Ethics and Fairness in Finance

This discussion provides students with an opportunity to deepen their understanding about the behavioral aspects of ethics and fairness. The discussion begins with ethical issues related to cheating and then explores connections with the ethical dimension of business decisions. The discussion concludes with a general framework for understanding how people think about ethical issues in finance, and the role that perceptions of fairness have on the regulation of financial markets.

A8.1 UNETHICAL BEHAVIOR STARTS EARLY

CONCEPT PREVIEW
Question A8.1

a. During the past year, have you cheated on an assignment, test, or exam?
b. Indicate the extent to which you agree or disagree with the following statement: "When it comes to doing what is right, I am better than most people I know."

Strongly agree___ Agree___ Disagree___ Strongly disagree___

Incidents of student cheating have been increasing. The Josephson Institute of Ethics has been polling students since 1992. In their 2002 study, they reported that of the 12,000 students that they polled, 74 percent admitted to cheating on an exam at least once in the past year.[1] This rate was the highest ever achieved in the survey's 10-year history, although the rate dropped to 62 percent in the 2004 survey conducted two years later. Similar findings for college students are reported by the Center for Academic Integrity, based at Duke University.

How endemic is dishonesty? Students even cheat in courses about ethics. In one incident that occurred at Carleton University in Ottawa, Canada, students cheated by passing off as their own an essay they had downloaded from the Internet. In commenting on the issue, an associate dean of the university indicated that in addition to being disappointed, he was surprised that the students believed they would not be caught.[2]

Being surprised is the hallmark of overconfidence, and in this case the associate dean was overconfident. The 2002 Josephson Institute survey found that 95 percent of those surveyed thought they could get away with dishonest behavior. Moreover, cheating seemed to be worse at religious schools than at nonreligious schools, and the incidence of cheating was higher among varsity athletes.

The Josephson Institute survey does not confine itself to cheating. The 2002 study found that during the year just under 4 of every 10 adolescents acknowledged stealing from a store, and 93 percent confessed that they had lied to their parents or relatives. In the 2004 study, these figures declined to 3 out of every 10, and 82 percent respectively.

Students are the executives of the future. How will they behave when they become executives? In this respect there is cause for concern. Many of the 25,000 students responding to the 2004 Josephson survey were highly cynical about the ethics of successful people. Two-thirds of young males and half of young women believe that "in the real world, successful people do what they have to do to win, even if others consider it cheating." Half the young men and one-third of the young women agree with the following statement: "A person has to lie or cheat sometimes in order to succeed."

Why Students Cheat

Why do students cheat? The Josephson study indicated that the drive toward academic excellence has become a negative excuse for cheating. For example, honors students might justify ethical lapses as a necessity for keeping up with rigorous studies. In other words, a student cheats in order to achieve a particular grade goal, not necessarily in order to avoid a failing grade. This is a reference point issue and relates to prospect theory. If the probability of missing a goal and ending up in the domain of losses is high, aversion to a sure loss can be particularly strong.

Although some people are simply unethical at their core, most people like to view themselves as good and decent. At the same time, self-deception is strong. In the 2002 Josephson Institute report, 76 percent of those surveyed agreed with the following statement: "When it comes to doing what is right, I am better than most people I know." In other words, the overconfidence, better-than-average effect applies in the ethical dimension, even among those who engage in cheating. For varsity athletes and student leaders and honors students, over 80 percent perceived themselves to be better than their peers.

Most people want to be able to look at themselves in the mirror and feel proud of their accomplishments rather than shame. Yet, somehow they wind up sliding down the slippery slope leading to unethical behavior. A major reason is aversion to a sure loss, coupled with self-delusion.

Ethics and Psychology

The bankruptcy of Enron in 2001 was the first among a series of major corporate financial scandals in the United States. Enron's chief financial officer Andrew Fastow pled guilty to a long list of charges for having instituted a series of practices at Enron that enriched him at the expense of Enron's shareholders.

Was Andrew Fastow a villain through and through? Notably, Fastow was regarded as a model citizen in his Houston community, known for being a major benefactor to Houston's art museums, fund-raising for its local Holocaust Museum, and being a cofounder of a synagogue. People recognized Fastow for personal acts of kindness, such as delivering flowers to the house of a banker after his son's baptism. One of Fastow's closest friends, Robert Lapin, was quoted as saying: "The Andy Fastow I know is one of the most thoughtful and generous people in Houston."[3] When one of Lapin's three children was diagnosed with a rare disease, Lapin says that Fastow was one of the first to call and offer to help.

