INTRODUCTION

Working at a successful hedge fund bestows upon members of the team not only attractive compensation but often a stream of perks from brokers eager to sway trading business their way: dinners in high-end restaurants, open bar tabs, and the occasional round of golf or outing at sought-after sporting events. Not so at Watermark Group, a long-standing Princeton-based hedge fund. When an investment analyst broke an internal rule against broker favors by accepting US Open tickets from Lehman Brothers, co-founder Andy Okun insisted that the analyst pay back not simply the ticket's face value, but its (much greater) scalp value. It took months of prodding for Lehman to cash the check.[1]

Okun, an energetic intellectual who would more naturally fit in an academic setting than a hedge fund, quietly rages at the extent to which the finance industry has entangled itself into conflicts of interest and become increasingly self-serving. Coming out of Salomon Brothers' famed fixed-income arbitrage group, Okun and his co-founder Stephen Modzelewski wrote their client terms on a blank sheet of paper based on first principles rather than industry standards. Their terms were skewed in favor of their clients, even in the fine print. They cared about creating reciprocity between the fund manager and its clients. For close to twenty years, this meant for Okun and his partners not simply retaining a share of clients' profits in good years but *paying back* to clients a portion of losses in unprofitable years from their own savings – a complete outlier in the industry. Okun, who now runs the fund on his own, would come across as eccentric, and perhaps even self-indulgent, to many hedge fund managers.

For an industry whose hallmark traits include being nimble and creative, there is a noticeable homogeneity across hedge fund fee structures, with few outliers. I queried on separate occasions the heads of the two leading prime brokerage departments in New York, who both have a commanding view of the hedge fund industry since they act as the gate-keepers for all the services their banks provide to hedge funds, if they could point out fiduciary leaders in the universe of hedge funds. Both drew blanks. Whether in the hedge fund industry, investment banking, or most other parts of the finance industry, the trend has been toward obsessive short-term profit maximization, often at the expense of clients.

Why is it worth pausing on Okun's client terms, a technical and pedestrian aspect of his fund? Because they carry meaning by deviating from the norm. Vulnerable to conflicts of interests, hedge funds are often characterized by complexity, opacity, and information asymmetry between fund managers and their own investors. Terms and the accompanying fine print typically embed a bias in favor of the fund manager rather than the client.

Most hedge fund managers would agree on several characteristics that would enhance returns to their clients, including, at the top of the list, lower fees and a cap on assets under management. Yet, successful hedge funds almost always end up eventually disregarding these best-practice guidelines. What distinguishes those who breach them from those who don't is often simply the fact that they can: the temptation is too great, the rewards too outsized to resist.

Okun obsesses about serving his clients faithfully, even in areas where the client might not notice. His motivation to offer terms favorable to his customers is not driven by commercial considerations – he is convinced that clients are not swayed by better terms, at least in his narrow field. Rather, he took a stand against industry norms to express his values, at the cost of leaving money on the table.

Okun's departure from the crowd raises the question of what makes a finance professional virtuous. At a minimum, his claim to virtue as a finance professional stems from carrying out his professional mandate to serve his customers purposefully, by prioritizing their interests. And while the earnest and diligent fulfillment of that client responsibility is critical, and arguably the most important way in which a finance professional can contribute to society, being a virtuous finance professional can be defined more broadly.

Consider Frédéric Samama, a manager at Amundi, a large French asset manager, who became convinced that the forces of commercial finance deployed to serve his bank's clients could be harnessed to address social and economic problems, in conjunction with the bank's client mandate.[2] In the late 2000s, he took it upon himself to convene financiers and academics to reflect on ways in which long-term capital holders could solve various market failures, including climate change.

In partnership with Patrick Bolton, an economist at Columbia Business School, and Mats Andersson, the then head of Swedish national pension fund AP4, Samama and his team became pioneers in embedding environmental, social, and governance (ESG) factors in investments. They developed the first mainstream low-carbon equity index, in partnership with MSCI, paving the way for a new market in low-carbon or "decarbonized" exchange-traded funds (ETFs). That market has gained considerable traction, under the premise that capital allocators can make passive investments that will apply pressure on listed companies to lower their carbon footprint, with either no or a positive impact on their investment returns.

Erin Godard illustrates yet another approach to contributing to society as a finance professional. Early in her career as an accountant in Toronto, she became convinced of the linkages between accounting and economic development after spending a summer volunteering in Kigali.[3] In a developing economy such as Rwanda, many firms and not-for-profits founder because of the pervasive lack of financial training and experience. Having a weak or non-existent accounting system creates permanent managerial confusion, preventing organizations from functioning sustainably. With only about 400 Certified Public Accountants (CPAs) in a country of twelve million, few Rwandan organizations can be managed efficiently. At the age of twenty-eight and with only five years of professional accounting experience, Godard moved to Rwanda, partnering up with another Canadian accountant to create an accounting training institute. In doing so, she is helping address a gaping hole holding back Rwandan firms, while contributing in a small but tangible way to the development of Rwanda's middle class by creating a path for young men and women to become accountants.

