Chapter Two

Fundamentals of Finance Ethics

Ethics is concerned, in large measure, with *conduct*—by both individuals and organizations. Ethical conduct involves doing what is right and not doing wrong, fulfilling one's duties or obligations (these mean the same), respecting people's rights, acting fairly or justly, and treating others with dignity. In addition to what we *do*, ethics is also about who we *are*, about our character and about having integrity or virtue. Further, ethics deals with the evaluation and justification of practices, states of affairs, institutions, and systems. For example, is insider trading wrong? Is income inequality fair? Should corporations aim solely at shareholder wealth? Is capitalism the best economic system? The language of ethics is rich and varied because of all that ethics attempts: to prescribe, to evaluate, and to justify.

In approaching finance from an ethical point of view, it is necessary to have some understanding not only of the language of ethical discourse but also of the principles of ethical reasoning. At a minimum, we need to be able to determine what is ethical conduct in finance and how financial activity ought to be conducted. This is a matter not merely of identifying rules—which are often contained in law and regulation, as well as in codes of conduct—but also of understanding the reasons for these rules, the reasoning behind them. We need to know, for example, what makes right conduct right? Unfortunately, the desirable understanding of ethics for approaching finance is not easily obtained, but a useful framework for ethics is available that should be sufficient for the discussion in the remainder of this book.

This framework considers, first, the ethics that governs market activity when parties are merely in buyer–seller situations. A second part in this

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framework addresses ethics when people and organizations are in certain roles and relationships, which constitutes a substantial portion of financial activity. One of the most common ethical problems in roles and relationships is conflict of interest, and so this chapter also contains an explanation of what are conflicts of interest, what is wrong with them, why they occur, and how they can be managed.

A Framework for Ethics

No framework can possibly provide all that is needed for ethical understanding, but it is possible to approach ethics in finance, as well as ethics generally, with a few key elements of ethical reasoning. Indeed, an understanding of ethics and the ability to engage in ethical reasoning is part of human development; it is something that everyone learns by growing up in a culture. Ideally, an ethical framework should simply express explicitly what we all understand, at least implicitly. However, ethical reasoning can be done with greater or lesser degrees of depth and validity. The first step in applying any framework is recognizing the presence of an ethical issue and, then, identifying the ethical element in this issue. This first step can be achieved with a checklist of six key elements that indicate the presence of an ethical issue. This discussion is followed with a division of ethics into, first, the ethics of the market and, second, the ethics of roles and relationships.

The elements of ethics

Although ethics is complex, its main elements can be broadly sketched. Virtually the whole of ethics can be easily understood by means of six familiar concepts. Identifying these elements may be only the beginning of a long, difficult ethical inquiry, but at least they are useful starting points.

First, ethics invariably involves some impact on people's *welfare*. We generally feel that it is a moral matter to avoid inflicting harm on others, as well as to relieve suffering when it occurs; we also believe that morality is related somehow to the promotion of people's welfare by providing some benefit, which is the opposite of harm. Indeed, the moral theory of utilitarianism is often expressed as "the greatest good for the greatest number," with "good" understood in terms of pleasure and pain. Although the infliction of harm is not always wrong, it often is, and, in any event, it always requires some justification. So whenever a course of action or a state of affairs bears on people's welfare, one should be alert for the presence of ethical issues.

Second, much of ethics consists of having a *duty* or an *obligation* to act in certain ways (these concepts are generally interchangeable). Whenever one recognizes a duty or an obligation, or is in situations in which is it appropriate to speak of what *ought* to be done or what it is *right* to do, ethics is somehow involved. Of course, it may be difficult to determine what duty requires or what one is obligated to do, but the presence of ethics is usually undeniable.

Third, the concept of *rights* is prominent in ethics. We often speak of human rights, which are fundamental moral requirements, and we decry their violation. The United Nations Universal Declaration of Human Rights and the Bill of Rights in the US constitution are familiar examples. Also commonly recognized are employee rights, customer rights, shareholder rights, and so on. Rights are also conferred by agreements and contracts, for example, as when a lender claims a right that a borrower repay a loan. Rights are thought by many to be correlated with duties so that they are two sides of the same coin. Thus, if people have a right of free speech, for example, then others have a duty not to interfere with people's speech. One especially important right is *freedom* or *liberty*, which might deserve to be treated separately as a basic moral concept.

Fourth, the concepts of *fairness* or *justice* are often at issue in matters of ethics. In finance, we often speak of fairness in market exchanges, of fair competition, of the fair treatment of investors, and the like. Not only may individual actions be assessed for fairness or justice, but the concepts are also used to evaluate practices and institutional arrangements, such as the fairness of high executive compensation or the justice of the tax system. *Equality* is also an important concept in ethics that is closely related to fairness or justice inasmuch as we often consider unequal treatment to be unfair or unjust. There is much discussion in economics and finance of the equity/efficiency trade-off, in which equality and welfare come into conflict.

Fifth, *honesty* might be regarded as a duty or obligation—we ought to tell the truth, for example—but it is important enough, especially in finance ethics, to be recognized separately. Honesty is essential in market exchanges when a buyer and a seller each make representations to the other, and much of finance involves the reporting of information, which should be accurate, complete, and reliable. Honesty is important in developing the kind of relationships that are essential in financial activity, and it is lost when fraud or bribery occurs. Being honest is a basic moral requirement in finance as well as other spheres of life.

Sixth, the concept of *dignity* expresses the fundamental moral requirement that all people be treated with respect as human beings. This concept, too, might be reduced to another, in this case rights: to respect the dignity of others is to respect their rights. However, in addition to having rights, people should be recognized as autonomous moral agents with the freedom to pursue their own ends. This autonomy is violated when people are subjected to humiliation, violence, coercion, degradation, or enslavement. Less serious violations of people's dignity occur when they are treated merely as means to our own ends.

With these six concepts in mind, we can identify and address the ethical issues in any situation. The key elements of ethics can be expressed as six questions:

1. Welfare: Is anyone being harmed, and if so, can the harm be justified?
2. Duty: What is my duty or obligation in this situation?
3. Rights: Are anyone's rights being violated, and if so, can the violation be justified?
4. Justice: Is everyone being treated fairly or justly?
5. Honesty: Am I being entirely honest in my actions?
6. Dignity: Am I showing respect for all persons involved?

These six questions express the basic elements of ethics in general, no matter the area of application. These elements need to be specified in greater detail to apply to the ethical issues in finance.

One distinctive feature of financial activity is that it is conducted in *markets* between buyers and sellers, as well as in *firms*. Markets and firms are the two main venues for financial activity. Market participants make exchanges at arm's-length, solely with a view to their own interests. Although markets often have a win–win outcome, they can also create large winners and losers. Markets of all kinds create opportunities for gain at other's expense by exploiting any mistakes or merely by making winning bets. Firms, by contrast, are cooperative ventures, in which people are organized for productive activity by means of hierarchies, which are structured orders of roles and relationships. In firms, people act not as traders—entering into exchanges or transactions with a view to maximizing their own gain—but as role players with responsibilities, performing their assigned tasks and submitting to the authority of a superior.

Despite the occasional ruthlessness of market activity, there is still an ethics of the market that is binding on all participants. Not all is ethical in market transactions, and market actors are prohibited, by both ethics and law, from engaging in certain practices. When people occupy roles and enter into relationships, they have removed themselves from markets and assume yet other ethical obligations. This is especially true when people operate in firms, although roles and relationships exist outside of firms as well as within them.

Markets and firms

The next step in developing a framework for ethics in finance is understanding the ethics of the market that governs the activities of mere buyers and sellers, followed by a discussion of firms.

Markets

Markets are exceedingly useful mechanisms that also have a substantial moral justification. In a typical market exchange between a buyer and a seller, each party gives up something of value in return for something that he or she values more. In theory, both traders leave a market better off than they came—or at least no worse off—because of the voluntary character of the exchange. That is, market participants make exchanges voluntarily, without any force or coercion, and, by assumption, no traders would voluntarily make themselves worse off. (Of course, market exchanges are based on each party's judgment of value at the time, which may later change or not meet expectations.) In market exchanges, the participants act solely out of self-interest, each seeking to get the best deal or the greatest advantage for themselves. However, any gain to one party is achieved with the voluntary consent of the other, who is similarly self-interested and who may also benefit from the transaction.

The moral justification of markets is based on the twin considerations of *welfare* and *rights*. First, the welfare enhancing feature of market exchanges is assured when not only individuals but the whole of society benefits from a system of voluntary transactions. In economic terms, every market exchange is a *Pareto improvement*—in which at least one party is better off and no one is worse off—and eventually free trading should lead to a *Pareto optimum*—which is a state in which no trades remain that will make anyone better off without making at least one person worse off.[1] (These terms were developed by the Italian economist Vilfredo Pareto, who lived 1848–1923.) Furthermore, in the larger economy, when business decisions are made in a market with accurate prices, the result is maximal *efficiency* (which may be defined as the greatest output for the least input). Maximal efficiency also leads to increased welfare in society since all resources are put to their most productive uses, leading to an abundance of goods and services.

Second, markets are further justified because they enhance freedom or liberty. Market exchange presupposes property rights inasmuch as each party in an exchange gives up the ownership of something of value and transfers right of ownership to the other party. Property rights themselves are of moral importance because they secure the use of resources for our own welfare. For example, a farmer who owns a plot of land can cultivate it and thereby feed a family—and the farmer can also sell some of the produce in exchange for other goods. Ownership rights confer freedom or liberty not only by enabling people to provide for their own needs without dependence on others but also by giving them power to counter that of the state. Historically, the development of private property has been instrumental in the creation of free, democratic societies, which consist of *citizens* with independent power instead of powerless *subjects*, like serfs under feudalism.[2] In addition, part of the value of owning property is the freedom or liberty to exchange it advantageously for other property in order to increase one's welfare. The feature of property whereby it can be sold or transferred is *alienability*. Not all property has this feature, but the alienability of property clearly adds greatly to its owner's freedom or liberty.

