be prescriptive and this can limit its ability to deal with ethical epidemics such as the crisis in the financial sector.

B. Searching for an Equilibrium Standard

The goals and emphasis vary quite dramatically in the ethical standards that have been prescribed by theorists. Virtue ethics sets the bar high. Without detracting from its aspirational value, it is probably too lofty for realistic application to business behavior. At the other end, instrumental ethics and wealth maximization goals can justify a sizable part of the wrongful behavior reported against banks. The need is for a unifying theory that offers an optimal or equilibrium standard. Basic moral precepts (do not lie, be fair, respect the environment, and the like) are important, but such broad-brush concepts cannot provide full moral clarity to enterprises.[58] Rather, the goal must be to develop an ethical culture that encourages the practice of moral precepts. Recent financial misconduct provides a useful context to explore these issues.

There are at least three dimensions to the challenges in developing a climate that encourages business rectitude, and these are interrelated. First, business behavior occurs mostly in the corporate setting, which is a collective arrangement.[59] It is not just individuals doing their own things; rather, it is individuals in groups engaging in corporate, collaborative action that has its own logic and rationale. At the next level, corporate enterprises operate in competitive markets and their practices are often shaped by trends in the

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[53] *Zeitgeist*, ENCYC. BRITTANICA, http://www.britannica.com/topic/Zeitgeist-philosophy (last visited Oct. 6, 2015).

[54] *See* Donaldson & Dunfee, *supra* note 22, at 1855.

[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] THOMAS DONALDSON & THOMAS W. DUNFEE, TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS 8 (1999) [hereinafter TIES THAT BIND].

[59] *See* Dobson, *supra* note 20, at 21.

market.[60] These factors are exogenous, at least in a limited sense.[61] They are the second aspect.[62] The third is incentives—a thing economic theory often overemphasizes.[63]

The dynamics of business behavior and their intersection with ethics are apparent in Citigroup's credit derivatives business.[64] Derivatives are particularly appropriate for ethical analysis because of the complex nature of these instruments and reports about inadequate understanding of the risks in them.[65] The ambiguity was highlighted by Judge Jed Rakoff, in the context of criminal law.[66] Judge Rakoff questioned whether the banks' brush with derivatives was merely a case of negligence or "at least in part, . . . fraudulent practice[ ], of dubious mortgages portrayed as sound risks and packaged into ever more esoteric financial instruments, the fundamental weaknesses of which were intentionally obscured?"[67] There is no clear answer to this question. Citigroup recently made a $7 billion settlement with the Department of Justice to close the charges over its mortgage securities business.[68] The story of Citigroup's derivatives business brings out some important dynamics of corporate conduct, the play of hierarchical influences, and the impact of personal friendships. They underscore the complexities of corporate ethics.

1. Individual Behavior and the Corporate Setting

Business ethics in the corporate context, to state the obvious, is not simply about individuals making their own moral choices. Many times, they could be acting under organizational pressures, possibly even against their personal judgment.[69] Citigroup made a rather late plunge into credit

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[60] *See id.* at 21–22.
[61] *See id.*
[62] *See id.*
[63] *See id.*
[64] Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014), http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/.
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] Michael Corkery, *Citi Settles Mortgage Securities Inquiry for $7 Billion*, N.Y. TIMES, July 15, 2014, at B1, http://dealbook.nytimes.com/2014/07/14/citigroup-and-u-s-reach-7-billion-mortgage-settlement/?_r=0. This is subject to a caveat: given the circumstances, it is not clear whether the mere act of making a settlement can be treated as admission of wrongdoing by banks. *See infra* Section II.B.1. The settlement could be no more than a strategy to buy peace and to show contrition. These would be useful from a business standpoint in the prevailing atmosphere of hostility to the financial sector, exemplified by the Occupy Wall Street movement.
[69] This problem is true of any collective setting. A major ethical question is how far individuals who are a part of the system have the moral freedom to act according to their

derivatives business. The company became active in the business in 2002 when Charles Prince became the head of corporate and investment banking.[70] Prince, understandably, wished to improve business, and turned to derivatives for generating greater volumes.[71] Between 2003 and 2005, Collateralized Debt Obligations (CDO) issued by Citigroup went up from $6 billion to over $20 billion.

The chain was complicated. Charles Prince, who was instrumental in Citigroup's derivatives business, had little personal knowledge on the subject.[72] He was encouraged in joining the derivatives bandwagon by Robert Rubin, who at the time was a director on the bank's board.[73] Rubin had impressive credentials as a former Goldman Sachs executive and Treasury Secretary under President Clinton.[74] Incidentally, he was also among the leading proponents of financial deregulation in the 1990s.[75] Rubin reportedly urged Prince saying: "You have to take more risk if you want to earn more."[76] To be fair, a factor in Rubin's recommendation of derivatives business was a concern that Citigroup was falling behind rivals such as Morgan Stanley and Goldman Sachs.[77] This is dealt with in the next subsection in the discussion on competitive pressures.[78]

Another issue was with the risk oversight function in Citigroup.[79] This was about personal friendship among longstanding employees.[80] Thomas Maheras, the functional head of derivatives trading, Randolph Barker, the deputy of Maheras, and David Bushnell, the senior risk officer charged with monitoring risk were all colleagues of long standing.[81] Reportedly, the personal friendship among them affected the quality of oversight and in 2008 the Federal Reserve made a "scathing review" of risk management at

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conscience without risking adverse impact. The recently-developed whistle-blower mechanism seeks to empower diligent employees and even provide an economic incentive to them.

[70] Eric Dash & Julie Creswell, *Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1, http://www.nytimes.com/2008/11/23/business/23citi.html?pagewanted=all.

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.* (internal quotation marks omitted). There is an interesting aside from the perspectives of corporate governance and accountability. Dash and Creswell described Rubin as "an architect of the bank's strategy," and pointed out that he "did not have direct responsibility for a Citigroup unit." *Id.* This would be a case of an individual initiating an action without responsibility for its consequences.

[77] *Id.*

[78] *See infra* Section II.B.2.

[79] Dash & Creswell, *supra* note 70.

[80] *Id.*

[81] *Id.*

Citigroup.[82]

Superior-subordinate relationships and interpersonal ties are among the influences that shape behavior in corporations, as the Citigroup story indicates. They mold decision-making and determine outcomes. In the setting described, it is debatable whether the decision to do business in derivatives could have been avoided, even with greater knowledge about their complexities and risks. Individual employees can hardly disagree with the strategy determined by the leadership. Leaving aside ethical conundrums, consequences can be serious for subordinate employees in hierarchical organizations unwilling to act according to directions.

2. Competitive Pressures and Their Impact

Market competition was a major consideration in Robert Rubin's efforts to promote derivatives business in Citigroup.[83] When competitors were active in the business and were earning sizable profits, it would be challenging for Citigroup to stay away merely on principle or for lack of expertise. In a company operating in competitive markets, under relentless scrutiny from media and equity analysts, CEOs can ignore an apparently profitable business only at their own peril. Charles Prince stated in mid-2007 at the peak of the derivatives saga, just before the implosion in 2008: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."[84]

Seemingly flippant, yet Prince's statement accurately reflected the transient nature of the derivatives business as well as the competitive pressures of the market. Liquidity was a product of trade in derivatives by the major banks, which made it hard for other players to stay away from the melee. Prudence, while probably valid for bankers of an earlier age, would have been out of place in Wall Street, *circa* 2007 AD. In the new age, the ethics that underpin prudence could be a casualty.