A *BusinessWeek* article about Fastow indicates that old high school friends recall Fastow as "popular and well-liked, though extremely ambitious." And that ambition may serve as the key link between behavioral factors and unethical behavior. Being ambitious typically means setting high reference points when it comes to goals. When someone sets their reference point very high, the result is that many reasonable outcomes get internally coded in the domain of losses. And what do we know about behavior in the domain of losses? In the domain of losses people act as if they are risk-seeking, being willing to accept bad bets, meaning bets that pay off poorly on average.

Does Andrew Fastow have a dual personality? Or was he operating in the domain of gains in his personal life, but in the domain of losses in his professional life? Behavioral studies find that attitude toward risk is contextual. Whether people act as if they are risk averse or risk seeking depends on the particular problem at hand and how they frame the problem.

In July 2002, the telecommunications firm WorldCom (now MCI) became the largest corporate firm to go bankrupt in U.S. history. In yet one more case of control fraud, WorldCom's CFO had misclassified more than $3.8 billion of expenses as capital expenditures, in order to report positive earnings instead of losses. WorldCom's chief executive officer, Bernard Ebbers, was tried and convicted of having oversight for WorldCom's fraud. Like Fastow, Ebbers was active in his religious community, serving as a deacon in his church. However, he was also ambitious.

A8.2 ETHICS, FAIRNESS, AND FINANCIAL MARKET REGULATION

The scandals involving firms such as Enron and WorldCom led investors to experience a crisis of confidence in accounting numbers. The financial services firm UBS, together with the polling firm The Gallup Organization, regularly survey the opinions of individual investors. In July 2002, they found that their index of optimism plunged to an all-time low. In a UBS report describing the main factors underlying this drop, the most prominent item mentioned is "growing concern over corporate accounting scandals." The report states that the "vast majority of those surveyed, 80 percent, cited questionable accounting practices as having a very negative impact on the investment climate."

In the wake of these scandals, Congress passed the Sarbanes-Oxley Act of 2002, directing the SEC to require that the chief executive officer and chief financial officer of every publicly traded firm certify, under oath, the veracity of their firm's financial statements. Sarbanes-Oxley represents yet one more link in the chain of U.S. financial market regulations that have evolved over the course of two centuries. A key theme that pervades the debates that have shaped financial market regulation is the notion of fairness. Fairness is an important issue for corporate executives to understand and serves as a backdrop for their interactions with investors, analysts, customers, and the firm's employees. It is clear from the use of terms such as "moral hazard" that agency conflicts are viewed within the wider lens of ethics and fairness. This section describes the nature of that wider lens.

In order to set the stage for the discussion of fairness, consider Concept Preview Question A8.2.

CONCEPT PREVIEW
Question A8.2

A hardware store has been selling snow shovels for $25. The morning after a large snowstorm, the store raises its price to $35. Please rate this action as:

Completely fair___ Acceptable___ Unfair___ Very unfair___

Next, consider a slightly altered version of Concept Preview Question A8.2.

CONCEPT PREVIEW
Question A8.3

A hardware store has been selling snow shovels for $25. The morning after a large snowstorm, the store places a rush order for new shovels and receives them later the same day. Because of the rush shipment, the store has to pay an additional $10 per shovel in shipping. The store raises its price to $35. Please rate this action as:

Completely fair___ Acceptable___ Unfair___ Very unfair___

Concept Preview Questions A8.2 and A8.3 were originally part of a study on fairness in economic transactions.[4] In the first question, the price increase reflects the normal response to the usual forces of supply and demand. Nevertheless, 82 percent of the respondents in the original study judged the store's action to be unfair or very unfair.