Firms

A business firm or corporation is an organization that brings together many different groups—most notably managers, employees, suppliers, customers, and, of course, investors—for the purpose of providing some product or service. The nature of this entity, the firm or business corporation, can be understood from many different perspectives, including economics and law.[3]

In economics, neoclassical marginal analysis regards the firm as a profit-maximizing unit, and for the purposes of economics there is no need to inquire into its internal workings. It might as well be viewed like the sole proprietor of a business. As the entry on the theory of the firm in the *New Palgrave* dictionary of economics observes: "*If* firms maximize, *how* they do it is not of great interest or at least relevant to economics." The marginalist theory has been challenged in economics, however, by behavioral and managerial theories of the firm, which are based on the operation of actual corporations, in which the functioning parts must be considered.[4]

Legal theorists have also developed theories of the firm in order to answer the many puzzling questions that arise in corporate law. Debate rages to this day over the nature of the corporation: Is the corporation the private property of the stockholders who chose to do business in the corporate form, or is the corporation a public institution that is sanctioned by the state in order to achieve some social good?[5] On the former view (which may be called the property rights theory), the right to incorporate is an extension of the property rights and the right of contract that belong to everyone. Because the right to incorporate is alleged to "inhere" in the right to own property and to contract with others, this view is also known as the *inherence theory*. The latter view (let us call it the social institution theory) holds that the right to incorporate is a privilege granted by the state and that corporate property has an inherent public aspect. The view that incorporation is a privilege "conceded" by the state in order to achieve some social good is also known as the *concession theory*.

The original form of the modern corporation was the joint-stock company, in which a small group of wealthy individuals pooled their money for some undertaking that they could not finance alone. The property rights theory would view this corporate form of business organization as an extension of the property rights and the right of contract enjoyed by everyone. Just as individuals are entitled to conduct business with their own assets, so too have they a right to contract with others for the same purpose. Because they jointly own the common enterprise, they are entitled to receive the full proceeds, as though it were a business conducted by one person alone. However, the fact that the earliest joint-stock companies were also special grants that kings bestowed on favored subjects for specific purposes fits the social institution theory. Incorporation is possible today only because the state allows this form of business organization to exist, in part because of its contribution to the public welfare. Further, the right of the state to regulate business for the public benefit is based, partially, on a view that corporate property is "affected with a public interest."[6] Thus, corporations are not wholly private; they fill some public role.

However, the premise of the property rights argument that shareholders are the owners of a corporation was challenged in 1932 in a book that profoundly changed all thinking about corporate governance. That book was *The Modern Corporation and Private Property*, by Adolf A. Berle Jr and Gardiner C. Means, which documented a dramatic shift that had occurred in American business.[7] The dispersion of stock ownership in large corporations among numerous investors with little involvement in corporate affairs, combined with the rise of a professional managerial class that exercised actual control, had resulted in a separation of ownership and control, with far-reaching implications. In particular, the separation of ownership and control changed the nature of corporate property as well as the ownership rights of shareholders.

Strictly speaking, property is not a tangible thing like land but a bundle of rights that defines what an owner can and cannot do with a thing, such as a piece of land. Shareholders provide capital to a corporation in return for certain rights, such as the right to vote and to receive dividends. However, full ownership involves control over property and an assumption of responsibility, both of which shareholders have relinquished. By doing so, shareholders of large, publicly held corporations have ceased to be owners in the full sense and have become one among many providers of the resources needed by a corporation. Because of the separation of ownership and control, managers have assumed the position of trustee for the immense resources of a modern corporation, and in this new position, they face the question: For whom are corporate managers trustees? Managers, they observe, "have placed the community in a position to demand that the modern corporation serve not alone the owners . . . but all society."[8]

Although the separation of ownership and control documented by Berle and Means undermined the property rights theory, a fully developed social institution theory did not replace it. Instead, a conception of the corporation as a quasi-public institution emerged, in which managers have limited discretion to use the resources at their command for the good of employees, customers, and the larger society. In a world of giant corporations, managers are called upon to balance the interests of competing corporate constituencies, and in order to fill this role, they developed a sense of management as a profession with public responsibilities. Managers ceased being the exclusive servants of the stockholders and assumed the mantle of public-spirited leaders.

The theory of the firm that is prevalent in modern finance is the contractual theory, according to which a firm is viewed as a nexus of contracts among all corporate constituencies. On this theory, different groups, including investors, employees, suppliers, and customers, each contract with a firm to supply some needed resource in return for some benefit. The manager's role in the nexus-of-contracts firm is to coordinate the vast web of mutual agreements. The contractual theory of the firm stands in sharp contrast to the social institution theory, in which the corporation is sanctioned by the state to serve the general welfare. In contrast to the property rights theory, which it more closely resembles, the contractual theory does not hold that the firm is the private property of the shareholders. Rather, shareholders, along with other investors, employees, and the like, each own assets that they make available to the firm. Thus, the firm results from the property rights and the right of contract of every corporate constituency and not from those of shareholders alone.

The contractual theory of the firm originated in the work of the economist Ronald Coase.[9] One of Coase's many insights is that firms exist as less costly alternatives to market transactions. In a world where market transactions could occur without any costs (what economists call *transaction costs*), economic activity would be achieved entirely by means of contracting among individuals in a free market. In the actual world, the transaction costs involved in negotiating and enforcing contracts can be quite high, and some coordination can be achieved more cheaply by organizing economic activity in firms through hierarchies. Thus, there are two forms of economic coordination—markets and firms, which operate by exchange and hierarchy respectively—and the choice between them is determined by transaction costs.

In the Coasean view, the firm is a market writ small in which parties with economic assets contract with the firm to deploy these assets in productive activity. Generally, an individual's assets are more productive when they are combined with the assets of others in joint or team production. Individuals will choose to deploy their assets in a firm instead of the market when the lower transaction costs of a firm combined with the benefits of team production yield them a higher return. Deploying assets in a firm involves some risks, however, when those assets are *firm-specific*, which to say that they cannot easily be withdrawn and redeployed elsewhere. Firm-specific assets enable any group—including employees, customers, suppliers, and investors—to gain greater wealth, but this wealth can also be appropriated by the firm itself. Thus, these groups will make their firm-specific assets available to a firm only with adequate safeguards against misappropriation. A major challenge in a nexus-of-contracts firm, then, is forming contracts that provide not only a return but also adequate protection for it.

Market ethics

Since all market exchanges occur, at least in theory, with the voluntary consent of two parties, one might ask how it is possible for one party in a transaction to *wrong* the other, or indeed anyone. It has been argued that a world in which all activity took place in perfect markets—with everyone interacting solely by means of mutual consent—would have no need of morality. Such a world would be a "morally free zone."[10] Valid or not, this argument rests on the critical assumption of perfect markets, and so certainly one role for morality is to provide guidance when markets are imperfect—as they often are.[11]

Force and fraud

In a perfect market, there is no place for force or coercion since, by definition, each party freely consents to every exchange. Any forced exchange, where a person is threatened with violence for not making a trade, is not really a market transaction at all but a case of theft or expropriation, which is a moral wrong in any context. (A gunman in an alley who says "Your money or your life" is not engaging in market activity despite the offered trade, and the same is true for making the proverbial "offer that cannot be refused.") Of course, a person can obtain goods without force by merely stealing unawares, but this, too, is a moral wrong that scarcely constitutes market activity.

Coercion is commonly defined as inducing a person to choose an undesirable alternative under some threat, and such an action is not necessarily wrong as long as no right is violated.[12] For example, a bank that threatens to foreclose on a loan unless payment is made may force a borrower to seek funds elsewhere, but the bank is within its rights to make this threat. The borrower may be coerced into repayment, but no right is being violated. Wrongful coercion, which, on this analysis, involves some violation of a right, is like theft in being a recognized moral wrong. Thus, one rule of market ethics, addressing both force and coercion, is "Do not steal!"

Every market exchange involves the making of a promise or an agreement or a contract to act in certain ways, and so both parties in a transaction have a duty or obligation to act as promised or agreed. For a seller, this includes the delivery of the promised good, while the buyer is committed to making the agreed-upon payment. Failure to do either is a moral wrong that violates the common norms "keep your promises" and "abide by agreements made." Since every market exchange can be viewed as a kind of contract, failure to act as required may be called a *breach of contract*, which is also a moral wrong. All of these wrongs can be addressed by the simple moral rule "Keep your promises."

In a perfect market, no party would lie to the other about what is being given up or offered in an exchange. Such lying may consist of concealment or a failure to disclose certain facts that are relevant to an exchange or, worse, misrepresenting these facts. Lying of this kind in a market transaction is commonly called *fraud*, which may be defined as a material misrepresentation that is made with an intent to deceive and that causes harm to a party who reasonably relies on it. For example, when the seller of a house cleans up the sawdust from termite activity, fails to disclose the problem, and, further, denies the existence of any infestation, the result may be a bad deal for the buyer, who may then own a house that is worth less than expected. When lying occurs in market exchanges, not only may a trade fail to produce an overall benefit for both parties (which is an important virtue of markets), but one party commits a wrong against the other because of the common moral prohibition against lying. As everyone knows, it is wrong to tell a lie.