3. Incentives and Their Power

The third dimension is incentives. Competitive pressures and staying ahead in the market are about profits for corporations. The incentives are

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[82] *Id.*

[83] *Id.*

[84] Michiyo Nakomoto & David Wighton, *Citigroup Chief Stays Bullish on Buy-Outs*, FIN. TIMES (July 9, 2007, 10:08 PM), http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz3njjQR1hp.

organizational. For executives, a more direct and personal reward would be bonus. Compensation structures generally link pay to performance. This assures executives of personal benefit and sensitizes them to competition and market developments. Thomas Maheras, head of Citigroup's derivatives business, was among the most highly paid employees and made over $30 million at the peak.[85] His deputy Randolph Barker made between $15 million and $20 million.[86]

Financial incentives are an important influence on executive behavior. Directions set by organizational superiors and financial reward motivate executives to pursue business opportunities. In this pursuit, ethical ambiguities might not be serious deterrents as long as there is no criminality. This supports the argument made in the concluding part for personal accountability as a powerful incentive in providing a better ethical compass for executives.[87]

III. FINANCIAL WRONGDOING—SEEN THROUGH THE ETHICAL LENS

The misconduct reported against banks is wide-ranging and varied. Each type—mortgage securities and interest rate manipulation, to name two—is different in character and warrants individual analysis from an ethical perspective. This part examines the instances of financial misconduct through the ethical lens. The analysis begins with credit derivatives,[88] which are probably the most challenging from the ethical standpoint. The position with most other types of misconduct is relatively straightforward. For instance, manipulation of currency and interest rates involved breach of a basic moral precept: Do not lie.[89] Similarly, bank operations in commodities markets amounted to profiteering which has been recognized for a long time as unethical, often even illegal. This part consists of three sections that deal with credit derivatives,[90] banks' operations in non-financial markets,[91] and manipulative practices in forex and interest rate markets.[92]

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[85] Dash & Creswell, *supra* note 70.
[86] *Id.*
[87] *See infra* Part V.
[88] *See infra* Section III.A.
[89] TIES THAT BIND, *supra* note 58.
[90] *See infra* Section III.A.
[91] *See infra* Section III.B.
[92] *See infra* Section III.C.

A. *Credit Derivatives and Their Ethics*

The credit derivatives phenomenon has a number of ingredients. These include financial engineering on Wall Street, congressional encouragement to affirmative lending, facilitation by government-sponsored housing agencies Fannie Mae and Freddie Mac, questionable practices in mortgage lending and marketing of derivatives, problems with credit ratings by rating agencies, and failure of Congress to regulate derivatives despite sufficient warnings. Each had its own limited logic. Together, however, they formed the heady mixture that caused the Financial Crisis of 2008–2009, followed by unprecedented financial intervention by the U.S. government through the Troubled Asset Relief Program (TARP) and by the Federal Reserve with its quantitative easing. The components of the derivatives imbroglio are discussed below.

1. *Financial Engineering on Wall Street*

The financial community, understandably, is in a constant quest to improve returns for clients. For investors looking for fixed income securities, the effort was to increase yield by combining low-risk/low-return debt (e.g., treasury bonds) with high-risk/high-return debt (e.g., credit card debt and junk bonds).[93] The goal was to achieve optimal risk-return balance.[94] This was the theory behind pooling a variety of debt securities into credit derivatives consisting of a range of portfolios: corporate bonds, residential mortgages, automobile loans, credit card debt, and so on.[95] These pools were named Collateralized Debt Obligations (CDO), Collateralized Loan Obligations (CLO), and so on.[96] By creating and selling these derivatives, banks could transfer their loan portfolios and the risk in them to investors and free up their capital. This would enable them to lend more, leading to credit expansion.

The pools in CDO/CLO contained debt of varying quality that had been put together. Credit rating was used to divide the pool into different slices or tranches according to the level of risk. This would help in selling individual tranches to different investors according to their risk appetite. Treasury bonds and secured corporate debt would have high credit rating, but low return.[97]

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[93] *See generally* P.M. Vasudev, *Credit Derivatives: Understanding Their Characteristics and Risk Potential*, *in* THE RISK OF INVESTMENT PRODUCTS: FROM PRODUCT INNOVATION TO RISK COMPLIANCE 101 (Michael CS Wong ed., 2011).

[94] *Id.*

[95] *Id.*

[96] *Id.*

[97] *Id.*

Conversely, subprime mortgages and credit card debt would have low rating but high returns.[98] Investors could buy a tranche of debt that matched their risk tolerance level and the yield was acceptable.

The debt portfolios, or credit derivatives as they came to be called, were obviously complex pools and making sense of them was a challenge. To overcome this problem, credit rating was used as a tool. In buying the tranches, investors did not have to rely solely on representations from sellers. They could look to the rating given by expert agencies.

A further protection for the buyers of credit derivatives, in particular the high-risk tranches, was Credit Default Swaps (CDS). These are similar to credit insurance. Investors could purchase CDS from companies such as American International Group (AIG) to protect themselves against default. In this arrangement, the CDS seller would be liable to pay in case of default by borrowers of the underlying debt. More significantly, they also had to pay in case of a fall in market value of the credit derivatives held by investors. Finally, banks that sold the derivatives retained the most risky part of the portfolio, which was termed the "toxic waste." This provided further assurance to investors who purchased the other tranches. These were the building blocks on which derivatives trade was structured.[99]

It would be hard to find moral faults with the credit derivatives business as it developed on Wall Street—up to the stage described. There was economic substance in the transactions, and also a purpose. Investors looking for better yield from fixed-income securities were offered instruments that promised higher returns. The picture got murkier with the advent of "synthetic" credit derivatives developed for "reference" portfolios of debt. The synthetic version did not, in fact, have actual debt portfolios in them but were built on other portfolios; hence their name. JPMorgan with its BISTRO (Broad Index Synthetic Trust Offering) was among the first to offer synthetic CDO that were purely speculative.[100]

With synthetic CDO and reference portfolios, banks sold non-existent bundles of debt.[101] Several reference portfolios were constructed for a given bundle of debt and this practice, coupled with sale of CDS for synthetic CDO, contributed to systemic risk.[102] Buyers of synthetic credit derivatives had an

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[98] *Id.*

[99] *See generally id.*

[100] *See generally* J.P. Morgan & RiskMetrics Group, *The J.P. Morgan Guide to Credit Derivatives*, INVESTINGINBONDS.COM, www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf (last visited Aug. 2, 2015).

[101] *Id.*

[102] Michael Gibson, *Credit Derivatives and Risk Management*, 4 FED. RES. BANK ATLANTA

incentive that could be termed perverse. They stood to gain on default in the debt portfolio, which triggered liability of the CDS seller.[103] Buyers of synthetic derivatives would pay a fraction of the value of the reference portfolio and use the money to purchase default swaps.[104] JPMorgan's BISTRO had a value of $10 billion for its reference portfolio of debt, but was funded only to the extent of $700 million or seven percent.[105] With the default swaps in hand, buyers of synthetic credit derivatives could collect money from the swap seller if there was a default in the underlying portfolio or a fall in its market value.

AIG was a large seller of default swaps. It sold swaps both for real credit derivatives that had debt portfolios and the synthetic version modeled on the real ones.[106] Synthetic credit derivatives and default swaps for them multiplied the liability of swap sellers several times the actual value of the debt in real portfolios.[107] This was the systemic risk in credit derivatives.[108] Payment obligations for swap sellers could be a multiple of the value of the debt covered by the swaps.[109] This factor contributed to the meltdown in AIG in 2008, which was averted by financial assistance from the Federal Reserve.[110]

Synthetic CDO and default swaps for them probably pushed the line of ethics. The legitimacy of the instruments and selling them in the market were both questionable. They represented a move from legitimate risk-taking into the realm of pure speculation. This was, moreover, speculation of a destructive variety because buyers of CDS for synthetic CDO would profit only on the happening of a negative event—namely, default in the underlying portfolio or fall in its market value. These buyers had no substantive economic interest in the debt, but they had a vested interest in default or other negative developments. To this extent, the ethics of recent financial engineering on Wall Street is open to challenge. However, the financial sector was not the only actor on the scene.

