Fair and Effective Markets Review ("FEMR")

Consultation Response by the Law and Ethics in Finance Project

1. The Law and Ethics in Finance Project commenced in 2013. A group of people with expertise in the fields of law, finance and ethics met in London in December 2013 for an initial scoping discussion.

2. The Project contributed to the consultation that preceded the Banking Standards Review Report presented by Sir Richard Lambert on 19 May 2014[1]. A pilot Colloquium was held at the Rolls Building, Royal Courts of Justice on 1 July 2014.

3. A Conference was then held at the Bank of England on 20 January 2015, and was addressed by Deputy Governor Shafik. With other senior judges, Lord Thomas, the Lord Chief Justice of England & Wales, attended the Conference and made closing remarks.

4. The Project welcomes FEMR.

5. In this Response to the FEMR Consultation we make a short overall, rather than question by question, contribution. We focus on the contribution to be made by encouraging a culture of ethics in finance. Our contribution is particularly directed to questions 1, 2, 13, 19, 27, 29-33, 38 and 40.

6. Finance has a fundamental role in society. Daily life and business could not function without it. It is key to development. Globalisation has increased its potential to effect change. Yet it has become mired in controversy.

7. The contribution made by the financial system can be improved by addressing what has been variously described as professionalism, standards and ethics. The Conference on 20 January consciously took as its title the perceptive phrase used by the Governor on a previous occasion[2] - "Seeking to re-establish finance as a true profession, with broader societal obligations".

8. We recognise of course that the law has a central role to play. The Lord Chief Justice has emphasized the importance of prosecuting fraud in financial markets.[3] Substantive reform of financial regulation and supervision has been the essential policy response to the crisis.

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[1] The Project's response is at http://www.bankingstandardsreview.org.uk/assets/docs/responses/Law%20and%20Ethics%20in%20Finance%20Response.pdf

[2] At a Conference on Inclusive Capitalism, London, 27 May 2014: http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech731.pdf.

[3] Reshaping Justice, 3 March 2014, lecture to the organisation "JUSTICE".

9. But at the same time, laws and regulations are limited by what they say. They tend to set standards of conduct below which one must not fall, rather than to which one might strive. A sanctions-based approach, seen in laws and regulations, will condemn the bad, but not necessarily develop the good. And regulatory arbitrage sets about avoiding laws and regulations.

10. The greater the volume of laws and regulations, the greater the risk that they are treated as complete, or that they leave no time for anything beyond compliance. For example, there are real risks in this regard from the complexity, and on occasion uncertainty, involved in the type of regulation that is seen in MIFID and AIFMD, each referred to the Consultation. Apart from the impracticality of constructing rules covering all possible behaviour, over-prescription gives rise to compliance difficulties as well as a sense of diminishing returns.

11. There is an emerging consensus that what might be termed a culture of ethics is needed as well. By this we mean a whole-sector culture, not a firm-by-firm culture. And we mean a culture for all—within firms, ethics are not to be left to or delegated to legal or compliance functions; culture involves leadership, training, corporate environment and more. It is not sufficient to look to the law alone in the form of financial regulation and otherwise to remedy the shortcomings.

12. What kind of culture should it be? Treating customers fairly and avoiding socially excessive risk is an important part of it[4], but it goes beyond this to encompass the broader societal obligations inherent in a responsible system of finance (see the Governor's remarks cited above).

13. Codes of conduct promulgated by firms and by market organisations can play an important role not least because market participants can understand and take ownership of them.

14. In this connection the Project undertook an initial survey of codes created by financial institutions across the world. This showed[5]:

    - A wide divergence in compass, length, terminology, objective and audience.

    - Different reasons given for providing codes – many banks state that they are necessary for the good of the business, as well as client welfare, the interest of shareholders and the welfare of staff.

    - Reference to the benefits for wider society tended to feature less widely, although examples do include "part of the change that is happening … is to consider the broader societal impacts of what we do", the need to respect the interests of "society as a whole", playing "an important role in supporting the growth and

[4] Dan Awrey, William Blair, and David Kershaw, *Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?*, 38 DEL. J. CORP. L, 191 (2013).

[5] Details of the survey are available by contacting Roland Susman on roland.susman@hotmail.co.uk or Dr Costanza Russo on c.a.russo@qmul.ac.uk.

stability of the economies in which we trade" and "commit[ing] to a culture that is sensitive to the society in which we operate".

- Codes are treated, directed and implemented differently within companies and sometimes it is not clear why: for instance in some, codes are part of the terms of employment and their violation could lead to dismissal; in others, there is no mention of the internal governance and applicability of the code; yet others have different "ethical policies" for their banking and for their securities activities; some banks overlap codes of conduct with CSR codes and some do not.

