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# Creating an ethical framework for the financial services industry

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# Creating an ethical framework for the financial services industry

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January 2013

The Herbert Smith Freehills and London School of Economics Regulatory Reform Forum held a roundtable event to discuss creating an ethical framework for the financial services industry. The event was attended by senior members of the financial services industry, academics, lawyers and key policy makers.<sup>1</sup> This paper summarises some of the matters discussed, including:

- What does an ethical financial services industry look like?
- How can ethics be instilled?
- Where does the balance of responsibility between firms and individuals lie?
- What should the role of lawyers be?
- Does the regulator need more powers or should it be using its current powers in a different way?
- Is enforcement the right focus point?

The discussion was subject to the Chatham House Rule and as such none of the comments have been attributed to the participants. The views expressed in this paper do not represent the views of the group as a whole.

## **1** What does an ethical financial services industry look like?

It should perhaps be said from the outset that there need not be anything intrinsically unethical about the financial

services industry. The industry provides essential services, which are fundamental to support a modern economy and society, such as safeguarding money and providing domestic lending. However, given the vital role that financial institutions play, the moral hazards may be more acute and it is therefore logical that the industry should be subject to higher ethical standards than other commercial sectors.

The question of what these ethical standards should be, how we judge them, and what we are ultimately aiming for, is central to this debate. When an aspect of the law needs to be determined, there is a mechanism for deciding what the outcome should be. But how should ethics and its grey areas be determined? Should public opinion be the point of reference? To do so could be a dangerous approach as public attitudes can change over time – ethics is not a static concept. Whilst we may agree the norms at a high level, how they are applied in practice will be hotly contested and bitterly fought. We can already see this in the retail sector, where the line between ‘mis-selling’ and ‘mis-buying’ can be closely contested. What constitutes a ‘mis-sold’ product for one person, may be seen as a fair transaction for another. Clients and shareholders can also push firms to conclude transactions or pursue profits at the expense of ethics.

Looking forward to the end picture, the fundamental principles that any ethical financial services industry should instil include:

1. Not pursuing profit at the expense of everything else including reputation.

2. Behaviour that is marked by integrity, fair dealing and acting in the best interests of clients.
3. Commitment to and delivery of technical excellence.
4. Prioritising good ethics over the instructions of clients where they conflict.
5. Looking beyond the question of what is legal – ie, being prepared not to act in a certain way on the basis that it is unethical, even though it is legal.
6. Consistent application of positive ethical behaviour across the industry.

## 2 How should firms and regulators go about instilling an ethical culture?

Building ethical cultures in firms is as difficult to do as ethics are to define. This section looks at the principles policy makers, regulators and firms should consider when building an ethical framework, what the regulatory/legislative approach may be, and what can be done at a practical level.

### What criteria should be kept in mind?

1. For both individuals and organisations, behaviour is shaped by the interaction of internal and external factors. For individuals those internal factors are their own ethical sense; for organisations it is their own structures, systems and culture. External factors in both cases arise from the social context (or as sociologists would say) the “organisational field” in which those individuals and organisations interact with one another.
2. As a result of this interaction, individuals’ personal ethical sense is socially derived. It is shaped by immediate interpersonal interactions and by broader social factors – in particular those of the organisations in which they work.
3. With respect to an organisation’s ethical culture – the “ethical whole” is not the sum of the parts, ie, is not the sum of the ethical cultures of those individuals within the organisation. Organisations are comprised of individuals, but individuals alone cannot necessarily withstand the structures, processes and the ethos of the organisation. As a result, those who may be

quite ethical in their lives outside work may behave unethically in their corporate or professional lives.

4. Organisational structures and processes (notably remuneration structures) are more likely to reinforce self-interested norms rather than those which are ‘other-interested’.
5. Organisations are difficult to manage and run. The leaders of large organisations face the same problem as regulators - thus management based regulation is not a solution to the regulators’ problem. It simply displaces it. Senior managers, like regulators, face problems of:

- seeing and knowing the activities which each is seeking to manage;
- governing at a distance: being able to affect a state of affairs or behaviour from a distance, both spatially and temporally (in the future); and
- scale and scope: being able to do so over a significant number of activities which in themselves may display significant variety.