ECON. REV. 25 (2007).

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *See generally* P.M. Vasudev, *Default Swaps and Director Oversight: Lessons from AIG*, 35 J. CORP. L. 757 (2010).

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *Id.*

2. *Affirmative Lending, Fannie Mae, and Freddie Mac*

The bundling of debt into credit derivatives and selling them in the market happened alongside an explosion in lending. There were at least three factors in this development. One was the expansion of mortgage market funds, which grew from under $100 billion in 1996 to a peak of over $600 billion in 2005.[111] A second factor was the stepping up of role by the government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac—in the mortgage market. The share of GSEs went up from 5 percent of the total market funds in the 1970s, gradually increasing in the following decades to cross 50 percent in the early 1990s.[112] The GSE's share stayed at this level except for a dip to about 40 percent during the years of the Credit Crisis.[113] By 2010, the percentage had leapt back to 54.[114] The data underscores the influence government policy had in the growth of the mortgage market in recent decades. This was a causal factor in the development of credit derivatives, which were bought in large numbers by the GSEs.

The two factors—namely, increased role of GSEs and expansion of the mortgage market—occurred in the backdrop of encouragement to affirmative lending under Congressional policy. This was an important factor in the subprime phenomenon. Direct policy intervention in lending began with the Community Reinvestment Act of 1977 (CRA)[115] enacted during Jimmy Carter's presidency (1976–1980). It continued with the social justice and affirmative action themes that animated the Great Society vision of President Lyndon Johnson (1963–1968). Earlier efforts in housing were the Fair Housing Act (1968),[116] the Equal Credit Opportunity Act (1974),[117] and the Home Mortgage Disclosure Act (1975).[118] These laws attempted to remove non-economic barriers to housing finance and used disclosures and transparency to encourage lending to weaker sections.

The effort under the CRA was more direct. It extended the affirmative principle to lending and encouraged banks to meet "the credit needs of [the]

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[111] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 70 (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter FINANCIAL CRISIS INQUIRY REPORT]

[112] *Id.*

[113] *Id.*

[114] *Id.* at 69.

[115] Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901–2908 (2015).

[116] Fair Housing Act, 42 U.S.C. §§ 3601–3619, 3631 (1968).

[117] Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1974).

[118] Home Mortgage Disclosure Act, 29 U.S.C. §§ 2801–2811 (1975).

entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation" of the banks.[119] Starting as a commendatory principle, it was strengthened over the years.[120] In 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)[121] introduced a procedure for evaluating banks that had their affirmative lending record as one of the measures. In 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act[122] listed the CRA score of banks among the criteria for grant of license to open interstate branches. These incentives encouraged commercial banks to increase affirmative lending and drove the growth of subprime lending in the years that followed.[123]

Another direct measure came from the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.[124] This legislation required Fannie Mae and Freddie Mac to set specific goals for purchase of loans made to low-income groups and underserved housing areas.[125] This was a major economic facilitator of subprime lending.[126] It provided a stream of funding and reduced the risk for banks in affirmative lending.[127] Government policies led to a steep rise in subprime mortgages from the mid-1990s.[128] The subprime category rose from under 10% of total mortgages in 1996 to over 23% in 2006.[129]

3. *Mortgage Selling Practices*

To reiterate, banks' ability to sell mortgage loan accounts was an important factor in the derivatives saga.[130] This improved banks' ability to offer new mortgages to customers.[131] This incentive clearly, encouraged banks to sell mortgage securities packaged into derivatives and they were not too

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[119] 12 U.S.C. § 2903.

[120] For a positive assessment of the impact of the CRA and affirmative lending, see Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y. L. REV. 513 (2005).

[121] Pub. L. No. 107-73, 103 Stat. 183.

[122] Pub. L. No. 103-328, 108 Stat. 2338.

[123] FINANCIAL CRISIS INQUIRY REPORT, *supra* note 111, at 444.

[124] Pub. L. No. 102-550, 106 Stat. 3941.

[125] FINANCIAL CRISIS INQUIRY REPORT, *supra* note 111, at 444.

[126] *Id.*

[127] *Id.*

[128] *Id.*

[129] *Id.*

[130] *Id.* at 452–53.

[131] *Id.*

particular about the methods adopted for the purpose.[132] The anecdotal instances, presented below, reveal the trends and their consequences.

- Countrywide Financial, which was later acquired by Bank of America, had a fast-lane lending program nicknamed "hustle."[133] Under the program, employees were awarded bonuses based on how fast they disbursed loans.[134] This led to compromises on borrower verification and the loans were later sold Fannie and Freddie.[135] A jury has found Bank of America liable for its practices and the government seeks $848 million in damages.[136]
- Out of the total settlement of $13 billion that JPMorgan Chase has agreed to, $5.1 billion is payable to the GSEs for the shoddy mortgages sold to them.[137]
- Wells Fargo paid $335 million to settle claims of the GSEs about misstatements made in the mortgage securities the bank sold them.[138]
- Dexia, a European bank that purchased mortgages from JPMorgan, has filed a lawsuit alleging that JPMorgan adjusted critical reviews to hide fraudulent home appraisals and overextended borrowers.[139]
- Royal Bank of Scotland (RBS) made a settlement of $153.7million with the Securities and Exchange Commission (SEC) over misstatements in the sale of mortgages to investors.[140]

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[132] Landon Thomas, Jr., *Jury Finds Bank of America Liable*, N. Y. TIMES, Oct. 24, 2013, at B1, http://dealbook.nytimes.com/2013/10/23/jury-finds-bank-of-america-liable-in-mortgage-case-nicknamed-the-hustle/?_r=0.

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] Ben Protess & Peter Eavis, *JPMorgan Reaches Deal with Agency over Loans*, N.Y. TIMES, Oct. 26, 2013, at B1, http://dealbook.nytimes.com/2013/10/25/regulator-announces-own-pact-with-jpmorgan.

[138] Shayndi Raice, *Wells Fargo Settles with FHFA for $335 Million*, WALL ST. J. (Nov. 6, 2013, 1:16 PM), http://www.wsj.com/articles/SB10001424052702304448204579181732009850594.

[139] Jessica Silver-Greenberg, *E-mails Imply JPMorgan Knew Some Mortgage Deals were Bad*, N.Y. TIMES, Feb. 7, 2013, at B1, http://dealbook.nytimes.com/2013/02/06/e-mails-imply-jpmorgan-knew-some-mortgage-deals-were-bad.

[140] Rachel Abrams, *Royal Bank of Scotland Agrees to Pay $154 Million to Settle Charges from S.E.C.*, N.Y. TIMES, Nov. 8, 2013, at B3, http://dealbook.nytimes.com/2013/11/07/royal-bank-of-scotland-to-pay-153-7-million-to-settle-mortgage-case.

Other than Fannie Mae and Freddie Mac, which were large purchasers of subprime mortgages, there were also smaller, private buyers as the data show. In addition to mortgage selling practices, other related misconduct has also been reported against banks.