Of course, difficult questions arise about what information each party to an exchange is morally obligated to disclose and what constitutes a falsehood or a material misrepresentation. A seller of a home has an obligation to disclose important defects that are not readily apparent, but the buyer may also be reasonably expected to exercise some level of care in discovering other problems with the property, perhaps by engaging his or her own inspector. Moral blame and legal guilt for fraud may also hinge on whether a person knew that a statement was false and had an intent to deceive, and also on whether the other party relied on the information and suffered a loss as a result.

Closely related to fraud is *manipulation*. This occurs most commonly in securities trading when investors attempt to move the price of a stock in order to profit from the change. For example, in a classic "pump and dump" scheme, investors boost the price of a stock by aggressive buying and then selling when other investors jump in, after being deceived by the inflated price. Manipulation differs from fraud in that there is no misrepresentation of a material fact; rather, investors are deceived by the manipulated appearance of the facts. The sharp dealings that occur in finance, especially in securities trading, constantly test the boundaries of moral and legal permissibility, and accusations of fraud and manipulation are frequent. Nevertheless, there are lines in both ethics and law about the disclosure and representation of information that ought to be observed. The simple moral rule in such matters is "Tell the truth" or "Don't lie!"

Wrongful harms

Market actors are prohibited, both morally and legally, from harming others in violation of their rights. The three cases considered so far all involve rights, which are violated in market exchanges when force is applied, promises are not kept, and lying occurs. Legally, these are matters of contract law. Market participants have many other rights, including protection from defective products, hazardous working conditions, racial and sexual discrimination, invasion of privacy, and so on. Violations of these other rights are generally the subject of tort law, which is concerned with compensation for wrongful harms—that is, when people are harmed by the wrongful acts of others. Not all harm is wrongly inflicted; what makes a harm wrongful is usually the violation of some right.

For example, when a bank sells a product, such as a loan, it has the same moral duty as a manufacturer to exercise due care to ensure that the product is not defective in any way. (On this duty, the law is less stringent, as Elizabeth Warren complained in observing that it is impossible to buy a toaster that might burst into flames and burn down a house, while one can buy a mortgage with the same chance of putting a family out on the street.[13] The newly created Consumer Financial Protection Bureau is intended to remedy this defect in the law.) Arguably, a mortgage that can cause great loss to a homeowner is a defective product for which a bank should be held responsible, both morally and legally. Similarly, cases in which banks failed to maintain proper records, which has caused great hardship to mortgage holders in foreclosure proceedings, are examples of negligence or a failure of due care that violated people's rights. The moral rule that is applicable to cases of wrongful harm is "Respect people's rights!"

Market failures

The final area where wrongs can occur in markets involves *market failure*. This encompasses a broad set of factors, much studied in economics, which prevents markets from functioning with maximum efficiency. Because of market failures, the ability of markets to secure welfare and rights may also be impaired. Some market failures result when the conditions of perfect markets are lacking, such as perfect information and perfect rationality. If buyers and sellers are poorly informed about the goods being exchanged or cannot process the information they have, then a market outcome may not increase either welfare or rights. Similar results may obtain if markets lack perfect competition, which occurs, for example, in the presence of monopolies and anticompetitive trading practices.

Another kind of market failure is the well-known feature of markets to neglect *public goods* and to favor private over public consumption. By definition, a public good is one that can be consumed by everyone with no one excluded. Examples of public goods include roads and parks, which are open to everyone and from which no one can be easily excluded. If an attempt were made to charge for public goods, those who could not be excluded would become *free riders*, benefitting unfairly from other's payment. Since public goods cannot be packaged and sold for exclusive use by one person, like toothpaste, there is no profit to be gained, and so these goods are ignored by markets and usually left for government to provide, if indeed they are provided at all.

A major source of market failure is the presence of *externalities* or spillover effects, which are costs to society that result from economic production. Pollution is a classic example. In economic theory, all costs of production are assumed to be borne by the producer and factored into the price of a product. When a resource, such as clean air or water, is used in production without any cost to the producer and returned in a polluted state, the cost of the damage is left to be borne by society. The result is not only a misallocation of resources that would otherwise be corrected by the price system but also a distortion in the distribution of costs and benefits of production. If the cost of using air or water were internalized by being factored into the price of a product, then producers would consume these resources more cautiously, and the cost would be borne by those who benefit and not shifted (unfairly) to others.

Finally, market failures occur in cases of *collective choice*. In a market system, many choices for the whole of society result from the aggregation of all the choices made by individuals in discrete market exchanges. Economic theory assumes that when individuals make choices that are rational for themselves, the outcome of all these choices is always a rational social choice. The falsity of this assumption is illustrated by an example known as "the tragedy of the commons."[14] It may be rational for individual herders to graze as many sheep as they can on pasture that is owned by everyone (a commons) since any effort by one or a few herders to limit their own use of the land would be offset by other herders, who simply would put more sheep into the vacated portion of the pasture. The rational collective choice would be for each herder to limit the number of sheep that herder grazes on the commons. However, if a collective choice is made only by individual herders considering what is rational for themselves without any ability to control the choices of others, then the commons will be destroyed, which is an irrational collective choice.

Market failures can be addressed by many means. Much of the legal regulation of business is concerned with these defects or imperfections in markets. For example, disclosure laws of various kinds and antitrust and fair competition laws attempt to secure the conditions of perfect information and perfect competition respectively. Ethics also has a role to play, although it is difficult to formulate simple rules like those for other components of market ethics. The best that can be done is perhaps "Contribute to efficient markets and do not take undue advantage of the opportunities provided by market failures."

Finance consists of more than buying and selling in markets. People engaged in financial activity also enter into roles and relationships that entail specific duties or obligations and also confer some rights. Despite the importance of markets in finance, finance ethics is, to a great extent, the ethics of roles and relationships with their corresponding duties and rights. Two of the most important roles and relationships in finance are those of agent and fiduciary, and these moral categories constitute a large part of finance ethics, along with the ethics of the market. A framework for ethics in finance consists, then, of two parts: an ethics of the market and an ethics of roles and relationships.

Roles and relationships

When a person or an organization is in a purely market situation, dealing with another party merely as an arm's-length buyer or seller, self-interest holds sway, and tough bargaining and sharp dealing are ethically and legally permissible—within the limits of market ethics. However, much financial activity involves individuals and organizations assuming roles and entering into relationships in which market ethics still applies but which entail further duties or obligations that limit and often preclude self-interest. These roles and relationships are essential for finance inasmuch as many goals could not be achieved solely in markets but require a high degree of cooperation and coordination.

Much of the skill and knowledge possessed by people in finance can be put to productive use only by serving others. A financial adviser, for example, would make a poor living without clients to advise. Many of the financial functions served by banks, mutual funds, insurance companies, and the like require large organizations that could not function merely through market activity. Indeed, a bank, for example, can be understood as a complex of roles embedded in relationships. When a bank agrees to make payments from a customer's checking account, it becomes an agent for the customer, and in safeguarding deposits in a savings account, the bank serves as a fiduciary. A bank also serves an important intermediary function by channeling customers' deposits into loans for borrowers.

One feature of roles and relationships is that they are voluntarily *assumed*: one typically occupies a role or enters into a relationship by making an agreement, often in a market. For example, when a financial adviser agrees to serve a client, both parties cease to be merely market participants, dealing with each other in a pure buyer–seller situation. The adviser becomes a trusted counselor with a duty to serve that client's interests without regard for his or her own—within the limits of the agreement, of course. For this selfless service, the financial adviser is compensated, and part of this compensation is to induce the adviser to act on the client's behalf. Furthermore, the agreement to become an adviser is itself made in a market in which the adviser may rightly consider his or her self-interest.

The key point about roles and relationships is that by making an agreement *in a market*, the parties in question take themselves *out of the market* and now conduct their activities not merely on the basis of the ethics of the market but in accord with a new set of duties or obligations that belong to—indeed, are created by—these new roles and relationships. In general, the duties or obligations of roles and relationships are whatever the two parties have agreed on. Thus, a financial adviser agrees to provide certain services to a client, which may vary considerably. No financial adviser would be ethically permitted to steal from a client; this would violate a rule of market ethics. However, the amount of time spent and the level of care exercised may rightly depend on the agreement made—on how much service the client is "buying" from the adviser.

As an illustration, some financial advisers are compensated solely by a fee, while others depend on commissions from the client's investments. Fee-for-service advisers are free from conflicts—they derive no benefit from recommending one investment over another—while commission-based advisers have an incentive to recommend investments with higher commissions, which might not be in the client's best interests. Either compensation system is ethical as long as the method of compensation is understood and accepted by both parties. Further, the choice between the two methods can be left to the choice of the two parties. That is, it is subject to their agreement.

The two most common roles in finance and business generally are those of agent and fiduciary, which each carry certain duties or obligations. Some people in finance are also professionals, who, like physicians and attorneys, have special duties that belong to these roles. Although there are some standard duties or obligations of agents, fiduciaries, and professionals, there is also a great deal of variation and context-specificity to the ethics of roles and relationships.

Agents, Fiduciaries, and Professionals

An *agent* is a party that has been engaged to act on behalf of another, called the *principal*. Typically, an agent is engaged by a principal to act in place of the principal at the principal's direction. The agent may be an individual, such as a real estate agent, or an organization, such as a real estate agency. Employees are generally agents of an employer. A *fiduciary* is a person or organization that has been entrusted with the care of another's property or assets and that has a responsibility to exercise discretionary judgment in this capacity solely in this other person's interest. The other person in a fiduciary relationship is described as the *beneficiary*. Common examples of fiduciaries are trustees, guardians, executors, and, in business, officers and directors of corporations. Both agency and fiduciary relationships are ubiquitous in finance because of the need to employ specialized services and to safeguard people's assets.