The respondents' judgments about fairness are representative of people's reactions after snowstorms. For example, in January 1998 after a severe winter storm in upstate New York, the New York State Attorney General's office was inundated by complaints about price gouging. Typical complaints involved $500 generators selling for $3,000, price increases for propane and kerosene, and higher rates for hotels and motels.[5]

The presumption in Concept Preview Question A8.2 is that after the price increase, the owner of the store made $10 more in profit when selling a shovel. The presumption in Concept Preview Question A8.3 is that after the price increase, the owner of the store made no more in profit when selling a shovel. The difference is important for people's judgments about fairness. Given the additional shipping costs, about 80 percent of respondents judge it acceptable for the owner of the store to raise the price by $10. In other words, the owner's entitlement to profit now trumps the customer's right to paying the original price. Indeed, in the Upstate New York snowstorm incident just described, owners of stores defended the price increases on generators, noting that they had to pay additional charges in freight.

Behavioral Aspects of Fairness

Notions of fairness impact executives in their principal–agent relationships with investors, as well as their relationships with customers. Understanding the determinants of fairness is crucial. Moreover, principal–agent relationships do not just involve the principal and agent as parties. When the issue is sufficiently important, government officials also become involved, something that executives need to understand.

People feel themselves to be unfairly treated when they perceive themselves to be denied something to which they are entitled. From a behavioral perspective, the entitlement plays the role of a reference point. The denial of the entitlement is experienced as a loss. More precisely, the reference point is really a reference transaction, one in which the perceived entitlement is respected. For example, in Concept Preview Question A8.2 concerning the snow shovel, the typical reference transaction features the price remaining unchanged at $25.

Most people feel that it is unfair for the owner of the store to experience a gain, if that gain stems from the violation of the customer's perceived entitlement. Notice that people who feel they have been treated unfairly seek redress through political and legal channels.

Entitlements

The behavioral approach to fairness seeks to identify how people frame entitlements in terms of gains or losses and how they form judgments about the acceptability of sharing rules for gains and losses among parties.

Entitlements can take many forms. Below are seven categories of entitlements that have played roles in the regulation of financial markets. Each entitlement can be framed in terms of some reference transaction. Some entitlements are relatively innocuous and are consistent with general notions of liberty and freedom. Others are more severe.[6] Although not everyone feels entitled to each of the seven categories listed, each category has played some role in the development of U.S. financial market regulation.

1. **Freedom from coercion:** Entitles people not to be coerced into a transaction and not to be prevented from engaging in a transaction. A transaction is fair when the parties enter into it voluntarily.
2. **Freedom from misrepresentation:** Entitles people to rely on voluntarily disclosed information as being truthful. The scandals at Enron, WorldCom, and HealthSouth are examples of misrepresentation of information.
3. **Fairness in equal information:** Entitles people to equal access to a particular set of information. For example, in 2000 the SEC passed Regulation FD, where the FD stands for *fair disclosure.* Regulation FD requires that when publicly traded companies intentionally release material, nonpublic information to select groups, they must simultaneously disseminate the news to the public, either through an SEC filing or through a press release.
4. **Fairness in equal processing power:** Entitles people not only to equal access to information but also to a "competency floor" of information-processing skills. This class of fairness recognizes that some people commit cognitive errors. Protecting them may take the form of compulsory disclosure (as with interest rates pursuant to the Truth-in-Lending Act) or the outright prohibition of certain types of transactions (for example, trading in options).
5. **Fairness in freedom from impulse:** Entitles people to protection from possible imperfect self-control. Such protection may involve remedial mechanisms, such as laws providing for a cooling-off period during which buyers may cancel an impulsive transaction.

6. **Fairness in efficient prices:** Entitles people to prices they perceive to be efficient. This is the notion of fairness inherent in the term *fair and orderly market,* whereby specialists on the New York Stock Exchange (NYSE) are required to intervene in the event of an order imbalance that might distort prices. In the wake of the 1987 stock market crash, the NYSE instituted rules (80A and 80B) that restrict index arbitrage trading and institutes trading interruptions known as circuit breakers. These mechanisms are designed to reduce short-term volatility, even if that means preventing prices from adjusting to equalize investor supply and demand.
7. **Fairness in equal bargaining power:** Entitles people to equal power in negotiations leading to a transaction. Bargaining power inequality can occur, for example, when one party to a transaction is wealthier than the other. One example of a remedy to such inequality is the interest rate ceilings some states impose on loans.

Fairness and Confidence

Financial market regulations have typically emerged in response to investors' feeling that they have been treated unfairly, leading them to lose confidence in markets. As was mentioned earlier, the loss of investor confidence was a serious issue during 2002 after the accounting scandals involving Enron and WorldCom, not to mention the collapse of the technology stock bubble at the turn of the century. When investors lose confidence, they reduce their trading activity. Sarbanes-Oxley was part of a concerted effort by government and the private stock exchanges to address that loss of confidence.

