

## ETHICS IN FINANCE

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Finance covers a broad range of activities but the two most visible aspects are financial markets, such as stock exchanges, and the financial services industry, which includes not only commercial banks but also investment banks, mutual funds companies, pension funds – both public and private, and insurance less visible to the public are the financial operations of a corporation, which are the responsibility of the Chief Financial Officer (CFO).

If we think seriously, we are bound to say that finance would be impossible without ethics as in Finance, we need to place our assets in the hands of others, who most of the times are unknown persons. This demands immense trust. Ethical issues in finance are important because they are correlated with our financial well-being. Ethical misconduct, may be individuals activity alone as by financial institutions, has the potential to cheat and rob the people of their life savings. As huge money is involved in financial dealing, there must be well developed and effective safeguards in place to ensure personal and organizational ethics. Though the law governs much financial activities, strong emphasis must be placed on the integrity of the financial professionals and on ethical leadership in the financial institutions. Certain principles of financial ethics are common to other aspects of business:

- (a) Duties of fiduciaries (held in trust)
- (b) Fairness in sales practices
- (c) Securities markets

Activities like insider trading and hostile take over raise unique issues that require special consideration. We shall discuss the major areas of ethical implication of finance by discussing about financial services, financial markets, insider trading and hostile takeovers.

**(A) Financial Services :** The financial services industry is dependent mainly on personal selling by stockbrokers, insurance agents, financial planners, tax advisers and other finance professionals. Personal selling creates innumerable opportunities for abuse, and although finance professionals take pride in the level of integrity in the industry, misconduct still is prevalent. However, the customers who are not happy over failed investments or rejected insurance claims are quick to blame the seller of the financial product, sometimes with good reasons whatsoever. Now we shall discuss three objectionable & unethical practices in selling financial products to clients, namely deception, churning and suitability.

- (i) **Deception:** Only if it is said to be ethical on part of the sales people when all of the relevant information are explained truthfully in an understandable, non misleading manner. Nowadays, the brokers, insurance agents, and other sales people have deceptively developed a vocabulary that obfuscates rather than revealing. If someone walks into a broker's office these days, no product will be sold and no broker will be found. Instead, a "financial advisor" will "help to select" an "appropriate planning vehicle", or "offer" a menu of "investment choices" or "Options" among which one may "allocate the money". Salespeople avoid speaking of commissions, even though they are the source of their compensation. The agents now-a-days represents life insurance policies as "retirement plans" and referred to the premium as "deposits".
- (ii) **Churning:** Churning can be defined as excessive or inappropriate trading for a client's account by a broker who has control over the account with the intent to generate commissions rather than to benefit the client. Although churning occurs, there is disagreement on the frequency or the rate of detection. The brokerage industry contends that churning is a rare occurrence and is easily detected by firms as well as clients. The ethical objection to churning is that it is breach of a fiduciary duty to trade in ways that are not in a client's best interests. Churning as distinct from unauthorized trading.

ing, occurs only when a client turns over control of an account to a broker, and by taking control, a broker assumes a responsibility to serve the client's interests. A broker who merely recommends a trade, is not acting on behalf of a client or customer and is more akin to a traditional seller, but a broker in charge of a client's portfolio thereby pledges to manage it to the best of his or her ability. The legal definition of churning contains three elements,

- I. The broker controls the account;
- II. The trading is excessive for the character of the account;
- III. The broker acted with intent.

The most difficult issues in the definition of churning is the meaning of "excessive trading". First, whether trading is excessive depends on the character of the account. A client who is a more speculative investor, willing to assume higher risk for a greater return, should expect a higher trading volume. Second, high volume is not the only factor; pointless trades might be considered churning even if the volume is relatively low. Third, churning might be indicated by a pattern of trading that consistently favours trades that yield higher commissions.