The concepts of agent and fiduciary are very closely related and often overlap. Thus, directors are often held to be fiduciaries for the corporation and its shareholder and also their agents. In general, the duty of an agent to act in the interest of a principal is not as inclusive as the duty of a fiduciary. For example, the duty of a broker who is acting merely as an agent in the sale of securities is usually narrower than that of a broker who is acting as a fiduciary in managing a client's portfolio. Thus, an agent-broker may not have an obligation to advise against an unwise trade that he or she is asked only to execute, but a broker-adviser, acting as a fiduciary, would have such an obligation. The difference between the two cases is the scope of the engagement—which is to say, the range of services that the client seeks and the broker has agreed to provide.

Moreover, the duty of a fiduciary is usually more stringent than that of an agent. Generally, failure in the performance of a fiduciary duty is considered to be a greater moral wrong than the failure to fulfill the duty of an agent or of a mere participant in a market exchange. As Justice Benjamin Cardozo famously observed "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is the standard of behavior."[15]

Need for agents and fiduciaries

Agency relationships arise from the need to rely on others for specialized knowledge and skills. For example, selling a house requires considerable knowledge and skill, as well as time, and so a seller may engage a real estate agent to act on the seller's behalf, doing what the seller would do if that person had that person's knowledge and skills. An agent thus becomes an extension of the principal, acting in the principal's place, with a duty to use his or her abilities solely for the principal's benefit. An agent can also be authorized to affect a principal's legal relationships. For example, an authorized agent may enter into contracts that bind a principal. An insurance agent, for example, is an agent of an insurance company, not of the client, and sellers of policies (who are often independent contractors rather than employees of the insurer) become agents of the insurance company because of their legal power to commit the company in selling a policy. A person may also become an agent because of the potential to expose another to legal liability. Thus, a truck driver for a company is made an agent, subject to the employer's direction, because the employer might be held liable for the cost of an accident.

Fiduciaries provide a valuable service for individuals who are unable for some reason to manage their own property or assets. Thus, a person saving for retirement might prefer that the assets in a pension fund be managed by a professional manager, who assumes the role of fiduciary. The executor of an estate, who is a fiduciary, distributes property and assets in accord with a will that the deceased person wrote but is unable to implement. Similarly, the trustee of a trust for a minor child manages the trust in place of the person who created it but can no longer exercise control. Shareholders elect directors as their representatives with a fiduciary duty to manage a corporation in their interest when they choose not to manage the corporation themselves (which is typically the case in the modern corporation that features a separation of ownership and control). In all these cases, control over property or assets is delegated to a trusted party who has a duty to exercise this control for the benefit of others.

Duties of agents and fiduciaries

Broadly, the duty of an agent is to act as directed by the principal with competence, diligence, and care. For example, employees as agents of employers have assigned tasks with a duty to complete these tasks as directed. Often, it is not possible for a principal to specify in detail the expectations for an agent. Indeed, agents are typically engaged because they know better than the principal what should be done and how it should be done. The duties of an agent, as well as of a fiduciary, tend to be open-ended. That is, the specific acts that are to be performed are not fully specified in advance, and agents and fiduciaries have wide latitude or discretion in the choice of means to advance the interests of others. Agency and fiduciary duties serve as means to ensure that this discretion is properly exercised.

Aside from a positive duty of an agent to act in the interest of another, there is a negative duty to avoid advancing personal interests in the relationship. It would generally be a violation of an agent's duty, for example, to use the principal's property or information for personal gain. An example of personal advantage-taking in an agency or a fiduciary relationship is self-dealing, as when a director or executive buys some asset from the company or sells something to it, unless it can be shown that the transaction is fair and would have occurred at arm's-length. Insider trading or other personal use of confidential information gained in an agency or a fiduciary relationship is another violation of a duty. It is also wrong for a fiduciary to gain some personal benefit, even if the beneficiary is not harmed, because the fiduciary would no longer have an undivided loyalty. In general, the duty of a fiduciary is to act solely in the interest of the beneficiary within the scope of the relationship without gaining any material benefit except with the knowledge and consent of the beneficiary.

A fiduciary relationship has two elements: trust and confidence. Something is entrusted to the care of a person with the confidence that proper care will be taken. A fiduciary relationship can be created by a contract, as when one person (called a *trustor*) creates a trust and another agrees to be a *trustee* who manages the trust. However, a fiduciary relationship, with its attendant duties, can be imposed by legislation. For example, the law governing pensions makes any pension fund manager a fiduciary for the intended beneficiaries, and corporate law makes officers and directors fiduciaries of the corporation and its shareholders. More specifically, the elements of fiduciary duty are *candor*, *care*, and *loyalty*.

1. *Candor.* In a market, everyone has an obligation of honesty or truth-telling. It is wrong to say something false or to make a material misrepresentation. However, market actors are not required to disclose all information that others might want to know. A fiduciary, on the other hand, has a duty of candor—that is, a more extensive obligation to disclose information that the beneficiary would consider relevant to the relationship. Thus, it would be violation of a fiduciary duty for an attorney or an investment banker to conceal important, material information from a

client (unless doing so would violate a duty to another party). Similarly, the director of a company would fail in a fiduciary duty by remaining silent about a matter that is critical to a decision under discussion.

2. *Care.* When property or assets are entrusted to a fiduciary—the trustee of a trust, for example—that person should manage what is entrusted with due care, which is the care that a reasonable, prudent person would exercise. Although an extraordinary level of care may not be required, a fiduciary is expected not to act negligently. Although market actors also have a duty of due care with respect to certain matters, this obligation governs only how the party conducts a chosen activity and not the activities that are chosen. For example, a manufacturer should exercise due care in the design and assembly of its products, but it has no responsibility of due care in the products it chooses to manufacture. A fiduciary, by contrast, has a duty to act in all matters with a high level of care.
3. *Loyalty.* A duty of loyalty has two aspects: it requires a fiduciary to act in the interest of the beneficiary and to avoid taking any personal advantage of the relationship. In a market transaction, there is generally no obligation to serve the interests of another except to make good faith efforts to abide by the contracts made; gaining some personal advantage is the whole point of entering into a market transaction. In general, acting in the interest of a beneficiary is acting as the beneficiary would if that person had the knowledge and skills of the fiduciary. Taking personal advantage, by contrast, is deriving any benefit from the relationship without the knowledge and consent of the beneficiary.

Another important duty of both agents and fiduciaries is to maintain *confidentiality*. The need for confidentiality arises from the fact that in order to serve another's interest, agents and fiduciaries must often have access to sensitive, privileged information, and this kind of information will generally be revealed by those who have it only under a pledge of confidentiality, in which the agent or fiduciary provides assurances that the information will be held in confidence and used only for the purpose for which it was provided. Finally, agents and fiduciaries, by virtue of their commitment to act in the interest of some other parties, have a duty to avoid *conflict of interest*, since a conflicting interest would interfere with their ability to serve this other interest.

The role of professionals

The conduct of physicians, lawyers, engineers, and other professionals is governed by special professional ethics. Which occupations are professions and which are not is a subject of much dispute. Historically, the three main recognized professions have been law, medicine, and the clergy, although in recent years engineers, architects, healthcare providers, social workers, journalists, and realtors, among many other occupational groups, have claimed professional status. Certainly, not all people in finance are professionals, but some might rightly claim this status, especially those that provide specialized services to clients, such as financial advisers and insurance underwriters. Before we can determine whether anyone in finance is a professional, we need to understand the criteria for a profession.

Three features of a profession are commonly cited:

1. *A specialized body of knowledge.* Professionals do not merely have valuable skills, like those of a plumber, but they possess a highly developed, technical body of knowledge that requires years of training to acquire.
2. *A high degree of organization and self-regulation.* Professionals have considerable control over their own work, and, largely through professional organizations, they are able to set standards for practice and to discipline members who violate them.
3. *A commitment to public service.* The knowledge possessed by professionals serves some important social need, and professionals are committed to using their knowledge for the benefit of all.

These three features are closely related and mutually reinforcing. It is because professionals possess a specialized body of knowledge that they are given a high degree of control over their work. For the same reason, we leave it to professionals to determine what persons need to know to enter a profession and whether they know it. There is a danger in giving so much independence and power to professionals, but we have little choice if we are to enjoy the benefit of their valuable specialized knowledge. Consequently, professionals enter into an implicit agreement with society. In return for being granted a high degree of control over their work and the opportunity to organize as a profession, they pledge that they will use their knowledge for the benefit of all. Without this guarantee, society would not long tolerate a group with such independent power.

The standards of a profession include both technical standards of competence and ethical standards. Ethical standards are generally presented in a code of professional ethics, which is not only a mechanism for the self-regulation of a profession but also a visible sign of the profession's commitment to public service. A code of ethics is not an option for professionals but something that is required by the nature of professionalism itself. Developing a code of ethics is often the first step taken by an occupational group that is seeking recognition as a profession.