As finance professionals, Okun, Samama, and Godard have distinguished themselves in the way they contribute to society, yet they have done so taking completely different paths. They share a willingness to challenge industry standards and traditional definitions of success. To new entrants into the industry, they don't fit any recognizable patterns, because no parameters have been developed to assess how, in today's finance industry, individuals can pursue enduring careers that contribute to society and reflect humanistic values. Practitioners seldom question whether industry norms reasonably serve customers. They rarely stray outside of their increasingly narrow silos to question the impact of their work. In a variation on an old saying, what is good for Goldman Sachs or Citadel is assumed to be good for society. But that is not systematically the case.

In this book, I propose a simple framework to assess in a structured manner how finance professionals affect others, and I illustrate it with the stories of remarkable individuals. The framework can be reduced to simple messages: Serve your customers faithfully. Do not extract value from others. Treat colleagues with dignity. And, as much as possible, apply your finance skills and resources toward the collective interest. By evaluating personal impact along these four dimensions, the framework addresses how a finance professional can contribute to society, suggesting models of behavior and career paths to do so.

A Piece of the Puzzle

This book does not offer a comprehensive solution to the role of finance in society. It complements the continuous debate on how best to regulate the industry and channel financial institutions to set employee incentives in a manner that can both motivate individual performance and be consistent with collective interests. The framework I propose seeks to influence the behavior of well-intentioned practitioners, while acknowledging that their decisions are largely shaped by standard incentives to maximize short-term profits and tend to be clouded by cognitive biases. Within these constraints, the framework aspires to guide a subset of finance professionals away from self-serving ends toward serving clients and society more earnestly. It intends to spur greater mindfulness of what might constitute virtuous, yet self-interested behavior and an Aristotelian "good life" in the finance industry.

A fundamental context for the proposed framework is that individual behavior is swayed by incentives, which, in turn, are shaped by structural factors – for instance, the legal structure of financial institutions, the contractual agreements between financial institutions and their customers, and the regulations in place. Incentives evolve as these structural factors evolve. Conflicts of interest have proliferated as a result of structural changes experienced by the industry over the past four decades, particularly in the United States and the United Kingdom. A clear example is that of US and British banks and the extent to which their transition from unlimited liability private partnerships up to the mid nineteenth century to limited liability public companies post-1990s has led to a fundamental change in incentives and behaviors.[4]

No longer on the hook for potential losses incurred by their firms, CEOs and their senior colleagues have been Q incentivized to manage them more aggressively, often translating into greater leverage and a potential personal upside that vastly exceeds potential downside, even accounting for situations in which a bank goes bankrupt. The lure of ever-larger bonuses and the prevalence of stock option-based compensation have fueled a drive to boost their firms' share price over short time horizons and to crystallize gains quickly. Angelo Mozillo and Dick Fuld respectively led Countrywide Financial and Lehman Brothers into bankruptcy but still emerged dynastically rich, albeit reputationally impaired.

To be clear, the premise of this book is that finance is a force for good. Popular culture has traditionally portrayed finance as a value-extracting activity, from the historical linkages with usury[5] to the more recent depiction of Goldman Sachs as a "vampire squid wrapped around the face of humanity."[6] But finance underpins economic processes in fundamental ways – by, for instance, facilitating payments, enabling savers to preserve and grow their capital, channeling capital toward productive uses, and creating insurance mechanisms to mitigate the risk of a large loss. Going back at least to the Dutch Republic's establishment of the first modern financial system in the seventeenth century, finance has been a critical driver of economic development.[7] Since the 1990s, empirical research has identified multiple channels through which finance helps society. It spurs economic growth (up to a certain point), promotes entrepreneurship, accelerates the rate of innovation, improves corporate governance, and increases opportunities for low-income individuals, to name a few of its benefits.[8]

At the same time, the impact of structural and behavioral changes on the finance industry's client-serving mission over the past few decades appears to have been resoundingly negative. Wall Street has strayed far from its original mission aimed at supporting the real economy. Its objectives have become increasingly self-serving. Excess risk-taking, a by-product of that shift, led to a crisis that devastated our financial system and felled several of its largest institutions. After years of extolling the benefits of finance, research has shifted its attention to the limits of finance.