As a result, internal pronouncements may be misunderstood, may be counteracted by other practices, and simply may be ignored.

6. As a result of these factors:
  - organisations risk sending contradictory signals about what behaviour is expected;
  - individuals lower down the hierarchy may not trust senior management to behave ethically themselves, either in relation to clients or internally; and
  - what it means to be “ethical” is not always clear.

### The response

#### Do we need more legislation?

Some advocate the introduction of more legislation, for example a legal obligation for firms and individuals to have regard to ethics, and/or more personal liability for unethical behaviour. Indeed, two attempts were made (albeit unsuccessfully) to introduce fiduciary obligations into the Financial Services Act 2012. Support for this approach may be drawn from the criminalisation of insider dealing, which had the effect of changing perceptions and conduct for the better. However, ethical duties are already in the regulatory<sup>1</sup> and legal realm and have been for nearly 25 years – they

were first articulated in regulatory rules in 1988, and have been present in equitable duties for far longer. A better view may be that firms may have failed to understand, implement and execute the existing principles, and that the regulator failed to properly supervise, rather than there being a lack of regulation and law.

One important objection to the introduction of a legal requirement to act ethically, is that it would not give guidance as to how a person should behave. Ethics vary according to the issues at hand and are very much a matter of judgement. Arguably, ethics is simply about how a person chooses to act because of who they are, and not because of what they are required to do by law. The more one places a reliance on the law as a substitute for taking responsible decisions, the more one devalues ethics as it then becomes a question about what is required, rather than what is just the right thing to do.

### ***Incentives and levers***

A better angle would be to look at what drives the behaviour of individuals and firms and to examine how those drivers can be leveraged to incentivise ethical action. Firms and individuals are motivated to a large extent by the desire to:

- satisfy shareholders and clients;
- compete against industry peers; and
- maintain positive reputation and public image.

A set of objective indicators of good and poor ethical behaviour could therefore act as benchmarks for firms to compete against one another and could provide an impetus for change. This would not require any significant costs or a change in law. Further, if clients and shareholders make it clear that they expect firms to act ethically, this could also provide a powerful incentive. Changing financial incentives and looking at remuneration structures (currently a fashionable area) will also be a key tool. The FSA enforcement process already publicly “names and shames” miscreants.

### ***Self-regulation***

There could also be a role for self-regulation in this area, with the creation of an industry ethics group to collectively look at ethics across the industry.

### ***Ethical scenario analysis and stress-testing***

Ethical scenario analysis and stress-testing within organisations could also be a way for regulators and firms to examine and address ethical weaknesses, in much the same way as stress-testing for capital and resolution issues operates. The results could have implications for regulatory strategy and serve to increase awareness within organisations. In order to ensure consistency across the industry, we would need agreement on the most ethical conduct and outcomes in the scenarios to be tested – a likely challenge given how difficult it is to define ethics, but the approach could at least raise the profile of ethics within firms and across the industry as a whole, and form part of its dialogue with regulators.

### ***Embed the regulator within firms?***

One possibility is for the regulator to embed staff within organisations. The physical presence of the regulator could help towards raising ethical standards where there are issues. However, this suggestion requires considerable levels of resourcing from the regulator and does not sit comfortably with intention for the FCA to have less routine contact with firms. Whilst it might be possible to achieve these for a small group of domestic banks providing deposit taking services, it is clearly not a practical solution for the conduct regulator of upwards of 28,000 firms. There is also a risk of regulatory capture, although this could presumably be managed.

### ***Translating the principles into practice***

How to translate the principles into practice will be challenging and vary from firm to firm. This section raises some suggestions.

#### ***1. Cultural change and embodiment***

For cultural change to occur within an organisation, it must be stimulated from the top of the hierarchy, ‘mainstreamed’ down and embedded at each level. Responsibility for cultural change cannot be delegated or siloed into compliance or risk divisions. The board must understand the need for an ethics policy and be committed to monitoring its effectiveness. Senior staff, including at board level, must be made an example of if their behaviour falls short of ethical compliance.