Is finance a profession? Merely proclaiming an occupation to be a profession does not make it so, and so any group that lays claim to professional status must provide a convincing rationale. The best case is made by financial planners and insurance underwriters, who provide highly technical services that meet some important needs. Organizations such as the Institute for Certified Financial Planners (which bestows the designation of Certified Financial Planner on those who meet its standards) and the International Association for Financial Planning have developed codes of ethics that include enforcement procedures. Members of each organization are required to subscribe to the organization's code of ethics, and they can be reprimanded, suspended, or removed from membership for infractions. Organizations in the insurance industry confer the designation Chartered Property Casualty Underwriter, Chartered Life Underwriter, and Chartered Financial Consultant on their members and have detailed codes of ethics. All of the codes stress the commitment of the profession to public service and profess such ideals as integrity, objectivity, competence, diligence, and confidentiality, and they also address the problem of conflict of interest.[16]

Conflict of Interest

Mark S. Ferber, a politically well-connected partner in the investment bank Lazard Fréres, was selected to oversee the financing of a $6 billion project to clean up Boston harbor with the power to recommend the firms that would raise the money. In a secret agreement, Merrill Lynch, which obtained much of the business, agreed to share the underwriting fees with Lazard Fréres, and over a four-year period, the two firms split $6 million. In addition, Mr Ferber received $2.6 million in retainer payments, while Merrill Lynch garnered millions more from other clients of Mr Ferber who were steered to the firm. An SEC commissioner described the fee-splitting arrangement as outrageous and declared, "I hire an investment adviser to give me prudent objective advice and they have a financial incentive to skew the business to a particular party? That's troubling, and if I were a client, I'd have a fit."[17]

Merrill Lynch and Lazard Fréres denied that the secret agreement was improper or that they had any obligation to reveal it. Mr Ferber said, "I'm not telling you it's pretty. But there is no violation of my fiduciary responsibilities."[18] A federal judge disagreed and sentenced Ferber to 33 months in prison, in addition to a $1 million fine and a lifetime ban from the securities industry. Merrill Lynch and Lazard Fréres each paid $12 million to settle charges brought by the SEC. In a parting shot, the judge chastised the firms and their lawyers for creating an environment that fostered rampant graft and corruption. As for the obligation to disclose conflicts of interest, the judge concluded, "And if this sorry lot of municipal bond attorneys do not understand it, let me spell it out: it is required that every potential conflict of interest be disclosed in writing and in detail."[19]

Financial services could scarcely be provided without raising conflicts of interest. In acting as intermediaries for people's financial transactions and as custodians of their financial assets, financial services providers are often forced to choose among the competing interests of others—and weigh those interests against their own. Although personal interest plays some role, the conflicts of interest in financial services arise primarily from attempts to provide many different kinds of services to a number of different parties, often at the same time. Conflicts of interest are built into the structure of our financial institutions and could be avoided only with great difficulty. As one person noted, "The biblical observation that no man can serve two masters, if strictly followed, would make many of Wall Street's present activities impossible."[20] In addition, the inhabitants of Wall Street are motivated primarily by self-interest and can be induced to serve any master only within limits. The challenge, therefore, is not to prevent conflicts of interest in financial services but to manage them in a workable financial system.

Defining conflict of interest

Although much has been written about the definition of conflict of interest, the issues in the controversy over various definitions have little bearing on the understanding of conflicts in the financial services industry.[21] As a working definition, the following is sufficient: "A conflict of interest occurs when a personal or institutional interest interferes with the ability of an individual or institution to act in the interest of another party, when the individual or institution has an ethical or legal obligation to act in that other party's interest."[22] Conflicts of interest are inherent in financial services because of the ubiquitous roles of agent and fiduciary, with their attendant duties to serve the interests of others with whom another interest conflicts or interferes.

Three distinctions commonly made among conflicts of interest generally are especially relevant to conflicts in the financial services industry. First is the distinction between *actual* and *potential* conflicts of interest. An actual conflict of interest occurs when an individual or institution acts against the interest of a party whose interest that individual or institution is pledged to serve, whereas a potential conflict of interest is a situation in which an actual conflict of interest is likely to occur. Actual conflicts of interest generally constitute misconduct, but potential conflicts, while perhaps are best avoided, may need to be tolerated as unavoidable features of certain situations.

Second, a distinction is made between *personal* and *impersonal* conflicts of interest. A conflict of interest is personal when the interest that actually or potentially interferes with the performance of an obligation to serve the interest of another is some gain to an individual or an institution. Thus, a lawyer who stands to benefit personally by acting against the interest of a client is in a personal conflict of interest. However, the interfering interest may also be another person's interest that an individual or institution is duty bound to serve. For example, a lawyer who has two clients with opposed interests also faces a conflict of interest, which may be described as impersonal.[23] This is the classic "two masters" problem.[24]

Impersonal conflicts are more common in the financial services industry, where firms have large numbers of clients. For example, if a broker, in managing a discretionary account, selects an inferior security because it generates a higher commission, the broker is acting in a personal conflict of interest by putting self-interest ahead of the client's interest. However, a broker who manages accounts for multiple clients may be forced to choose among the interests of these different parties when he or she decides how to allocate a security in short supply. Trust officers who manage multiple trust accounts face similar conflicts. This kind of conflict also occurs for brokers and trust officers in the utilization of market-moving information. Which accounts receive the benefit of this information, and in what order? Mutual fund advisers may be forced to decide how to allocate investment opportunities between various funds. The individuals who manage multiple accounts and funds have an incentive to favor those that are more important to them personally or to the firm, because these accounts belong to large customers, for example, or because they generate higher fees and commissions. A mutual fund adviser may allocate an especially profitable investment that is in short supply to a lagging fund in order to boost its performance or to a high-performing fund in order to gain even greater publicity.

In many situations, the obligations that are owed to different parties (who may have competing interests) cannot all be fulfilled, in which case some priority must be followed in allocating gains and losses. Not every account or fund can receive a firm's undivided loyalty of the kind we expect from individual lawyers, for example. Moreover, the standard solution for a lawyer with an impersonal conflict of interest, namely to sever the relation with at least one of two competing clients, is not available to a broker or trust officer, who, of necessity, manages dozens, if not hundreds, of accounts, or to a mutual fund company, which generally offers a variety of funds.

Third, a conflict of interest may be either *individual* or *organizational*. Organizations as well as individuals act as agents and assume fiduciary duties, and an organization can fail to serve the interests of a principal or the beneficiary of a trust even when no individual is at fault. For example, if a trust officer in the trust department of a commercial bank learns that a corporate customer of the commercial bank is in financial difficulty, should he or she be permitted or required to use that information in managing trust accounts? On the one hand, a failure to use the information could result in avoidable losses for the beneficiaries of those accounts, but, on the other hand, use of the information would violate the confidentiality that the bank owes to the corporate customer. One solution is to separate the trust and commercial functions by implementing policies on information use or by constructing "Chinese walls" to prevent the flow of information.

Because financial services are delivered primarily by institutions that offer a multitude of services to multiple customers or clients, most of the conflicts of interest in this area are *potential*, *impersonal*, and *organizational*. They result from the deliberate design of our financial institutions and pose a problem for those responsible for creating, regulating, and managing these institutions.

Why conflicts occur in finance

Conflicts of interest are ubiquitous in finance because people and institutions in this field so often act as agents and fiduciaries or otherwise commit themselves to act in the interest of other parties. Absent any such commitment a conflict of interest cannot occur. Thus, parties in a purely buyer–seller relationship, who have no obligation to serve any interest but their own, cannot, by definition, have a conflict of interest. For example, a trader for a hedge fund cannot be in a conflict of interest situation in dealing with a trading partner whose interest the trader has no duty to serve. However, a conflict of interest could be present inasmuch as such a trader is acting on behalf of the hedge fund itself and could acquire an interest that would interfere with the ability to serve the interest of the fund and its investors. With respect to the fund, but not the trading partner, the hedge fund trader is acting as an agent, with an attendant duty to serve the fund's interest.

In determining whether a conflict of interest is present, it is critical to ascertain the role or relationship involved. Does one party indeed have an obligation or duty to act in the interest of another? In the professions, such as medicine and law, the answer to this question is easily answered because of the nature of a profession. To be a physician or an attorney is to occupy a professional role in which service to others is central. Once a physician accepts a patient or an attorney accepts a client, there is a commitment to serve that party's interest exclusively. Since people in finance are usually not professionals, and since the role or relationship is established by a contract, rather than by the nature of a profession, the question about what is owed is more difficult to answer. The duties of a physician are derived from what it means to practice medicine, and similarly for the duties of an attorney. By contrast, the obligations or duties of people in finance are founded in a specific contract between them to perform certain agreed-upon services. As a result, we cannot make many generalizations about what constitutes conflicts of interest for financial services providers, as we can for professionals. Judgments must be made on a case-by-case basis.

With respect to an obligation or duty to serve the interests of another, which is essential for the presence of a conflict of interest, there is another difference between finance and the professions, such as medicine and law. In finance, self-interest plays a large and legitimate role. Professionals typically forgo all right to pursue their self-interest in the offering of their services; once committed to a patient or a client, a professional ought to consider only that other interest. (Of course, such professionals are well compensated for their selfless service, and they may consider their self-interest in deciding whether to assume a professional role.) Thus, people in finance typically operate at all times as self-interested economic agents who legitimately engage in financial activity on their own behalf, often while they are also serving as an agent or a fiduciary.

For example, a commercial bank with a trust department may be a fiduciary in the management of a corporation's pension fund at the same time that it is acting as a seller in making a commercial loan to the corporation. Similarly, an investment bank might be an investor in a takeover for which it is also raising the capital and thus be both an agent (in its financing activities on behalf of the raider) and a principal (by being an investor on its own behalf). Portfolio managers for mutual and pension funds are generally permitted to trade for their own accounts, and in so doing they are not only fiduciaries for the fund's shareholders but also active traders, competing against them. The potential for abuse in such situations is obvious.