The Crash of 1987

In a similar fashion, the trading collars and circuit breakers on the NYSE emerged as a response to the loss of investor confidence after the stock market crash of 1987. Indeed, the report recommending these changes to the board of directors of the exchange was entitled "Market Volatility and Investor Confidence."

The Acts of 1933 and 1934

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the cornerstones of U.S. financial market regulation. These acts came into being in the wake of the stock market crash of 1929 that gave rise to four consecutive years of negative market returns. Investors felt that they were the victims of stock price manipulation and insider trading. By-products of these two acts were the creation of the SEC, disclosure requirements for publicly traded firms, the laws regulating insider trading by executives, and the limits on margin trading by investors.

The official reports from the House and Senate on the bills leading to the 1934 Act identify manipulative practices as a key issue. The Senate report[7] mentions that the purpose of the bill is "to prevent inequitable and unfair practices on such exchanges and markets." Among the unfair practices are "fictitious or 'wash' sales, 'matched' orders, or orders for the purchase and sale of the same security emanating from a common source for the purpose of recording operations on the tape and thereby creating a false appearance of activity; and other transactions specifically designed to manipulate the price of a security."

The notion of unfair practice described in the Senate report applies to the operation of Enron Online (EOL), the online trading business that Enron established. EOL can be thought of as a kind of eBay for energy trading, but with one important difference. Enron did not just operate the trading system. It was an interested party that had complete information about every market position. As such, it engaged in practices to manipulate prices.

The 1934 House report[8] identifies accounting as a key issue, stating: "It has been said a hundred times that accounting is a matter of conventions, and it is questionable whether these conventions have kept pace with the changes in modern business conditions."

The report goes on to quote the president of the New York Stock Exchange who stated:

> The public, today, insists upon more complete and accurate financial statements from publicly owned companies and I am sure that the officials and directors of these corporations, realizing the reasonableness of the demand, will furnish investors with adequate information. There have not been many instances where the failure to give complete information was due to a desire on the part of directors or officers to secure unfair personal advantage.

As you reflect on this passage, think about the practices of Enron's and WorldCom's executives.

Blue Sky Laws

The acts of 1933 and 1934 focused on disclosure of information, rather than restricting the securities that could be offered in the market. Disclosure represented one philosophy about how to deal with issues of fairness. A competing philosophy is *merit regulation,* which only permits the sale of securities that have "merit." Between 1900 and 1910 the price of farmland doubled in the state of Kansas. During that period, many fraudulent investment schemes were foisted on naïve investors. It was said at the time that the purveyors of these fraudulent schemes were so barefaced that they sold "building lots in the blue sky." These schemes led to a fall in investor confidence, and the state of Kansas reacted by passing merit regulations that came to be known as *blue sky laws.*

---

[1] See **www.josephsoninstitute.org.**
[2] See "30 Students Accused of Cheating on Ethics Essay," *National Post,* March 27, 2002.
[3] See Wendy Zellner, Mike France, and Joseph Weber, "The Man behind the Deal Machine as Creator of Iffy Enron Partnerships, Ousted CFO Andrew Fastow Is a Prime Target for Investigators," *BusinessWeek,* February 4, 2002.
[4] See Daniel Kahneman, Jack Knetsch, and Richard Thaler, "Fairness as a Constraint on Profit Seeking Entitlements in the Market," *American Economic Review,* vol. 76, no. 4, 1986, pp. 728–741.
[5] See Tony Fong, "Price-Gougers Cash in on Victims' Dire Needs: the Attorney General Wants to Track Down Those People Taking Advantage of Others," *The Post-Standard Syracuse,* January 14, 1998.
[6] See Hersh Shefrin and Meir Statman, "Ethics, Fairness and Efficiency in Financial Markets," *Financial Analysts Journal,* vol. 49, no. 6, 1993, pp. 21–29.
[7] Item 17. Senate Report No. 792, 73rd Congress, 2d Session, to accompany S. 3420, April 20, 1934.
[8] Item 18. House Report No. 1383, 73rd Congress, 2d Session, to accompany H.R. 9329, April 27, 1934.