- Goldman Sachs betted against its own credit product and paid SEC $550 million to settle the case.[141]
- Bear Sterns and Credit Suisse received compensation ($137.8 million and $5.7 million respectively) from sellers of shoddy mortgages, but did not pass on to the customers to whom they sold the mortgages.[142]

4. Derivatives and Regulatory Issues

Government policy, discussed above, facilitated banks' mortgage business and this was compounded by the omission to regulate derivatives, which were a by-product of the mortgage business. The problems with derivatives have been known for several years. Derivatives received constant attention from policymakers during the 1990s. Thomas surveyed the five proposals that were introduced in Congress, with varying regulatory approaches.[143] The legislative proposals included the following:

- Setting up a Federal Derivative Commission[144]
- Creating a self-regulatory agency for derivatives dealers[145]
- Tightening internal controls in financial institutions[146]
- Standards of financial responsibility applicable to derivatives dealers[147]
- Grant of authority to the Securities and Exchange Commission (SEC) to oversee derivatives dealers and insurance companies (e.g. AIG)[148]

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[141] Jessica Silver-Greenberg, *2 Banks to Settle Case for $417 Million,* N.Y. TIMES, Nov. 17, 2012, at B1, http://www.nytimes.com/2012/11/17/business/jpmorgan-and-credit-suisse-to-pay-417-million-in-mortgage-settlement.html.

[142] See *id.*

[143] Thomas C. Singher, *Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?* 18 FORDHAM INT'L L.J. 1397 (1995).

[144] *Id.* at 1440.

[145] *Id*. at 1441.

[146] *Id*. at 1443.

[147] *Id*. at 1446–47.

[148] *Id*. at 1448.

➢Ban on use of derivatives by regulated entities for speculation[149]

Together, the proposals were comprehensive in scope and content. Although lacking a common thread, laws based on their principles could have checked derivatives and their downsides. But the 1990s was the era of deregulation. Regulatory efforts fell by the wayside. Brooksley Born, then chair of the Commodity Futures Trading Commission (CFTC), was among the few who called for regulation.[150] But she was rebuffed.[151] Powerful voices opposed regulation, including Alan Greenspan, Larry Summers, Robert Rubin, and Arthur Levitt.[152]

Derivatives, or more precisely trade in them, are now regulated under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[153] The Dodd-Frank Act essentially regulates derivatives trade transactions by promoting transparency and better order in the market. It makes little effort to interfere with the speculative features that created systemic instability – for example, synthetic CDO and multiple CDS for a single portfolio of debt.[154]

5. Credit Rating Issues

Credit rating agencies' work can be cited as yet another factor in the derivatives phenomenon. Rating agencies were targeted by critics and regulators when the financial markets unraveled during the Crisis of 2008–09. There can be a basic issue with the business model of credit rating. The agencies normally work for the groups who would benefit from their rating, such as sellers of derivatives, and this can affect the independence of the agencies. Another potential explanation for the reportedly questionable quality of credit rating was the complex nature of the pools of debt and the mathematical models that were developed for valuing them.[155]

To be clear, treatment of subprime mortgages is an important criticism leveled against the rating agencies. However, in a universe of rising residential values, it might not be unrealistic for the agencies to assume that prices will continue to increase in the future – as they had done in the past. This

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[149] *See generally id.*

[150] Roig-Franzia, *supra* note 29.

[151] *Id.*

[152] *Id.*

[153] Pub. L. No. 111-203, 124 Stat. 1376.

[154] *See generally* P. M. Vasudev, *Credit Derivatives and the Dodd–Frank Act: Is the Regulatory Response Appropriate?* 15 J. BANKING REG. 56 (2014).

[155] JAMIL BAZ & GEORGE CHACKO, FINANCIAL DERIVATIVES: PRICING, APPLICATIONS, AND MATHEMATICS (2004).

reasoning, apparently, underpinned the model. Gillian Tett pointed out:

> While America's corporate world had suffered several booms and recessions in the later 20th century, the housing market had followed a steady path of growth[,] . . . [b]ut since the second world war, there had never been a nationwide house-price slump.[156]

If house prices could only go up, credit histories of individual borrowers mattered little. If a borrower defaulted, the house could always be sold and the loan recovered. This reasoning can explain, if not justify, much of the ratings awarded by the agencies for the credit derivatives created by the banks. Again, lack of diligence was not exclusive to sellers of derivatives or credit rating agencies. It equally afflicted buyers. Bayerische Landesbank, a German bank interested in buying credit derivatives that included subprime mortgages, was ready to make the purchase even without data on potential defaults.[157]

Significantly, the SEC has not brought criminal charges against rating agencies. In a 2010 report, the SEC criticized Moody's for issuing high ratings based on a coding error and for not revising the ratings after discovering the error.[158] The Department of Justice filed a civil lawsuit against Standard & Poor's in 2013 claiming damages of $5 billion, and according to a recent report, the agency is willing to pay $1 billion in settlement without admitting any wrongdoing.[159]

Several factors, thus, contributed to the derivatives phenomenon. The challenge for ethical theory is to deal with deficiencies of this nature. Within banks, it was the lack of diligence and prudence combined with behavior that was clearly unethical. These were compounded by external factors, mainly a ready market for mortgage securities. These factors have inflicted a huge cost on the banks and their shareholders in the form of penalties and settlements.[160]

B. Banks in Non-Financial Markets

This section reviews banks' participation in non-financial markets that raises serious ethical concerns. Banks went beyond simple investment in non-

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[156] Gillian Tett, *Genesis of the Debt Disaster*, FIN. TIMES (May 1, 2009), http://www.ft.com/intl/cms/s/0/51f425ac-351e-11de-940a-00144feabdc0.html.

[157] *See id.*

[158] Kara Scannell, *S&P faces DOJ lawsuit over 'rosy' ratings*, FIN. TIMES (Feb. 4, 2013), http://www.ft.com/intl/cms/s/0/c175fc48-6f03-11e2-b6da-00144feab49a.html#axzz3obdQFtEg.

[159] *S&P Open to Paying Up to $1 billion to Settle DOJ Lawsuit: WSJ*, REUTERS (July 15, 2014, 9:21 PM), http://www.reuters.com/article/2014/07/16/us-mcgrawhill-sandp-lawsuit-idUSKBN0FL03720140716#.

[160] *Id.*

financial avenues that were opened up by deregulatory legislation such as the Commodities Futures Modernization Act.[161] Questionable practices by banks are reported in the aluminum market, which is unregulated, in electric power, which is a regulated utility and in ethanol credits, which are needed for regulatory compliance. [162]

1. Goldman Sachs in the Aluminum Market

Goldman Sachs bought a warehousing company in 2010 and reportedly lengthened the storage time of aluminum to create shortages and drive prices up.[163] Goldman offered storage to clients who invested in aluminum, presumably on advice from Goldman.[164] The clients were also offered incentives to extend storage.[165] The stocks were moved around among warehouses to skirt London Metal Exchange (LME) regulations on storage period.[166] The practice created shortages in aluminum markets and pushed up prices.[167] The additional cost for American consumers over three years has been estimated at $5 billion.[168]

A further twist is Goldman's presence in LME, which regulates the aluminum market.[169] LME is owned by its members that included Goldman Sachs, Barclays Bank, and Citigroup.[170] The President of Goldman's warehouse subsidiary sat on the warehouse committee of LME that made the rules on storage times.[171] Goldman was apparently a player at both ends – with a seat on the rule-making committee at the exchange and in making use of the rules for its advantage.[172]

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[161] Pub. L. No. 106-554, 114 Stat. 2763. For an account of the role of the statute in the Credit Crisis, *see* Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011).

[162] *See infra* Sections III.B.1–III.B.3.

[163] *See* Jenny Anderson, *Barclays Said to Join Commodity Exodus*, N.Y. TIMES, Apr. 22, 2014, at B1, http://dealbook.nytimes.com/2014/04/21/barclays-poised-to-announce-exit-from-commodities.

[164] *Id.*

[165] David Kocieniewski, *A Shuffle of Aluminum, but to Banks, Pure Gold*, N.Y. TIMES, July 21, 2013, at A1, http://www.nytimes.com/2013/07/21/business/a-shuffle-of-aluminum-but-to-banks-pure-gold.html?pagewanted=all.