It is futile to try to pinpoint a single reason for the industry's turn. One can't bemoan the vanishing culture of stewardship on Wall Street without acknowledging that the financial system has structurally changed. It is not simply a matter of practitioners opting to act in a more narrowly self-interested manner or the industry attracting more self-interested individuals. And the institutional shifts that drove these changes in behavior were justifiable at every step of the way. Starting with Donaldson, Lufkin & Jenrette in 1970, the dominant investment banks publicly listed in order to raise capital and expand the scope of their business.[9] After the first few competitors went public, others were pressured to follow suit in order to remain competitive, especially in capital-intensive businesses such as underwriting.

Does this mean that addressing the industry's ills should entirely concentrate on regulatory solutions in order to fine-tune the industry's structure and incentives? Hardly. Even if regulation is critical, it is simply not enough. In fact, the more precise the rules and regulations, the more they tend to induce a gaming approach – a license to identify ways to skirt the rules or to circumvent them.[10]

The example of "manufactured defaults" induced by owners of credit default swaps (CDS) – a security that provides insurance against the default of a firm's bonds – is a case in point. In one of the most controversial iterations of this trade, Blackstone-owned hedge fund GSO Capital Partners purchased $330 million of CDS on Hovnanian, an American construction company, and extended attractive financing to Hovnanian, contingent on the company voluntarily missing a debt payment in order to trigger a payout from the CDS to GSO.[11] In order to shield Hovnanian from the negative brand effects of a default, GSO asked the company to miss the payment on specific bonds held by a subsidiary, thereby engineering a bespoke default, highly customized to GSO's interests.

To justify previous versions of the trade, GSO effectively argued that we need to see past its manipulation – the net result is that the recipient company ultimately benefits by receiving a cheap loan from

Cambridge University Press
978-1-108-47313-2 — Seeking Virtue in Finance
JC de Swaan
Excerpt
More Information

GSO, subsidized by the losses of the sophisticated financial firms who sold the CDS to GSO. This trade elicited awe from those who see beauty in the technical virtuosity of sophisticated finance professionals concocting bold, path-breaking mechanisms to extract profits from other sophisticated practitioners.[12]

But how can we not conclude that this type of market manipulation impairs the integrity of the financial instruments at stake and their fundamental purpose? Or that it treats in a cavalier manner the duty of good faith and fair dealing which underpins the good functioning of markets?[13] As many have observed, this is not far afield from burning down your own house after taking out insurance on it.[14] Going back to its first foray into inducing a manufactured default with Spanish gaming company Codere in 2013, GSO implicitly took the position that since no rule had considered the possibility that a company would voluntarily default, it was permissible to ask a company to do so as a condition to another loan.

This is by no means an outlier example of ruthless tactics adopted by financiers at the mercenary edge of the industry. As George Akerlof and Robert Shiller have argued in *Phishing for Phools*, deception and manipulation are intrinsic features of our free-market system (which, they recognize, has created unparalleled prosperity in the contemporary world).[15] If GSO had not come up with this clever trade, eventually someone else would have, since any weakness or loophole tends to be exploited given the pervasive pressure to generate excess profits.

Hovnanian's manufactured default triggered an even greater firestorm of criticism than previous examples of the trade such as Codere, because the company was asked to default despite not being financially stressed. In response, an industry group proposed new rules to prevent that particular trade from being deployed again. They stipulate that there should be a relationship between a company's failure to meet interest payments and its financial health. But as Bloomberg columnist Matthew Levine has observed, the new rules narrowly target the particular tactic used by GSO with Hovnanian, leaving the door open to multiple other derivatives of that trade – for instance, the "orphaned" CDS, when a provider of new financing makes it a condition for the recipient to transfer its debt to a new subsidiary, benefiting the sellers of CDS on the old debt, who are left insuring CDS owners against the default of bonds which have now vanished.[16] To the extent that aggressive, sophisticated groups like GSO consider technical loopholes fair game, even if they go against the spirit of fair play, regulation will not stamp out this form of gaming of finance on its own. A broader toolkit is necessary.

Since the time when the industry was dominated by private partnerships, the boundaries of permissible behavior have continuously been pushed toward shorter-term, profit-oriented tactics. As it is shaped by the industry's prevailing structure, set of incentives, and norms, the behavior of finance professionals at any given point in time tends to be broadly consistent. Still, behavior is not entirely uniform. Even if it is affected by incentives, it is not fully determined by them nor is it systematically swayed by the norms set by the most aggressive firms. Presented with the possibility of generating substantial profits from inducing a manufactured default, many practitioners would forgo that opportunity on the premise that it crosses a line.