15. In principle, there is merit in developing a single global approach commanding broad-based industry support. We support FEMR's suggestion that a global code be developed "written by the market in terms that market participants understand"[6]. In this connection and others, the BSRC has a most useful role to play.

16. We add a note of caution when FEMR talks of "giving codes teeth"[7]. That can suggest a code that is like a mandatory regulation. However principles expressed in codes are not the same as legal rules.

17. It can also suggest a code that is about minimum standards of conduct. The value of a code can come through the aspiration that it articulates to the highest standards of conduct.

18. It is one thing to create a Code which defines higher standards, and another thing to embed it. In this connection, FEMR rightly talks about the importance of communication to trading teams[8]. But communication is simply the first step in a process towards embedding so that the code supports cultural change.

19. In truth, embedding higher standards is likely to involve a mix of things—codes, role models (including "tone from the top"), training, membership of professional bodies where appropriate, and the development of success measurements additional to profitability alone. These can all help towards a culture of ethics.

20. We believe a consensus is in the course of emerging. We believe that the embedding of higher standards in the way we have been describing:-

    - should be forward rather than backward looking
    - should recognise the place of finance in society
    - should be driven by aspiration
    - should avoid giving rise to another layer of regulation

[6] FEMR Consultation executive summary

[7] FEMR Consultation para 5.4.3(c).

[8] FEMR Consultation para 5.4.3(d).

- should be pragmatic, market-based and international in approach

- should be seen as a badge of success

21. On the third of the points just mentioned ("driven by aspiration"), we emphasise that where FEMR notes[9] references made to "poor standards", "weak cultures" and "poor personal ethics", the range of solutions is not confined to "penalties for wrongdoing" or solutions which depend on "surveillance". They include identifying and developing drivers for aspiration to the highest standards, a strong culture and strong personal ethics, and engaging the power of self-review.

22. Two valuable papers were delivered at the Conference; one by Deputy Governor Shafik and one by Thomas C. Baxter, Jr, General Counsel and Executive Vice President of the Federal Reserve Bank of New York. Each is available to FEMR[10].

23. The Conference drew out these points, among others:

    - There is a public interest role for finance.

    - Cultural change is not a soft issue. A methodical and information-led approach is possible; exposing the differences between the status quo and objectives and creating programmes to achieve change from the former to the latter; monitoring what is happening. Leadership from the top is central. And the message must get across the middle and lower levels of employee who will be those that eventually will implement the ethical lead given.

    - A profession recognises an ethical standard that goes beyond legal duties.

    - A profession tends to be defined by service, and this illustrates the challenge especially where the financial activity is proprietary.

    - Other professions – for example the law and medicine and education – tend to have an embedded understanding of the importance of the integrity of the system as a whole. In them leadership, role modelling, training and support, and bottom-up initiatives can lead to change.

    - Looking back in the history of finance it is possible to find emphasis and training on service and values, on pride in the industry in which one works, and on probity and trust.

    - Consideration needs to be given to the question whether finance is one or a series of professions. There are differences in the challenges in, for example, retail banking and investment banking.

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[9] FEMR Consultation executive summary and sections 5.4 to 5.6. See also Table A to the FEMR Consultation.

[10] Mr Baxter's paper "The Rewards of an Ethical Culture" is at http://www.ny.frb.org/newsevents/speeches/2015/bax012015.html

- Credible regulatory deterrence remains important; enforcement is important but insufficient and possibly only retrospective.

- The focus on misconduct must not prevent ethics from surfacing and playing its full role alongside regulation.

- A challenge is the fact that many market participants do not see the impact of their actions (positive or negative).

- It is important to develop incentives other than financial incentives. Can we develop altruism through incentives, or are we confined to restraining self interest?

- Reputation is a considerable force, and it can harness constructively with self-interest.

- Leadership from the top, by actions and not just words, has a crucial part to play; but examples must be set and encouraged at all levels in an organisation; young people can act as a strong force for change.

- Some consideration should be given to the question whether the shareholder model, and existing company law obligations, serve higher ethical standards.

- There is shared international interest in the subject area at this time.

24. Follow-up remarks after the Conference have remarked on the positive aspects of the UK markets providing a lead in this area, and appreciation of the fact that this is being done. The next steps are likely to involve the internationalisation of the subject, since the same principles are likely to be applicable elsewhere.

Sir William Blair
Sir Ross Cranston FBA
Sir Robin Knowles CBE[11]
Dr Costanza Russo[12]

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[11] Each judges of the Queen's Bench Division.

[12]. Lecturer in International Banking Law and in Business Ethics and Deputy Director of the Institute for Regulation and Ethics at the Centre for Commercial Law Studies, Queen Mary University of London.