In each instance, we might be able to separate the functions and require those who are agents and fiduciaries to forgo all self-interested activities. Some have suggested removing trust departments from commercial banks, for example, or prohibiting fund managers from trading for their own account, but such proposals for change are generally rejected on grounds of efficiency. Since people in finance primarily enable others to make money, they cannot easily be induced to employ their special money-making skills solely for other people's benefit. Persuading them to combine self-interested and altruistic activities is perhaps the best that can be achieved.

Examples of conflict of interest

The conflicts of interest in financial services are too numerous to list exhaustively, and they are even difficult to classify because of the range of activities. However, a typology of conflicts of interest in finance might be obtained by imagining a world of pure market transactions, where no conflicts of interest can occur, and identifying the need for agents and fiduciaries and other roles that involve a commitment to serve the interests of others, which creates the conditions for conflicts to occur. If individuals conducted their financial affairs as rational economic agents in a free market, there would be no conflicts of interest because, by definition, each person in a market is legitimately pursuing his or her self-interest. No one has any obligation in a free market to serve the interests of anyone else. There are plenty of competing interests in a free market but no conflicts of interest. However, this world would be unsatisfactory for many reasons, and insofar as rational economic agents are free to form contracts that advance their interests, they would do so. It is from this kind of contracting in a free market that the conditions for conflicts of interest arise, and from examining what contracts would be formed, the types of conflicts can be determined.

In a free market, participants would create an array of *financial instruments* that impose obligations on both parties. For example, few people have enough money saved to buy a home. Thus, instead of exchanging money for a house in a single transaction, the buyer and seller might draft a mortgage, which is a secured long-term loan. Similarly, a farmer and a mill owner might seek to reduce the risk inherent in the grain market. A glut of grain at harvest time would depress prices and possibly ruin the farmer, whereas a shortage would raise prices to the detriment of the mill owner. Instead of waiting until harvest time and exchanging at the market price, which is risky for both parties, they might agree in advance to a futures contract for the delivery of grain at a predetermined price. Mortgages and futures contracts solve two critical problems at once, namely how to create long-term financial relationships and how to manage the risks that result from our lack of knowledge of the future.

Financial instruments also create the need for a variety of financial intermediaries to handle the complex transactions between contracting parties. More important, intermediaries are necessary because the parties may not be able to contract face to face but may require the services of a third party. For example, when a savings bank collects deposits from customers and lends the funds to home buyers, the two parties never meet; their "transaction" is mediated by the bank, which combines the functions of saving and lending. Similarly, the farmer and the mill owner might act independently to protect themselves by operating through a futures market. Investment banks, serving as underwriters, handle the many different tasks that are involved when a corporation issues new securities, including the task of finding buyers for the securities. Insurance companies enable large numbers of people to protect themselves from risk by pooling premiums, which are then used to satisfy claims.

In all these cases, financial intermediaries act as agents, performing transactions and other activities that require specialized skills that are employed for the benefit of others. In so doing, they have an obligation to act in the principal's best interest. Thus, a broker has an obligation to achieve the best execution of a trade, and a fund manager has an obligation to select brokers who will provide the best execution. Both can be swayed by a personal or an institutional interest to make decisions that result in less than the best execution. For example, if the trust department of a commercial bank allocates the commissions for trades in trust accounts to brokerage firms that maintain a customer relation with the bank—a practice known as reciprocation, or "recip" for short—then the quality of the brokerage service might be compromised. Even if a broker-customer provides the best execution, the bank has still used its power to allocate brokerage commissions, which ought to be exercised solely for the interest of the beneficiaries of the trust funds, in order to advance the bank's commercial interests. The bank might have been able to use this power in some other way that would secure a benefit to the trust beneficiaries instead of the bank itself.

Insofar as an intermediary is the custodian of funds, such as uninvested cash in a trust or brokerage account, the intermediary is also a fiduciary. Individual accounts often contain positive cash balances from the sale of securities that have not been reinvested and from funds deposited in anticipation of purchases. Although the amount in each account is often small, the aggregate amount is usually quite large. If the trust department of a commercial bank leaves uninvested cash in noninterest bank accounts, then the bank, not the individual trust beneficiary, is benefited. Brokerage firms can also deposit uninvested cash in interest-bearing accounts and claim the interest for themselves, or they can leave it in noninterest accounts in order to gain some other benefit from a bank. SEC Rule 15c-3 stipulates that uninvested cash can be used only to provide some benefit to customers, such as providing funds for purchases on margin and for short sales. However, trust departments and brokerage firms need not credit accounts for any interest or other benefits that they derive from invested cash. Brokerage firms defend these cash management practices on two grounds. First, funds left on deposit are for the convenience of the customer and not the firm, which, in any event, could derive greater income from the commissions generated by new investments.

Second, the benefits they derive help keep their fees low, so that customers are credited with the income, albeit indirectly.

Trust departments are in a position to advance the interests of the parent bank in many other ways. For example, in managing trust accounts, a trust department may buy the stock of important bank clients and hold it when it would be prudent to sell. Trust departments may also cooperate with the management of bank clients by voting proxies in favor of management and by helping management defend against hostile takeovers. Such practices are known as "customer accommodation." In their other trust activities, such as disposing of assets during probate, banks can serve or accommodate their customers' interests (and perhaps their own) in the sale of property or other valuable assets. For example, a trust department may be required, in the probate of an estate, to sell controlling interest in a company that had been a bank customer. By selling the controlling interest to another bank customer, a continued relationship is assured.

In addition to financial instruments, free-market participants would seek to build *financial markets*, in which financial instruments could be issued and traded. Securities, such as stocks and bonds, are sold first in a primary market and then traded in a secondary market. A bond, for example, can be held to maturity, but a holder may also wish to cash out of this investment, in which case another buyer must be found. Mortgages can be exchanged between institutions and even pooled to form mortgage-backed securities that trade in markets. The liquidity of a financial instrument, which is the ease with which it can be traded, adds to its value and reduces the risk of holding it—hence the benefit of secondary markets. Many aspects of primary and secondary markets, including the obligations of the various participants, are a matter of law, specifically the Securities Act (1933) and the Securities Exchange Act (1934). Securities markets are regulated by the Securities and Exchange Commission (SEC). However, within the legal framework established by law, the obligations of participants in financial markets are flexible and subject to negotiation.

Primary and secondary markets create many different specialized roles. A major source of business for investment banks is the underwriting of new issues of securities, including not only corporate stocks and bonds but also initial public offerings (IPOs) of formerly private companies. Underwriting itself consists of several distinct roles with accompanying obligations. An underwriter serves as adviser, analyst, and distributor. As an adviser, the investment bank is an agent, providing advice on how to structure and price the offering. As an analyst, the bank serves its own customers and the investing public by certifying the value of the securities. As a distributor, the underwriter also buys the securities for sale to its customers or, at least, conducts the sale, and it may pledge to buy any unsold portion of the offering.

The commitment to sell the securities underwritten by an investment bank creates an incentive to sell the stocks or bonds to customers, regardless of suitability, and there is also a temptation to place any unsold securities in accounts that the firm manages. Because any unsold securities have been judged a poor value by informed market participants, placing them in individual accounts, without the clients' knowledge and consent, would appear to be a violation of a firm's fiduciary duty.

The underwriting role has a built-in conflict of interest. As an adviser to a corporate client, the bank should seek to obtain the highest price for the securities, but it serves its investment customers by obtaining the lowest price. However, this is a "virtuous" conflict of interest because the outcome is usually fairly priced securities. The investment bank must act like an auctioneer, seeking to obtain the highest price for the corporate client consistent with selling the whole offering to the bank's customers. The price, therefore, must be fair to both parties. A "vicious" conflict of interest may result, though, from the fact that the underwriter is compensated, in part, by the spread between the amount paid to the issuer and the public offering price. Thus, an underwriter has an incentive to "buy low" from the corporate client and to "sell high" to their customers.

Conflicts of interest also arise for organized markets and exchanges. In the United States, there is one major national stock exchange, the New York Stock Exchange, as well as smaller regional exchanges. The stocks of many smaller companies trade through NASDAQ, which was founded as an over-the-counter market by the National Association of Securities Dealers (NASD, now the Financial Industry Regulatory Authority, FINRA). Other exchanges exist for bonds, commodities, futures, and other financial instruments. These organizations serve multiple constituencies and must balance various competing interests. For example, the NASD recognized a conflict between its role as an association of securities dealers and as an operator of a market and so divested itself of NASDAQ.[25]

Particular roles within organized markets and exchanges give rise to role-specific conflicts. For example, floor traders in commodities and futures exchanges are privy to market-moving information that they can exploit by timely trading on behalf of themselves or others. Such trading constitutes a misappropriation of confidential or proprietary information and is strictly prohibited. A floor trader operates in an *auction market*, which is characterized by large numbers of buyers and sellers trading small lots. In an auction market, prices are known to all, and the trader operates purely as an agent in the execution of trades. By contrast, in a *dealer market*, in which large blocks of securities are traded between a few parties, trades are brokered by a dealer, known as a *block positioner*. In a dealer market, both prices and commissions are generally hidden and subject to negotiation, and the dealer may be acting as both an agent for other parties and as a principal for the firm. These conditions create potential conflicts of interest.