[166] *Id.*

[167] *Id.*

[168] *Id.*

[169] *Id.*

[170] *Id.*

[171] *Id.*

[172] *Id.*

2. *JPMorgan I – Power Business*

In the acquisition of Bear Stearns in 2008, JPMorgan also obtained rights to sell electricity from some power plants.[173] The plants were inefficient and operated with obsolete technology.[174] Between September 2010 and June 2011, JPMorgan executives adopted several schemes to offer energy at prices "calculated to falsely appear attractive."[175] This resulted in overpayments by power authorities in California and Michigan.[176] When an investigation was launched, JPMorgan did not cooperate and drove the regulators to court to obtain documents.[177] The bank allegedly "planned and executed a systematic cover-up."[178] JPMorgan has settled the California case by paying $410 million in penalty and disgorgement, and has also given up disputed claims of $265 million.[179]

3. *JPMorgan II – Ethanol Credits*

To promote the use of renewable fuel, federal regulations require mixing gasoline with ethanol and a carrot-and-stick approach is used for enforcement.[180] Failure to add ethanol can result in fines up to $32,500 a day, while compliance earns credits.[181] The credits are transferable and this presents an opportunity for profit.[182] There is a market for ethanol credits because of the problems in storing ethanol-mixed gasoline at conventional gas stations.[183][184] Ethanol-mixed gasoline causes faster corrosion of tanks.[185] The

[173] Ben Protess & Jessica Silver-Greenberg, *JPMorgan in Talks to Settle Energy Manipulation Case for $500 Million*, N.Y. TIMES, July 17, 2013, http://dealbook.nytimes.com/2013/07/17/jpmorgan-in-talks-to-settle-energy-manipulation-case-for-500-million.

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] *Id.*

[178] *See id.*

[179] Brian Wingfield & Dawn Kopecki, *JPMorgan to Pay $410 Million in U.S. FERC Settlement,* BLOOMBERG BUS. (July 30, 2013, 12:09 PM), http://www.bloomberg.com/news/2013-07-30/jpmorgan-to-pay-410-million-in-u-s-ferc-settlement.html.

[180] Gretchen Morgenson & Robert Gebeloff, *Wall St. Exploits Ethanol Credits, and Prices Spike*, N.Y. TIMES, Sept. 15, 2013, at A1, http://www.nytimes.com/2013/09/15/business/wall-st-exploits-ethanol-credits-and-prices-spike.html.

[181] *Id.*

[182] *Id.*

[183] *Id.*

[184] *Id.*

[185] *Id.*

choice is, therefore, between renovating the facilities and purchasing ethanol credits.[186] Gas stations often prefer to purchase credits and thereby save on the investment that is needed for upgrading their facilities.[187] This has contributed to the growth of the ethanol credits market.[188]

Trade in ethanol credits requires registration with the US Environmental Protection Agency (EPA), which is open to anyone – not just persons who earn credits and those who want to buy them for use.[189] In keeping with recent orthodoxy, the EPA conceived the open structure to encourage a free market in ethanol credits.[190] Morgan Stanley, JPMorgan, Citigroup, and Barclays are among the registered traders.[191] The ethanol credits market has seen a twenty-fold price increase in six months.[192] Reportedly JPMorgan is a major purchaser of the credits and its strategy is to "buy up every available credit."[193]

It is apparent that the activities of banks in non-financial markets, narrated above, are not simple investments.[194] They were attempts to profiteer through ethically-questionable methods. The cases are hardly border line. For Goldman Sachs, it would be legitimate to advise clients on investments and help improve returns. But the issue becomes ethical when efforts are made to manipulate markets and drive prices up, imposing unreasonable costs on consumers. This case is no different with JPMorgan's power business schemes that had clear ethical dimensions. With ethanol credits, JPMorgan used its financial power to build a commanding position in the market. This can explain the steep rise in the price of credits.[195]

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[186] *Id.*

[187] *Id.*

[188] *Id.*

[189] *Id.*

[190] *Id.*

[191] *Id.*

[192] *Id.*

[193] *Id.*

[194] On bank participation in commodities markets, there have been complaints about negative effects. Following the spurt in oil prices in 2008-09, efforts made to check speculation were resisted by the financial sector. Silla Brush & Asjylyn Loder, *CFTC Urged to Curb Speculation as Wall Street Resists*, BLOOMBERG BUS. (Dec. 15, 2010), http://www.bloomberg.com/news/2010-12-15/cftc-urged-to-curb-commodity-speculation-as-wall-street-resists.html; *see* Murray Worthy, *Broken Markets: How Financial Market Regulation can Help Prevent another Global Food Crisis*, WORLD DEV. MOVEMENT, www.wdm.org.uk/sites/default/files/Broken-markets.pdf (last visited Dec. 11, 2013) (discussing a complaint about rise in food prices due to financial firms' entry in agricultural markets).

[195] More recently, several large banks (among them Barclays, JPMorgan, Morgan Stanley, and Deutsche Bank) are reported to be exiting commodities business. *See* Anderson, *supra* 164. Goldman Sachs also decided to sell its controversial metal warehouses. *See* Gregory Meyer & Xan Rice, *Goldman Moves to Offload Metals Warehouses*, FIN. TIMES (May 20, 2014), http://www.

C. Rate Manipulation – LIBOR and Forex

Manipulation of interest and exchange rates is another major class of financial misconduct. The LIBOR (London Inter-Bank Offer Rate) scandal surfaced in 2011 and huge penalties were levied on major banks. It has also led to changes in the system for setting the anchor rate. Forex market practices are more recent and investigation is still underway.

1. The LIBOR Issue

The emergence of LIBOR as a benchmark can be traced to financial globalization, the emergence of flexible or floating interest rates under the Garn–St. Germain Depository Institutions Act of 1982,[196] and, more recently, the development of interest rate derivatives.[197] The core complaint against banks is that they misreported the rates at which they could borrow in the London money market.[198] Until April 2013, LIBOR was constructed by British Bankers' Association (BBA), an industry group, based on inputs from the international banks on BBA's LIBOR panel.[199] The panel banks would regularly report the rates at which they could borrow in the London market and BBA would set the rate by eliminating the highest and lowest of the reported rates and averaging the rest.[200] This average rate is LIBOR, published worldwide by Thomson Reuters.[201] LIBOR is reported for transactions in several currencies and for many tenors, such as one, three, and six months.[202]

LIBOR is the anchor or the benchmark rate in variable rate credit transactions worldwide.[203] The banks on BBA's LIBOR panel are among the largest in the world and the rate at which they can borrow is treated as the lowest possible interest in financial markets.[204] LIBOR forms the basis for other loan transactions and a premium is added for borrowers depending on their credit standing, perceived level of risk and similar factors.[205]

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ft.com/intl/cms/s/0/4b4cc3fe-e04e-11e3-9534-00144feabdc0.html.

[196] Pub. L. No. 97-320, 96 Stat. 1469.

[197] John Kiff, *What is LIBOR?* INT'L MONETARY FUND (Dec. 2012), http://www.imf.org/external/pubs/ft/fandd/2012/12/basics.htm.