- (iii) **suitability:** The brokers, insurance agents, and other sales people have an obligation to recommend only suitable securities and financial products. However, suitability, like churning, is difficult to define precisely. The most common causes of unsuitability are (1) unsuitable types of securities, that is recommendation of stocks instead of bonds while bonds would better fit the investor's objectives; (2) unsuitable grades of securities, such as selecting lower rated bonds when higher rated ones are more appropriate; (3) unsuitable diversification, which leaves the portfolio vulnerable to changes in the markets; (4) unsuitable trading techniques, including the use of margin or options, which can leverage an account and create greater volatility and risk; (5) unsuitable liquidity. Limited partnership, are not very marketable and are thus unsuitable for customers who may need to liquidate the investment.

Investments are most often deemed to be unsuitable because they involve excessive risk, but a few risky investments may be appropriate in a well balanced, generally conservative portfolio. Furthermore, even an aggressive, risk taking portfolio may include unsuitable securities if the risk is not compensated by the expected return.

**(B) Financial Markets:** Financial transactions typically take place in organized markets such as stock markets, commodities markets, futures or options markets, currency markets and the like. These markets presuppose certain moral rules and expectations of moral behaviour. The most basic of these is a prohibition against fraud and manipulation, but generally the rules and expectations for markets are concerned with fairness, which is often expressed as a level playing field. In this context the following demands attention.

- (i) **Equity and Efficiency :** The main emphasis of financial market regulation is to ensure efficiency, but markets can be efficient only when people have confidence in their fairness or equity. Efficiency is itself an ethical value because achieving the maximum output with the minimum input- which is a simple definition of efficiency- provides an abundance of goods and services and thereby promotes the general welfare. A society is generally better off when capital markets allocate the available capital to its most productive use. People will participate in capital markets, however, only if the markets are perceived to be fair, that is fairness has value as a means to the end of efficiency.
- (ii) **Fairness in Markets:** Fairness is not a matter of preventing losses. Markets produce winners and losers, and in many cases, the gain of some persons comes from an equal loss to others. In this respect it can be said that, playing the stock market is like playing a sport where the aim is not to prevent losses but only to ensure that the game is fair. The regulation of financial markets protects not only individual investors, but also the general public. The possible ways in which individual investors and members of society can be treated unfairly by the operation of financial markets are many, but the main kinds of unfairness are the following:
- (a) **Fraud and Manipulation :** One of the main purposes of securities regulation is to prevent

fraudulent and manipulative practices in the sale of securities. The common law definition of fraud is the willful misrepresentation of a material fact that causes harm to a person who reasonably relies on the misrepresentation. Investors- both in the form of buyers and as sellers are particularly vulnerable to fraud because the value of financial instruments depends almost entirely on information that is difficult to verify.

Manipulation generally involves the buying as selling of securities for the purposes of creating a false as misleading impression about the direction of their price so as to induce other investors to buy or sell the securities. Like fraud, manipulation is designed to deceive others, but the effect is achieved by the creation of false or misleading appearances rather than by false as misleading representation.

Fraud and manipulation are addressed by mandatory disclosure regulations as well as by penalties for false and misleading statements in any information released by a firm. Mandatory disclosure regulations are justified, in part, because they promote market efficiency i.e. better informed investors will make more rational investment decisions, and they will do so at lower overall cost.

- b) **Equal information:** When there is competition amongst parties but there is availability of unequal information to the parties, it is regarded as unfair because the very concept of "level playing field" requires not only that every one play by the same rules but also that they be equally equipped to compete. When there come the issues of equal information, however, it stands for the factor that parties to a trade actually possess the same information or have equal access to information. The trouble with defining equal information as having equal access to information is that the notion of equal access is not absolute but relative. We also hold that some information asymmetries are objectionable to the extent that they reduce efficiency. Although efficiency and fairness both support attempts to reduce information asymmetries in financial markets, exactly what fairness or justice requires is not easy to determine.
- c) **Equal bargaining power:** Fairness of bargained agreements assumes that the parties into it have relative equal bargaining power. Unequal bargaining power, which arises from factors like resources, processing ability and vulnerabilities, is an unavoidable feature of financial markets, and exploiting such power imbalances is not always unfair. In general, the law intervenes when exploitation is unconscionable or when the harm is not easily avoided, even by sophisticated investors.
- d) **Efficient Pricing:** Efficient prices which reasonably reflect all available information is being considered to be included in fairness in financial markets. Volatility that results from mismatch of buyers and sellers is eventually self- correcting, but in the meantime, great harm may be done by inefficient pricing. Individual investors may be harmed by buying at too high a price or selling at too low a price during periods of mispricing. Volatility also affects the market dynamism by reducing investor confidence and thus driving investors away. At its worst, volatility can threaten the whole financial system.