One market role worth noting is the *market specialist*, who has responsibility for maintaining a fair and orderly market in one or more stocks. Whenever the numbers of buyers and sellers in a stock market are mismatched, the specialist is expected to buy or sell, using his or her own inventory, in ways that approximate a market with a sufficient number of buyers and sellers. A specialist also holds a "book," which is information about calls and puts and limit orders. Because of the specialist's privileged access to the market and to sensitive information, the possibility exists for abuse. Not only can a specialist manipulate the price of stocks but he or she is able to engage in trading as a principal with virtually no risk in so-called "riskless principal transactions." For example, a specialist with an order to buy a stock when it drops to a certain price can buy the stock just above that price, with the assurance that if the price drops further the stock can be sold to the customer who placed the order. As long as the commission for the sale exceeds the loss on the transaction, the specialist takes no risk.

Active trading of securities in markets and the holding of diverse portfolios would lead free-market participants to seek an *investment adviser* and perhaps a *professional manager* for an investment portfolio. For example, a broker acts not only as an intermediary by executing trades but also as an investment adviser, recommending suitable securities, and as a portfolio manager if the customer has given the broker discretionary authority to trade for the customer's account. If a broker is compensated only for executing trades, then he or she has an incentive to recommend frequent trading of (possibly) unsuitable securities, and especially to engage in excessive trading in discretionary accounts, a practice known as "churning." Similar practices occur in banking, when loan customers are urged to replace one loan with another, and in insurance, when agents persuade customers to replace one policy with another, in order to generate extra fees and commissions. These abuses are called "flipping" and "twisting," respectively.

Investment advisers, who must register with the SEC under the Investment Advisers Act of 1940, offer investment advice to the public. Because a conflict of interest is created when investment advisers are paid a commission on the investments selected by the client, some advisers attempt to remove this source of conflict by charging a flat fee. Investment banks derive a large portion of their income from advising corporate clients on a wide range of matters, including financial restructurings, mergers and acquisitions, and hostile takeovers. Because investment banks offer other services to the same clients and also have clients with competing interests, their advisery activities create multiple conflicts of interest. Finally, mutual funds, pension funds, and insurance companies provide professional management for large portfolios of securities. Two potential conflicts of interest for portfolio managers arise when they engage in personal trading for their own accounts and when they allocate commissions to brokers for the execution of trades in return for research and other nonmonetary benefits in the form of "soft dollars."

Finally, because of the complexity of providing financial services and the problem of marshaling vast resources, free-market participants create large organizations, which create conflicts of interest in the governance of these organizations. Just as corporate law specifies the form of governance for business corporations, so other pieces of legislation create governance structures for financial organizations. The Investment Company Act of 1940 sets forth the framework for investment companies, including mutual funds, and most private pension plans are regulated by the Employee Retirement Income Security Act of 1974 (ERISA). Each of these acts requires the fund to be under the control of trustees with a fiduciary duty to the shareholders (of a mutual fund) or the beneficiaries (of a pension fund).

The governance structure of any organization creates potential conflicts of interest, not only because of the personal interests of the responsible persons but because of the multiple roles that these persons fill. An investment banker, for example, who is a director of a corporation or a trustee of an endowment fund is offered a plethora of opportunities to advance the interests of one group to the detriment of another group's interests. Individuals who wear two or more hats may be able to compartmentalize their roles and their attendant obligations. A more difficult challenge faces institutions that attempt to fill multiple roles, in which legitimate interests are continually competing.

For example, mutual fund trustees are obligated to represent the interests of the shareholder-investors of a fund. However, some are people with a close association with management who also do business with the fund in various ways. Critics have accused these trustees of paying insufficient attention to fund fees and other investor concerns and have called for a greater number of independent trustees on fund boards. Real estate investment trusts (REITs) raise special governance problems, not only because of a lack of independence among the trustees, who are often associated with the sponsoring institution, but also because of the prevalence of outside management of REITs. Unlike mutual funds, REITs can assume debt and leverage their assets, and when management fees are based on total assets of the trust, the managers have an incentive to assume more debt than may be beneficial to the investors. Because of the externalized management structure of REITs, shareholders are usually unable to evaluate the fees, which are not stated separately from REIT returns. As a result, the governance structure of REITs does not provide the degree of accountability that is present in other financial institutions.

Managing conflict of interest

Despite the prevalence of potential conflicts of interest in financial services, the occurrence of actual conflicts has been minimized by relatively effective preventive strategies. These strategies are embodied in much of the regulation of the financial services industry and in accepted industry practices. They can be conveniently classified under the headings of competition, disclosure, rules and policies, and structural changes.

Competition

Fierce competition among financial services providers for customers and clients provides a powerful incentive to avoid actual conflicts of interest and even the appearance of conflicts. Because results are critical in this competition, any source of inefficiency must be eliminated. For example, "recip" in commercial banks with a trust department has been virtually eliminated because of the need for returns on trust accounts to compare favorably with those of other trust departments and mutual funds. The allocation of brokerage commissions must be based on "best execution" rather than other institutional interests. In competing for customers by keeping fees low, trust department and brokerage firms must also employ responsible cash management practices. It has been argued that competition prevents the abuse of soft dollars, because fund managers who misallocate them will pay a price in the marketplace.[26] Competition is still limited in some areas of the financial services industry, and perhaps conflicts could be further reduced by eliminating these barriers, for example, by increasing the kinds of firms that could serve as trustees of pension funds.

However, competition also contributes to conflicts of interest. It is because of competitive pressures that firms branch out into related services and combine with other service providers. A bank that makes real estate mortgage loans might be tempted to sponsor a REIT, for example, despite the increased risk of conflicts. The entry of retail brokerage firms into underwriting puts them in direct competition with investment banks, thereby increasing competition, but the move also creates conflicts with their retail customer business. The mergers of retail brokerage firms with investment banks, which have been prompted by competitive pressures, give rise to even more conflicts. Furthermore, competition depends for its force on other factors, most notably disclosure. For example, unless fund earnings are properly disclosed, competition cannot exert pressure on firms to reduce conflicts of interest.

Disclosure

Disclosure as a strategy for managing conflicts of interest is generally understood as the disclosure of adverse interests, as when politicians disclose their investment holdings. This kind of disclosure is important in financial services. For example, a broker who is acting as a principal in a transaction is required by SEC Rule 10b-10 to disclose this fact to a customer. Section 17 of the Investment Company Act requires detailed disclosure of transactions involving "affiliated persons" who stand to gain personally from a mutual fund's activities. Under the Securities Act, the prospectus for a security must include a description of any material conflicts of interest held by the issuing parties.

However, disclosure in finance includes much more than disclosure of adverse interests. It has been noted that disclosure of performance data of all kinds, including levels of risk, facilitates competition, which in turn reduces conflicts of interest. In addition, conflicts of interest can be avoided by making known a firm's policies and procedures for dealing with conflicts. For example, if a trust department discloses its policies concerning the priority given to accounts or the treatment of uninvested cash, there need be no violation of fiduciary duty because the terms of the contract that create this duty have presumably been accepted by the trust beneficiaries. In this case, an informed beneficiary has no justified complaint if an account receives less attention than that of a corporate pension fund. Similarly, an investment bank can reduce conflicts of interest by announcing its policies in advance should two clients be involved in a hostile takeover.

Disclosure is a frequently recommended and employed remedy for conflicts of interest, but it has shortcomings. First, since it is easy to disclose conflicts and requires little else, it does not threaten existing arrangements, which may be in need of reform. As *New Yorker* columnist James Surowiecki has observed, "It has become a truism on Wall Street that conflicts of interest are unavoidable. In fact, most of them only seem so, because avoiding them makes it harder to get rich. That's why full disclosure is suddenly so popular: it requires little substantive change."[27]

Second, disclosure may worsen conflicts of interest by affecting both the disclosing party and the party being warned. The effectiveness of disclosure as a remedy rests on the assumption that, once warned, a party likely to be harmed by a conflict will take protective measures, such as discounting possibly biased advice or seeking additional information. However, psychological research suggests that the warning provided by disclosure is often not heeded sufficiently to provide adequate protection.[28] Moreover, this research also shows that people who have made disclosures may be emboldened to take even greater advantage of an opportunity with the rationalization that the other party has been warned. The result might be greater harm than would occur without any disclosure at all.

Rules and policies

Specific rules and policies serve to reduce conflicts of interest by prohibiting conduct that constitutes or facilitates conflicts. These rules and policies may address conflicts of interest directly by requiring people to avoid conflicts of interest or by prohibiting the kinds of conduct that would constitute conflicts of interest. Other rules and policies may operate indirectly by creating conditions that reduce the possibility of conflicts of interest. For example, policies on the flow of information in any financial services firm, such as who has access to what information, are vital for many reasons, including the prevention of conflicts of interest. Some commercial banks require that only the securities of sound, creditworthy corporations be selected for trust accounts. Not only is such a policy a good practice for a trust department but it also prevents the possibility of conflict if, for example, the bank is also a creditor of a corporation in danger of bankruptcy. In such a case, the sale of the stock by the trust department might endanger the bank's commercial loans, which creates a conflict of interest.

Rules and policies have many sources, including legislatures, regulatory agencies, industry associations, exchanges, and financial services firms themselves. These rules and policies need to mesh with each other and be mutually supporting. However, the prevention of conflicts of interest is probably best achieved by financial services institutions themselves: that is, an employee's own firm provides a strong first line of oversight. Every firm is different, and each one can provide better oversight if it has the flexibility to tailor measures to its own circumstances. Also, whether any given action constitutes a conflict of interest is not always easy to determine, and judgment is required for carefully evaluating each case. Thus, broad rules and policies for the whole industry are likely to be less effective than finely crafted ones from individual companies.