Along a spectrum, some approach their professional activities with siloed focus and intensity that can easily devolve into self-serving behavior, often unwittingly so – the result is that they "grab what they can when they can," while others endeavor to serve their customers, are mindful of their impact on other stakeholders, take interest in mentoring junior colleagues, and care about contributing to society. This book's proposed framework seeks to inform the behavior of a subset of well-intentioned finance professionals, over the long arc of a career in the industry.[17]

Bounded Awareness

The potential value of such a framework stems from the observation that well-intentioned people can end up making bad decisions. By simply following the rules of the game and emulating successful peers, finance professionals can unwittingly slide into self-serving mode, with little attention devoted to the moral dimension of their decisions and their impact on others. Behavioral ethics, a vibrant area of research, helps explain these dynamics.[18] Cognitive biases influence people's decision-making process. Situational factors have a considerable impact on these biases. Finance professionals may be particularly vulnerable because the industry offers unusually fertile grounds for these biases.

Consider, for instance, the finding that time pressure and stress – hallmarks of a large portion of the finance industry in which deal or market dynamics predominate – tend to impair people's ability to act ethically.[19] More broadly, finance can accommodate and even fuel people's propensity to self-serve because of its complexity, opacity, and the frequent asymmetry of knowledge base between finance professionals and their customers.

Finance professionals are also susceptible to slippery slope biases, which lead well-meaning people to incrementally cut ethical corners and, at times, not notice for extended periods of time that they have allowed themselves to slip from initially pedestrian ethical lapses to major breaches of trust.[20] Companies beset by accounting misstatements often start by adjusting their numbers to manage earnings within the confines of accepted norms in order to meet earnings expectations or other benchmarks and eventually creep into more aggressive, intentional actions that are fraudulent.[21]

Motivated blindness, or the tendency to screen out others' unethical behavior when acting upon it would impair the interest of the observer, especially affects auditing firms and rating agencies. Both are hired and paid by the firms they are mandated to monitor and evaluate. Auditors may find it to be in their interest to disregard anomalies and turn a blind eye to small transgressions. In doing so, they are at risk of becoming captured by their customers and assimilating their clients' cognitive biases.[22]

This tendency helps explain why Arthur Andersen failed to take action on Enron's fraudulent accounting – leading to one of the most spectacular corporate collapses of the past decades in the United States, or why PricewaterhouseCoopers didn't identify Satyam Computer Services' massive accounting manipulation, signing off on the reporting of a fictitious USD 1 billion in cash on its balance sheet, in a fraud that spanned a decade and shattered one of India's most prominent corporate champions. In the same vein, feeder funds channeling capital to be managed by Bernie Madoff were highly incentivized by lucrative management and incentive fees to remain oblivious to the implausibly consistent high returns and low volatility of Madoff's portfolio.[23]

In many instances, sophisticated, well-meaning professionals end up making decisions which an outsider with the same level of financial sophistication and ethical proclivity would find indefensible – and yet, they often ardently rationalize those decisions. In the run-up to the Global Financial Crisis, Goldman Sachs professionals marketed to clients long exposure to the US subprime mortgage market via Abacus, a synthetic collateralized debt obligation (CDO), without disclosing to them that the security had been primarily designed by a fund whose intention was to short it, meaning that its value would decline, nor that Goldman Sachs as an institution was massively shorting that market. After several of its clients were wiped out soon after gaining exposure to either Abacus or similar securities structured and marketed by Goldman Sachs, Goldman executives vigorously defended their actions as well within the bounds of what is not only permissible but expected of an investment bank in that situation.

Finance professionals are also prone to conformity bias and the tendency to be overly obedient to authority. Unethical behavior can be "contagious."[24] An employee may feel that as long as management is pushing for a certain approach and colleagues or peers are adopting it, then there is little need to question the activity's underlying premise. At Wells Fargo, unrealistic cross-selling goals which were aggressively pushed through the retail business led to the creation of 3.5 million fake accounts by customer representatives who were driven to meet institutional objectives and avoid running afoul of an unforgiving corporate culture. The few employees who sought to ring alarm bells were either ignored or fired.

Finance creates conditions that facilitate bounded awareness, which occurs when people fail to incorporate into their decision-making process critical information that is available to them, due to blind spots.[25] The web of incentives, conflicts of interest, and pressure under which finance professionals operate often prevents them from being able to objectively evaluate their actions.

Much attention in behavioral ethics research is now devoted to identifying how best to utilize the considerable insights developed on cognitive biases to improve decision-making. Important channels include applying this understanding to nudge decisions toward desirable personal or social outcomes with the use of "choice architecture," which carefully calibrates how choices are presented and questions are asked – a concept popularized by Richard Thaler, Cass Sunstein, and John Balz.[26] Checklists can be helpful in explicitly raising issues that might otherwise be glossed over by cognitive limitations.[27]

Many of the behavioral solutions to improving finance's capacity to serve society work toward creating greater awareness among practitioners. This book's framework is one tool in that arsenal. It will not resonate with those who are well aware of their transgressions – the