[198] *Id.*

[199] *Id.*

[200] *Id.*

[201] *Id.*

[202] *Id.*

[203] *Id.*

[204] *Id.*

[205] *Id.*

As a benchmark, LIBOR determines the effective rate of interest in myriad credit transactions.[206] Its impact is enormous.[207] According to John Kiff, there are "uncounted tens of billions of dollars of adjustable rate home mortgages and other consumer loans around the globe in which LIBOR, in one way or another, is referenced."[208] LIBOR is also a standard in interest rate derivatives and forward rate agreements, which are used both for risk protection and speculation.[209] The Wheatley Review placed "the notional value of financial products using LIBOR" at a minimum of $300 trillion, and also referred to a "number of other estimates . . . ranging from $300 trillion up to $800 trillion."[210]

LIBOR was misreported both on the higher and the lower sides.[211] There were several incentives for misreporting rates, including illicit gain for rate submitters from traders in interest rate derivatives, efforts by senior management during the Credit Crisis to reduce perceptions of risk, and an apparent misunderstanding by Barclays' CEO that the Bank of England indicated a wish for reporting lower rates.[212] Networks of employees across banks misreported rates at one another's behest, often for illicit personal gain.[213] This was linked to trade in interest rate derivatives, which are another product of financial engineering.[214] Like with credit derivatives, the original rationale for interest rate derivatives was to manage risks – in this case, floating rates of interest would be converted to fixed rates.[215] But soon a market developed for trade in these derivatives with speculation becoming a feature.[216]

The Wheatley Review, commissioned by the UK government in the wake of the scandal, made a number of recommendations. These included transfer of the LIBOR setting process to a new regulator, use of actual transaction data for the purpose, and strengthening internal controls at the

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[206] *Id.*

[207] *Id.*

[208] *See id.*

[209] *Id.*

[210] MARTIN WHEATLEY, THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT 76 (Sept. 2012), http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf.

[211] *See* Final Notice from Fin. Servs. Auth. to Barclays Bank Plc (June 27, 2012) (on file with author), http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf.

[212] *See id.*

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] *See*, *What Are Interest Rate Swaps and How Do They Work?*, PIMCO (Jan. 2008), http://www.pimco.com/EN/Education/Pages/InterestRateswapsBasics1-08.aspx.

reporting banks.[217] The recommendations have been accepted by the UK government. The episode, which involved wrongdoing in banks, imposed costs on the banks running to several hundred million dollars. UBS of Switzerland paid penalties of $1.5 billion to regulators in UK and US while Barclays paid $450 million. For the Royal Bank of Scotland, the cost of settlement was over $600 million.[218]

Personal gain was a factor in the misreporting of rates by bank employees. To the extent misreporting generated profits, the banks were also beneficiaries. The breach of ethics in earning these profits is apparent and penalties have been paid as the cost of the breach. Significantly, reports also refer to a potential role of regulators in the LIBOR phenomenon. Bank of England is said to have encouraged banks to report lower rates.[219] The New York Federal Reserve was aware of misreporting of rates, but did nothing.[220]

2. Forex Rates Manipulation

Regulators in UK, US, Germany, and Switzerland are pursuing investigations into forex rate manipulation. A charge that has surfaced is that bank employees would execute transactions for clients and then wait for movements in rates before reporting to clients. If rate movements were favorable, transactions would be reported at higher rates.[221] Quite obviously, this would benefit the banks/their employees.

The city of Philadelphia and a group of institutional investors have filed an antitrust lawsuit against twelve large banks accusing them of rigging the forex market. According to the suit, bank employees used names such as The Cartel, The Bandits' Club, and The Mafia, and swapped confidential customer orders and trading positions. They colluded to set prices. The methods that were used had interesting names – "'front running/trading ahead,' 'banging the

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[217] *See* Paul Lee & Gulong Ren, *Recent Developments on the Regulation of LIBOR*, DLA PIPER (Apr. 19, 2013), http://www.dlapiper.com/an-overview-of-regulation-of-libor-04-10-2013/ (summarizing the regulatory measures proposed by the Wheatley report).

[218] Peter J. Henning, *A How-To Guide for Banks Facing LIBOR Settlements,* N.Y. TIMES (Feb. 6, 2013, 3:07 PM), http://dealbook.nytimes.com/2013/02/06/a-how-to-guide-for-banks-facing-libor-settlements/.

[219] *LIBOR scandal: Paul Tucker Denies 'Leaning on' Barclays,* BBC NEWS (July 9, 2012), http://www.bbc.co.uk/news/business-18773498.

[220] Michael J. de la Merced & Ben Protess, *New York Fed Knew of False Barclays Reports on Rates,* N.Y. TIMES (July 13, 2012, 12:00 PM), http://dealbook.nytimes.com/2012/07/13/barclays-informed-new-york-fed-of-problems-with-libor-in-2007/.

[221] Keri Geiger, Liam Vaughan & Julia Verlaine, *Currency Probe Widens as U.S. Said to Target Markups*, BLOOMBERG BUS. (June 19, 2014), http://www.bloomberg.com/news/2014-06-19/currency-probe-widens-as-u-s-said-to-target-markups.html.

close,' and 'painting the screen.'"[222]

Banks have initiated several measures in response. More than thirty employees in different banks have been dismissed or suspended.[223] Since a culture of conversation among employees across banks contributed to the phenomenon, banks have started switching to electronic operations to reduce human intervention in the forex market.[224] To eliminate conflicts of interests, Deutsche Bank, RBS, and UBS are reported to be "reviewing rules on currencies traders making bets with their own money".[225] The fact that they could do so, to begin with, offers an important insight into the culture at the banks.

With interest and forex rate manipulation, the case is clearer. Ethics was compromised, for corporate profits or personal gains for employees or possibly both. In all cases, banks' customers – City of Detroit, to name one[226] – were the victims.

IV. FINANCIAL MISCONDUCT AND THE ETHICAL ORDER

Misconduct in the financial sector, serial and varied, creates significant ethical challenges. This part explores whether, in the aftermath of recent events, an ethical order can still be treated as endogenous to the financial sector. The issue is examined from the prism of the Social Contracts Theory, which is underpinned by the efficiency hypernorm.[227]

In broad terms, the argument is that a moral order can arise from within the market. A combination of cultural and business factors would contribute to this outcome. Donaldson and Dunfee explained how implicit contracts are a part of the basic software of business ethics in the social contracts framework. The efficiency hypernorm that underpins these contracts motivates actors to

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[222] Jonathan Stempel & Lelie Adler, *Investors Accuse 12 Banks of Forex Price Rigging in U.S. Lawsuit*, REUTERS (April 1, 2014), http://mobile.reuters.com/article/idUSBREA301WC20140401?feedType=nl&irpc=932.

[223] *See id.*

[224] Swaha Pattanaik, *Inquiries to Change Dynamics of Currency Trading*, N.Y. TIMES (Mar. 11, 2014, 2:13 PM), http://dealbook.nytimes.com/2014/03/11/inquiries-to-change-dynamics-of-currency-trading/.

[225] Daniel Schafer, *Banks Review Rules on Forex Traders Betting Own Money*, FIN. TIMES (Feb. 17, 2014), http://www.ft.com/intl/cms/s/0/8b61494e-97ef-11e3-8dc3-00144feab7de.html#axzz3oQ9j2vuF.

[226] In the City of Detroit bankruptcy proceedings, the court blocked payment of $165 million to Bank of America and UBS for release from speculative interest swap contracts. Mary Williams Walsh, *Judge Disallows Plan by Detroit to Pay Off Banks*, N.Y. TIMES, Jan. 17, 2014, at A1, http://dealbook.nytimes.com/2014/01/16/judge-rejects-detroits-deal-to-exit-swap-contracts/.

[227] Donaldson & Dunfee, *supra* note 22.

achieve social goods such as health, education, housing, food, clothing, and social justice.[228] Other than protecting property rights, the hypernorm also requires duties and public remedies to support key business behaviors such as keeping promises.[229] The framework borrows from the contractarian principles of classicists–Thomas Hobbes, John Locke, and John Rawls–to strengthen the social argument and to identify an innate tendency in the community to develop efficient arrangements based on trust and reciprocity. In broad terms, rational actors will develop institutions that are geared to achieve the social goods and those actors are informed by ethical conduct that promotes overall welfare.