(C) **Insider Trading:** Insider trading is commonly defined as trading in the stock of publicly held corporations on the basis of material, non- public information. Insider trading occurs when securities are brought or sold on the basis of material nonpublic information as the executives of a corporation and other insiders know the organization well, and so might easily know about the events that are likely to have significant impact on the company's share price well in advance of other potential traders. Consequently, insiders are privileged over other players in the market in terms of knowledge, a privilege that they could take advantage of reaping a questionable profit.

In the long run, insider trading can undermine investors trust in the market. While the ethical assessment of insider trading is still quite controversial, there appear to be a number of possible routes. Jennifer Moore (1990) for instance, discusses four main ethical arguments that have been used against insider trading:

There are inequalities in the access to relevant information about companies leading to a situation where one party has a unfair advantage over other. Moore (1990) argues that this is the weakest, but most common argument that tends to be used against insider trading.

- Misappropriation of property
- Insider traders use valuable information which is essentially the property of the concerned firm, and to which they have no right of access.
- Harm to investors and the market
- Insider traders might benefit to the cost of 'ordinary investors', making the market riskier, and threatening confidence in the market.
- Undermining of fiduciary relationship:
  - The relationships of trust and dependence among shareholders, corporate managers and employees, are based on managers acting in the share holders' interest, yet insider trading is fulfilled by self-interest on the parts of insiders rather than obligations to their 'principal'.

As there is disagreement over the moral wrong involved, there is difficulty in defining insider trading.

There are two main rationales which are used in support of a law against insider trading. One is based on property rights and holds that those who trade on material, non public information are essentially involved in stealing property that belongs to corporations. The second rationale is based on fairness and holds that traders who use inside information have an unfair advantage over other investors and that, as a result, the stock market is not a level playing field. These two rationales lead to different definitions, one narrow, whereas the other broad. Only corporate insiders or outsiders, who bribe, steal or otherwise wrongfully acquire corporate secrets, can be held guilty of insider trading according to property rights or "misappropriation" theory.

#### **(D) Hostile Takeover:**

Hostile takeovers can be described as the acquisitions opposed by the management of the target corporation, appear to violate the accepted rules for corporate change. The ethical issues in hostile takeovers are threefold. First of them is whether hostile takeovers should be permitted at all or not. Hostile takeovers normally are conducted in a market through the buying and selling of stocks and it has been observed that there exists a "market for corporate control". Hence, the issue can be expressed in the form that whether there should be a market for corporate control not.

Secondly, ethical issues arise in the various tactics which have been used by raiders or incumbent management, often at the expense of shareholders. Thirdly, hostile takeovers raise important issues about the fiduciary duties of officers and directors in their responses to takeover bids. In particular, it is about the responsibilities and duties of the directors when an offer that shareholders want to accept is not in the best interest of the corporation itself.

Critics of hostile takeovers challenge the benefits and emphasise the harms. Targets of successful raids are sometimes broken up and sold off piecemeal or downsized and folded into the acquiring company. In the process, people are thrown out of work and communities lose their economic base. Takeovers generally saddle companies with debt loads that limit their options and expose them to greater risk in the event of a downturn. Critics also charge that companies are forced to defend themselves by managing for immediate results and adopting costly defensive measures. There is little evidence that newly merged or acquired firms outperform industry averages in the long run. The effect on the economy aside, the benefit of hostile takeovers must be viewed with some caution.

Firstly, not all takeover targets are underperforming business with poor management. Other factors can make a company a takeover target. Large cash reserves; expensive research programmes and other sources of savings enable raiders to finance a takeover with the company's own assets. Secondly, some of the apparent wealth that takeovers create may result from accounting and tax rules that benefit shareholders but create no new wealth.