## 2. Codification

Many financial institutions already have codes of ethics in place and require every employee to certify on a regular basis that they have read and complied with it. Indeed approved persons are already subject to the FSA's Statements of Principle for Approved Persons and members of trade and professional bodies are also likely to be subject to the body's code of practice. However, as events have shown, simply having a code of ethics in place is not enough. Firms should periodically review their codes and ask themselves whether they:

- address how consumers (not just shareholders) should be protected – not as a token gesture, but in a meaningful way;
- contain clear practical guidance on day-to-day ethical questions in a consistent and rigorous manner; and
- go beyond that which is simply required to comply with the law and regulation.

There is clearly a balance to be struck between prescriptive detail and high-level statements. It is important that firms get it right.

## 3. Education

All firms should be committed to regularly training employees in ethics at graduate level to senior management level, in all areas where the interests of the business and ethics may conflict (eg, product design), so as to infuse a sense of ethical sensitivity. It is difficult to change the way people think and act, but education can help.

## 4. Monitoring and adjudication

Firms should already have systems in place to police compliance with applicable law and regulation and resolve questions where there are uncertainties. However, firms should ask themselves whether their systems enable the discovery, adjudication and resolution of unethical behaviour, as well as technical non-compliance. Firms should also ensure there is an appropriate mechanism for employees to discuss ethical dilemmas and report unethical behaviour without the risk of being penalised. Firms cannot adopt a tick-box approach to compliance if they wish to meaningfully address unethical behaviour. Indeed such an approach is already discouraged by the FSA as it can, and does, enforce against transgressions of its principles in circumstances where breaches of specific rules have not occurred.

## 5. Secondments into compliance functions

The routine secondment of employees in business roles, into compliance functions, could be a way to help align interests in business and ethics/compliance. If such move is made compulsory for career development, this would help to infuse ethical responsibility into those seeking senior positions within firms. The transition would not necessarily be an easy one, and firms should be able to call on the regulator for assistance if required. This is perhaps something that could be achieved on a firm-by-firm basis, rather than being mandated by the regulator. However, the proposal is not without its own risks: Leeson, Kerviel and Adebale were each examples of individuals who were able to exploit their own knowledge of how the control systems worked to conceal their positions.

## 3

## Balance of responsibility between firms and individuals

Both firms and approved persons are subject to a bewildering array of regulatory duties. But, where does the balance of responsibility between the two lie? Firms are vicariously liable for the actions of their employees. But should firms be doing more to encourage employees to take responsibility for their ethical attitudes? To what extent should firms rely on employees' behaviour to be regulated through supervision and enforcement? When an employee seeks guidance as to what course of action should be taken, should they passively receive an answer? In addition to giving guidance on the law and regulation, individuals could be asked: Would you mind if others knew what you want to do? Would you be embarrassed if your actions were publicly known? Who may your decision affect or damage and would they consider it fair? Would you sell this product to your family?

## More disciplinary action and principles?

The FSA has submitted to the Parliamentary Commission on Banking Standards that the regulator should have the ability to take disciplinary action against employees of authorised firms outside the scope of the approved persons' regime, regardless of whether their conduct relates to regulated activities. It is hoped that the FSA will not push for this proposal, given that the extension of the disciplinary regime to such a wide pool of persons could render the disciplinary process of a criminal nature in European human

rights terms, and that a host of safeguards would therefore need to apply which would make enforcement difficult.

The FSA has also proposed (CP12/26) that the FCA and PRA should be able to make statements of principle that cover not only the conduct of persons in relation to their controlled functions, but in relation to any function that they carry on for the firm that relates to a regulatory activity. It is not clear what standards would apply in relation to those other functions.

#### **4** What should the role of lawyers be?

The FSA has recently turned its attention to the role of in-house lawyers in financial institutions. If the disciplinary regime is extended to non-approved persons, and principles are created for approved persons in respect of non-controlled functions, this could have important implications for the position of in-house lawyers.

The value in lawyers is the ability to give impartial legal advice and challenge decisions - to help promote a strong compliance culture and to bring integrity and most importantly objectivity to the business. There are however a number of recent developments (in addition to the FSA's proposed extension of the scope of the approved persons regime) which present challenges to the way financial institutions structure their legal function and the roles which they require their in-house lawyers to perform.