The general validity of the social contract framework is undeniable. It was evident in the self-governing traditions in leading Anglo-American business institutions–namely, the joint stock company and the stock market. The institutions were, to a significant extent, self-regulating and reflected the trends inherent in the society. An important question is whether the challenges and complexities of the present require more concerted response and systematic management. Specifically in the financial sector, some major problems that undermine the social contract theory are power and equational imbalances among actors, imperfections in enforcement, and changes in operational methods. These issues are examined below. The current environment, conditioned by the factors pointed out, is complex and increasingly impersonal. Approaches based on traditional contracting principles may need refinement in this setting.

A. Power Imbalances

Accommodative policies of the Federal Reserve and implicit government guarantees emerged in the 1990s, crystallizing with the rescue of Long Term Capital Management.[230] These policies undermine the culture of caution in which banks traditionally operated.[231] Goldman Sachs and Morgan Stanley's decision to adopt bank holding company structures in 2008, at the height of the Credit Crisis, is instructive. It enabled them to access Federal Reserve

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[228] *See id.*

[229] TIES THAT BIND, *supra* note 58.

[230] These came to be known in the financial markets as "Greenspan put" and have been criticized for encouraging complacency and moral hazard in the market. *See, e.g.*, Peronet Despeignes, "*Greenspan Put" May be Encouraging Complacency*, FIN. TIMES, Dec. 8, 2000.

[231] *See generally* John G. Taft, STEWARDSHIP: THE LESSONS LEARNED FROM THE LOST CULTURE OF WALL STREET (2012).

funds.[232] The structural arrangements and the safety net provided by the Federal Reserve empower and strengthen bank executives.[233] Conversely, they weaken other stakeholders–mainly, clients who transacted with the banks and shareholders who have borne the regulatory penalties.

Disparity and power imbalance are evident in the interest and forex rate markets. These markets are under near-complete control of banks, which are one of the parties to the transactions. Clients, who are the other party, lack access to the inner workings of the market; they have much less knowledge of the reported manipulative practices discussed above. This equation made it possible for banks and their executives to engage in wrongful practice and to benefit from wrongdoing, while customers lost. Therefore, imbalances in the market can hinder the development of social contracts based on shared values or even interests.

B. Imperfections in Enforcement

A moral order must necessarily include a remedy. Remedies are not simply about accountability, *ex post,* but are equally about having mechanisms that promote responsible behavior. In responding to financial misconduct, ranging from mortgage securities to manipulation of interest and exchange rates, government agencies have been at the forefront, levying huge fines on banks.[234] Their principal method has been to levy penalties on banks.[235] This approach effectively ignores the old maxim about corporations having no bodies to be kicked and no souls to be damned.[236] This method punishes bank shareholders, but largely ignores the accountability of the executives who were responsible for the misconduct.

To be fair, there have been sporadic actions against a small number of executives. The government punished executives, including Kareem Serageldin, former head of structured credit trading at Credit Suisse; Fabrice Tourre, a trader at Goldman Sachs; and Jerome Kerviel of Societe Generale

[232] Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of An Era,* N.Y. TIMES**,** Sept. 21, 2008, at A1, http://www.nytimes.com/2008/09/22/business/22bank.html.

[233] *See id.*

[234] Richard McGregor & Aaron Stanley, *Banks Pay Out $100bn in US Fines,* FIN. TIMES, Mar. 25, 2014.

[235] *See id.*

[236] The saying is attributed to Baron Thurlow (1731-1806). *See* John C. Coffee, Jr., '*No Soul to Damn, No Body to Kick:' An Unscandalized Inquiry into the Problem of Corporate Punishment,* 79 MICH. L. REV. 386 (1981).

whom the government convicted for acts of unauthorized trading.[237] Significantly, Kerviel of Societe Generale maintained that his superiors were receptive to his actions as long as they were profitable.[238]

Government's enforcement approach has attracted numerous criticisms. Zuberbuhler pointed out how penalties on banks ignored individual responsibility.[239] Henning explained that senior bank managers could escape by pointing fingers at lower-level employees.[240] Ted Kaufman, a former senator, targeted the legal profession for its role in the "complete breakdown in effective white-collar law enforcement against the most powerful in the wake of a devastating financial crisis."[241]

Reports are available about *some* private litigation against bank directors and executives. The outcome is not quite encouraging from the standpoints of accountability and standard-setting for future conduct. *In re Citigroup Shareholder Derivative Litigation*, shareholders charged Citigroup directors with breach of fiduciary duties in overseeing the derivatives business, but the suit was dismissed by the Delaware court.[242] A suit filed against JPMorgan directors for the loss of over $6 billion in its derivatives business–the so-called London Whale–was dismissed by the US District Court.[243] But the court allowed the suit against CEO Jamie Dimon and former CFO Douglas Braunstein to proceed.[244] Citigroup agreed to pay $1.13 billion to purchasers of mortgage securities.[245] On balance, reports do not indicate significant

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[237] *See* Jesse Eisinger, *The Fall Guy*, N.Y. TIMES MAG., April 30, 2014, at MM34; Nicola Clark, *Ex-Trader's Pilgrimage Culminates in Jail Cell*, N.Y. TIMES, May 19, 2014, at B3, http://www.nytimes.com/2014/05/19/business/international/convicted-trader-resumes-his-trek-toward-prison.html; Tracy Alloway & Kara Scannell, *Jury Finds Tourre Defrauded Investors*, FIN. TIMES (Aug. 1, 2013, 8:41 PM), http://www.ft.com/intl/cms/s/0/18098490-f86a-11e2-b4c4-00144feabdc0.html?siteedition=uk#axzz3njQDqPbZ.

[238] *See* Clark, *supra* note 237.

[239] Daniel Zuberbuhler, *In Banking Capital Punishment Works Better than Torture,* FIN. TIMES, July 2, 2014.

[240] Peter J. Henning, *Penalties for Companies, but Executives Often Emerge Unscathed*, N.Y. TIMES (July 1, 2014, 12:34 PM), http://dealbook.nytimes.com/2014/07/01/penalties-for-companies-but-executives-often-emerge-unscathed/?_r=0.

[241] Ted Kaufman, *Lopsided Approach to Wall Street Fraud Undermines the Law*, N.Y. TIMES (May 8, 2014, 10:05 AM), http://dealbook.nytimes.com/2014/05/08/lopsided-approach-to-wall-street-fraud-undermines-the-law/.

[242] *In re* Citigroup Shareholder Inc. Derivative Litigation, 964 A.2d 106, 114, 120 (Del. Ch. 2009).

[243] Jonathan Stempel, *JPMorgan Fails to End Lawsuit over London Whale Losses*, REUTERS (Mar. 31, 2014, 6:04 PM), http://www.reuters.com/article/2014/03/31/us-jpmorgan-chase-london whale-lawsuit-idUSBREA2U1M820140331.

[244] *Id.*

[245] Associated Press, *Citigroup to Pay $1.13 Billion to Settle Securities Claims,* N.Y. TIMES,

efforts by stakeholders to hold bank executives to account, which is surprising given the vibrancy of the plaintiff bar in the US and the incentive systems in place.

C. *Banks' Operating Methods*

There have been major changes in banking in the recent decades. For one, banks have become larger. Another is the increasing use of online transactions that reduces human interaction. Diminished face-to-face contact can undermine the personal element in customer relations and consequently, the concern for customers' interests. These trends can encourage self-seeking behavior by executives, at the cost of customers – be they retail mortgage borrowers or business enterprises doing forex transactions. These are some issues at the human or behavioral level.

At the business level, credit derivatives are an important development. They enable banks to offload customer loan accounts by selling them to others. This was an important factor in the subprime crisis. With derivatives, banks no longer had to worry about the credit quality of borrowers; moral hazard was a natural consequence. The Dodd-Frank Act, as pointed out, merely seeks to regulate trade in credit derivatives.