Structural changes

Because so many conflicts of interest in financial services result from combining different functions in one firm, these conflicts could be reduced by structural changes that separate these functions. The once-firm separation of commercial and investment banks, mutual funds, and insurance companies serves, among other purposes, to avoid conflicts. Many conflicts could be eliminated by separating the functions of trust management and commercial banking, of underwriting and investment advising, of retail brokerage and principal trading, and so on. Addressing the problem of conflict of interest by such radical structural changes is probably unwarranted, however, because of the many advantages of such combinations. For example, underwriting a corporation's securities requires an investment bank with substantial sales capability as well as personnel with analytical skills. The trend in the financial services industry is toward more rather than less integration.

Even within multifunction institutions, many structural changes are possible and perhaps advisable. One such change is strengthening the independence and integrity of functional units. In particular, steps can be taken to strengthen the autonomy of trust departments in commercial banks and research departments in investment banks by increasing the sense of professionalism among trust officers and research analysts. Managing the flow of information is an important factor in creating autonomy. This is done, in part, by building "Chinese walls," which create impermeable barriers between functional units. Chinese walls can also be built by policies that prohibit personnel from acting on restricted information, even if it is known. There are some drawbacks to Chinese walls, however. They take away some of the gains from integrating different functions in one firm, and firms may also lose the confidence of customers, who fear, for example, that investment advice does not represent all the information possessed by a firm. However, a customer may also benefit, by being assured that a broker's investment advice is not biased by the need to place unsold stocks in an underwriting. One significant benefit of Chinese walls to firms is increased protection against charges of insider trading.

Finally, financial services providers avoid conflicts of interest by seeking parties with independent judgment in situations in which their own judgment is compromised. Examples of such independent parties include independent trustees on the boards of mutual funds, independent appraisers in determining the value of assets in cases of self-dealing, independent actuaries in the operation of corporate pension funds, and independent proxy advisory services in deciding how to vote on shares held by trusts and funds.

Conclusion

This chapter presents a framework for approaching ethics in finance. Using this framework, one should always ask, first, am I acting solely in a market situation? If so, then the rules of market ethics apply. If not, then one should ask, second, what role or relationship am I in, and what is ethically required of me in this role or relationship? While market ethics permits a considerable amount of aggressive, self-interested behavior in the pursuit of gain, not everything is permitted. In particular, prohibitions against fraud and manipulation, the need to respect the rights of others, and responsible conduct in cases of market failure present considerable constraints on what may be rightly done. Roles and relationships, especially those of agents and fiduciaries, constitute much of financial activity, and very definite duties or obligations accompany them. One notable duty of agents and fiduciaries is to avoid conflict of interest, which is shown in this chapter to be a particularly challenging ethical concern.

Notes

1. An economy may have many possible Pareto optimal states, most of which would produce less than the total amount of welfare possible. Moreover, any of these states may be faulted for distributing welfare in unequal ways (which is called *distributional equity*). These points are commonly used to argue that markets alone may not lead to a just and prosperous society and that some government interventions may be necessary to achieve these (desirable) ends.
2. Because markets require property rights, which in turn facilitate democracy, some have argued that the use of markets in socialist planned economies, as in present-day China, will eventually lead to some degree of democracy in such societies. Experience shows that the link between markets and democracy is not secured merely by property rights but requires other conditions as well.
3. See G. C. Archibald, "Firm, Theory of," *The New Palgrave* (London: Macmillan, 1987); Richard M. Cyert and Charles L. Hedrick, "Theory of the Firm: Past, Present, and Future; An Interpretation," *Journal of Economic Literature*, 10 (1972), 398–412; Fritz Machlup, "Theories of the Firm: Marginalist, Behavioral, Managerial," *American Economic Review*, 62 (1967), 1–33; and Philip L. Williams, *The Emergence of the Theory of the Firm* (New York: St Martin's Press, 1979).
4. William J. Baumol, *Business Behavior, Value, and Growth* (New York: Macmillan, 1959); Richard M. Cyert and James G. March, *A Behavioral Theory of the Firm* (Englewood Cliffs, NJ: Prentice Hall, 1963); Robin Marris, *The Economic Theory of Managerial Capitalism* (New York: Free Press, 1964); and Oliver E. Williamson, *The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm* (Englewood Cliffs, NJ: Prentice Hall, 1964).
5. The distinction between the property rights and the social institution conceptions of the corporation is due to William T. Allen, "Our Schizophrenic Conception of the Business Corporation," *Cardozo Law Review*, 14 (1992), 261–281. See also William T. Allen, "Contracts and Communities in Corporate Law," *Washington and Lee Law Review*, 50 (1993), 1395–1407.
6. *Munn v. Illinois*, 94 U.S. 113; 24 L. Ed. 77 (1876).
7. Adolf A. Berle Jr and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

8. Berle and Means, *The Modern Corporation and Private Property*, p. 355.
9. Ronald H. Coase, "The Nature of the Firm," *Economica*, NS, 4 (1937), 386–405. The contractual theory has been developed by economists using an agency or transaction cost perspective. See Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," *American Economic Review*, 62 (1972), 777–795; Benjamin Klein, Robert A. Crawford, and Armen A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics*, 21(1978), 297–326; Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, 3 (1983), 305–360; Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics*, 26 (1983), 301–325; Steven N. S. Cheung, "The Contractual Theory of the Firm," *Journal of Law and Economics*, 26 (1983), 1–22; and Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: The Free Press, 1985). An authoritative development of the theory of the firm in corporate law is Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991). See also William A. Klein, "The Modern Business Organization: Bargaining under Constraints," *Yale Law Journal*, 91 (1982), 1521–1564; Oliver Hart, "An Economist's Perspective on the Theory of the Firm," *Columbia Law Review*, 89 (1989), 1757–1773; and Henry N. Butler, "The Contractual Theory of the Firm," *George Mason Law Review*, 11 (1989), 99–123.
10. David Gauthier, *Morals by Agreement* (Oxford: Oxford University Press, 1986). For criticism of this argument, see Daniel M. Hausman, "Are Markets Morally Free Zones?" *Philosophy and Public Affairs*, 18 (1989), 317–333.
11. For a development of this point, see Joseph Heath, "A Market Failure Approach to Business Ethics," *Studies in Economic Ethics and Philosophy*, 9 (2004), 69–89.
12. Robert Nozick, "Coercion," in Sidney Morgenbesser, Patrick Suppes, and Morton White (eds), *Philosophy, Science and Method* (New York: St. Martin's Press, 1969), 440–472.
13. Elizabeth Warren, "Unsafe at Any Rate," *Democracy: A Journal of Ideas*, Issue 5, Summer 2007.
14. Garrett Hardin,"The Tragedy of the Commons," *Science*, 162 (1968), 1243–1248.
15. *Meinhard v. Salmon*, 164 N.E. 545, 546 (1928).
16. For further discussion see Julie A. Ragatz and Ronald F. Duska, "Financial Codes of Ethics," in John R. Boatright (ed.), *Finance Ethics: Critical Issues in Theory and Practice* (New York: John Wiley & Sons, Inc., 2010).
17. SEC commissioner Richard Y. Roberts, quoted in Leslie Wayne, "A Side Deal and a Wizard's Undoing," *New York Times*, May 15, 1994.
18. Wayne, "A Side Deal and a Wizard's Undoing."
19. Quoted in Craig T. Ferris, "Ferber Judge's Words Are Chilling Indictment of Muni Industry," *The Bond Buyer*, January 21, 1997, p. 27.
20. Warren A. Law, "Wall Street and the Public Interest," in Samuel L. Hayes III (ed.), *Wall Street and Regulation* (Boston, MA: Harvard Business School Press, 1987), p. 169.

21. Michael Davis, "Conflict of Interest," *Business and Professional Ethics Journal*, 1 (1982), 17–27; Neil R. Luebke, "Conflict of Interest as a Moral Category," *Business and Professional Ethics Journal*, 6 (1987), 66–81; and John R. Boatright, "Conflict of Interest: An Agency Analysis," in Norman E. Bowie and R. Edward Freeman (eds), *Ethics and Agency Theory: An Introduction* (New York: Oxford University Press, 1992), 187–203. For criticism of these works, see Thomas L. Carson, "Conflict of Interest," *Business and Professional Ethics Journal*, 13 (1994), 387–404; Michael Davis, "Conflict of Interest Revisited," *Business and Professional Ethics Journal*, 12 (1993), 21–41, with replies by John R. Boatright and Neil R. Luebke.
22. This definition is adapted from John R. Boatright, "Financial Services," in Michael Davis and Andrew Stark (eds), *Conflict of Interest in the Professions* (New York: Oxford University Press, 2001).
23. Rule 1.7(a) of the American Bar Association's *Model Rules of Professional Conduct* labels a situation in which a lawyer represents clients with opposing interests a conflict of interest.
24. *Matthew* 6:24. "No man can serve two masters: for either he will hate the one and love the other, or else he will hold to the one, and despise the other."
25. Speech by Mary L. Shapiro, president, NASD Regulation, Inc., Vanderbilt University, Nashville, TN, April 3, 1996.
26. D. Bruce Johnsen, "Property Rights to Investment Research: The Agency Costs of Soft Dollar Brokerage," *Yale Journal on Regulation*, 11 (1994), 75–113.
27. James Surowiecki, "Financial Page: The Talking Cure," *New Yorker*, December 9, 2002, p. 54.
28. Daylian M. Cain, George Lowenstein, and Don A. Moore, "Coming Clean but Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest," in Don A. Moore, Daylian M. Cain, George Lowenstein, and Max H. Bazerman (eds), *Conflicts of Interest: Challenges, Solutions in Business, Law, Medicine, and Public Policy* (New York: Cambridge University Press, 2005).