In an SEC case, an administrative judge held that a general counsel who was aware of an issue with a broker and was involved in addressing red flags, effectively became the broker's supervisor because his opinions were viewed as authoritative and his recommendations were generally followed (on appeal, the case was dismissed because the presiding Commissioners failed to reach a consensus). In Australia the High Court ruled that a general counsel, who also fulfilled the role of company secretary, was to be treated as an officer of the company in respect of all of his responsibilities, including those of general counsel, so that the statutory duty of care he owed as an officer by virtue of the national legislation therefore included the duty to take care and employ diligence to protect the company from legal risk in relation to its legal obligations. Finally, recent decisions of the European Court of Justice deny in-house lawyers legal privilege and the right to represent their own firms in proceedings before European courts.

Firms need to consider what role they want their internal (and for that matter their external lawyers) to perform. Should they be advisers to business, or part of the institution's second line of defence? Should they act as gamers to help navigate the rules to facilitate innovation, or rather as gatekeepers, to ensure compliance? Should their role include advice on the ethical implications of decisions, in the same way as they may be asked to advise on reputational risk?

#### **5** Does the regulator need more powers or should it be using its current powers in a different way?

The financial crisis has activated heated debate as to whether the regulator needs new powers, enhanced powers, or whether it just needs to make greater use of its existing powers. The ostensibly new product intervention powers were introduced into the Financial Services Bill with much fanfare. However, what was perhaps overlooked was that the FSA already had powers to make product interventions, and indeed had been using them.

HM Treasury's consultation on "Sanctions for the directors of failed banks" which proposes that a director of a failed bank will be presumed unfit to hold further appointment, also raises questions as to whether these new powers are really needed, or whether they are being sought for political purposes. Arguably it is simply designed to relieve the regulator of the evidential burden of proving fitness. The case for the rebuttable presumption appears to be expedience - HM Treasury's consultation suggests that the presumption would make it easier for the FSA to refuse permission, than to have to go through the current process. And, even more disconcertingly, this appears to be driven by a wish simply to override the presumption of innocence which exists in English (and EU) law. One for discussion ....

As regards the introduction of criminal sanctions, even HM Treasury has acknowledged both that there will be difficulties in bringing such criminal prosecutions (including the time and expense) and most importantly, that it is already possible to bring a civil case. Criminal sanctions do not feature in the proposals being put forward at the EU level in the Liikanen report, which instead focuses on prohibitions and claw back of remuneration as appropriate sanctions. Should that not be enough?

## 6

### Is enforcement the right focus point?

The FSA's "credible deterrence" enforcement policy has in many ways been successful in encouraging people to stop and think, albeit after the event. Perhaps criminal prosecutions would make directors stop and think – although they may stop and think about taking the role at all, rather than about taking a particular commercial decision.

However, is a policy of negative reinforcement the right way to drive long-term change in attitude and behaviour across the industry? Whilst enforcement action may alter the thinking and behaviour of those directly affected, it is unlikely to result in wholesale ethical change. Even if people sit up and take notice of enforcement cases generally, in practice, the risk of regulatory action may not ultimately influence a person's behaviour, particularly if they make decisions quickly and under pressure from external forces.

A degree of negative enforcement is of course necessary. However, this must be accompanied by positive reinforcement of good behaviour, early intervention before issues arise (as the proposed strategy for product intervention), and addressing incentives which motivate unethical behaviour (including, but not limited to, financial incentives).

## 7

### Conclusion

There is little doubt that ethical standards across the financial services industry have been called into significant question across all areas, from the setting of benchmarks including Libor, to sales to retail investors. There is also little doubt that embedding ethical cultures within firms is a difficult task. Whilst regulation has a role to play in providing deterring unethical conduct and promoting appropriate behaviour, ultimate responsibility has to lie with firms themselves, including their shareholders. Firms need to focus on their incentives and remuneration structures to ensure that compliant and ethical conduct is rewarded, and provide clear and practical guidance on how it can be achieved.

## Endnotes

- 1 John Reynolds, co-author of Ethics in Investment Banking was a speaker at the event. We thank him for his contribution.
- 2 For example, Principle 1 of the FSA's Principles for Businesses: firms must conduct business with integrity.

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## Notes





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