Subprime credit, reportedly, continues; it has shifted in recent years from housing loans to automobile loans. Credit derivatives are, again, at the root of the boom in auto loans.[246] The Office of the Comptroller of the Currency noted that "signs of risk in auto lending [are] beginning to emerge" and even though the "results have yet to show large-scale deterioration at the portfolio level, . . . signs of increasing risk are evident."[247]

In sum, the financial sector is subject to myriad influences that undermine social contracts and ethical norms. Yet the need for social values and norms has never been greater. The conclusion explores a role for codes of ethics in inculcating ethical norms and accountability mechanisms – as endogenous to corporate institutions.

Apr. 8, 2014, at B2, http://dealbook.nytimes.com/2014/04/07/citigroup-to-pay-1-13-billion-to-settle-securities-claims/.

[246] Jessica Silver-Greenberg & Michael Corkery, *In a Subprime Bubble for Used Cars, Borrowers Pay Sky-High Rates*, N.Y. TIMES, July 20. 2014, at A1, http://dealbook.nytimes.com/2014/07/19/in-a-subprime-bubble-for-used-cars-unfit-borrowers-pay-sky-high-rates/.

[247] OFFICE OF THE COMPTROLLER OF CURRENCY, SEMIANNUAL RISK PERSPECTIVE FROM THE NATIONAL RISK COMMITTEE 31 (2014), http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2014.pdf.

V. CODES OF ETHICS – A POTENTIAL VENUE

Business ethics emerged as a regulatory concern in the 1970s.[248] The development was triggered by the corruption scandals that led to the enactment of the Foreign Corrupt Practices Act of 1977.[249] Since the mid-1970s, several corporations have adopted ethics codes and appointed ethics officers. Many corporations also offer employees training programs in ethics.[250] Ethics codes made an entry in business law with the Sarbanes-Oxley Act of 2002,[251] which was enacted by the Congress in response to corporate accounting scandals. The act requires codes of ethics for senior financial officers (§ 406) and affords protection to employees complaining about fraudulent activities in companies (§ 806).

The Dodd-Frank Act of 2010 carries on with the effort to internalize ethics, specifically in the financial sector. Agencies engaged in derivatives trade–namely, derivatives and securities clearing agencies (§§ 725 & 763), data depositories (§ 728), dealers and major participants (§ 731), and swap execution facilities (§ 733) must have Chief Compliance Officers (CCO). CCO job responsibilities include maintaining a code of ethics and a conflict-of-interests policy, and providing annual confirmation about them.

Additionally under the corporate governance standards of the New York Stock Exchange (NYSE), listed corporations must have codes of ethics.[252] The *Listed Company Manual* also provides guidance on the topics to be covered in the codes. Topics include dealing with conflicts of interests, appropriate use of corporate opportunities, confidentiality, fair dealing, taking proper care of company assets, legal compliance, and whistleblower protection[253]. Ethics codes must be posted on corporate websites and confirmation must be included in filings with the SEC[254].

The developments in regulatory ethics, outlined above, have carried the subject of ethics beyond voluntary initiatives, cultural habits, or market traditions. Now listed corporations are required to have ethics codes and NYSE rules prescribe the minimum content for the codes. "Fair dealing," which is

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[248] H.R. REP. NO. 95-640, at 4 (1977), www.justice.gov/criminal/fraud/fcpa/history/1977/houseprt-95-640.pdf (accessed Aug. 3, 2015). The Congressional report that recommended the ban on corrupt practices in overseas jurisdictions clearly stated moral concerns. *Id.*

[249] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494.

[250] DONALD H. CHEW & STEWART L. GILLAN, CORPORATE GOVERNANCE AT THE CROSSROADS: A BOOK OF READINGS (2004).

[251] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[252] NYSE LISTED COMPANY MANUAL, § 303A.10.

[253] *Id.*

[254] *Id.*

among the prescribed contents, can be a powerful tool in checking deviant behaviour and promoting the moral climate in companies. NYSE rules define fair dealing as follows:

> Each employee, officer and director should endeavor to deal fairly with the listed company's customers, suppliers, competitors and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice.[255]

The description sets the standard of ethical conduct in dealing with stakeholders, including customers. The standard would be appropriate for the financial sector. It incorporates the basic moral precepts against lying, stealing, and cheating. An implicit feature of the standard is its "prioritization," as Schwartz termed it.[256] This is about the overriding importance of values, unaffected by considerations of corporate profits or personal incentives for executives such as bonuses. The standard, if applied, can effectively check unfair dealing even for business advantage, not just personal gain of the executive in question. It can check much of the misconduct reported against banks.

The experience suggests the need for ethics codes to travel beyond providing commendatory guidance to executives. They must graduate into more effective, self-executing frameworks that also spell out the consequences of breach. NYSE rules are sensitive to this aspect. They require codes to have "compliance standards and procedures that will facilitate the effective operation."[257]

A method of making ethics codes more effective would be to clarify that executives are personally liable for the consequences of any breach of the standards. The proposition is founded in common sense notions of justice and fairness. It is about holding individuals accountable for their actions and failures.

A theoretical basis for personal liability is also available in corporate law. Piercing the corporate veil, a tool courts have long used, enables targeting individuals acting in a representative capacity.[258] Executives, as fiduciaries of

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[255] *Id.*

[256] Mark S. Schwartz, *A Code of Ethics for Corporate Code of Ethics,* 41 J. BUS. ETHICS 27, 30–31 (2002).

[257] NYSE LISTED COMPANY MANUAL, *supra* note 252.

[258] Personal liability of executives has become an issue in the ongoing ignition switch problem at General Motors. Senator Richard Blumenthal has introduced a bill for holding executives liable for failure to report dangerous defects in products. There could be practical difficulties in implementing the measure in case of defective products. Peter J. Henning, *The*

corporations, are conventionally placed under the duties of loyalty and care. Good faith is now recognized as the third element. Eisenberg included non-violation of accepted standards of decency in business conduct among the ingredients of the duty of good faith.[259] This resonates with the formulation of fair dealing in NYSE rules discussed above. A breach of the duty of good faith can be a ground for courts to lift the corporate veil and hold executives and directors personally liable for their actions and failures.

Provisions on personal liability can give teeth to the ethic codes. With appropriate training, executives can be sensitized to the ethical standards they must follow as well as the consequences of breach. This can be valuable in guiding executive behavior and in deterring wrongful conduct.

To be clear, there can be some logistical issues. The first is about initiating action to strengthen corporate codes of ethics on the lines discussed. As I have pointed out, penalties have been levied on banks and the affected group is shareholders. It would, therefore, be appropriate for shareholders to take up the mantle. With the rise of institutional shareholders and a nascent trend for them to communicate with corporate directors,[260] shareholders are well-placed for the task.

The second issue is about effective implementation of ethics codes, including liability of executives for breach. Here, boards would be the obvious candidate. With the recent emphasis on independence of directors and their skills sets, most boards ought to possess the expertise needed for effective oversight of the ethical governance of corporations. The Institute of Business Ethics in the United Kingdom has recently argued for including ethics among board responsibilities.[261]

Difficulty in Holding Executives Accountable, N.Y. TIMES (July 21, 2014, 11:51 AM), http://dealbook.nytimes.com/2014/07/21/the-difficulty-in-holding-executives-accountable/. But with misconduct, it may not be so hard to prove and may not also present comparable challenges in finding executives personally liable.

[259] Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law,* 31 DEL. J. CORP. L. 1 (2005).

[260] *See e.g.*, Andrew Ross Sorkin, *Investors to Directors, "Can We Talk?"* N.Y. TIMES, July 22, 2015, at B1, http://dealbook.nytimes.com/2014/07/21/investors-to-directors-can-we-talk/.

[261] PETER MONTAGNON, ETHICS, RISK AND GOVERNANCE (2014).