Preface

In the foreword to its March 2018 discussion paper on 'Transforming Culture in Financial Services', the Financial Conduct Authority writes that 'Culture in financial services is widely accepted as a key root cause of the major conduct failings that have occurred within the industry in recent history, causing harm to both consumers and markets. For markets to work and firms to be successful, it is critical that they are seen as trustworthy.'[1]

These ideas have become widely accepted in recent years, not least because of the lead given by central banks, regulatory agencies such as the FCA, and leaders of financial institutions themselves. The challenge after the global financial crisis – which has heightened the discontent that arises from income and wealth inequality – is how to reconnect the interests of bankers and financiers with the interests of society. At the heart of the debate is an understanding that the law, in the form of financial regulation, and in the form of soft as well as hard law, can never by itself raise standards in the industry. Furthermore, in a globalised financial industry, where problems in one country or group of countries quickly spread to other countries, there is a need to achieve a degree of convergence to avoid opportunities for regulatory arbitrage or a rush to the bottom in the search for profit.

The law is concerned to establish minimum obligations, a legal floor if you will. The role of standards, culture, incentives, ethics, trust – whatever term is used – is to build on that floor. The aim is to encourage the pursuit of business in a manner which pays due regard to 'doing the right thing', as well as societal needs, without imposing a further raft of obligations and complication on already burdened financial business. This is in the interest of the business of finance, which overall has made such a major contribution to the contemporary world, as well as to its multiple users.

This is however, also in the interest of financial markets as a whole, whose integrity is premised upon existing trust among participants. Therefore, any breach of that trust harms its proper functioning.

More recently, instances of interest rate rigging and mis-selling of payment protection insurance exposed how lack of integrity can have harmful repercussions on both banks' financial health and on the industry's reputation as a whole. Equally important is the impact that misbehaviour can have on the trust society places in the sector. Therefore, given that the positive role finance plays in society finds no easy substitutes, it is imperative that industry and regulatory efforts are successful in rebuilding that trust and creating a financial system which is fair and effective for all.

Of course, such an approach raises many questions. What do we mean by 'doing the right thing'? How can one quantify trust? Can these ideas be practically implemented? Will they make a difference?

[1] FCA, Transforming culture in financial services, DP 18/2, March 2018, 2, available at www.fca.org.uk/publication/discussion/dp18-02.pdf.

This Research Handbook investigates five main aspects of the debate. Its underlying theme though relates to the role as well as the (inherent) limitations that law, regulation and standards have in changing conduct and behaviour.

Part I explores the philosophical, legal and soft law foundations of ethical behaviour in finance. To this end, Tan Bhala's contribution considers deontology, virtue ethics, and the utilitarian and justice theories to explain why financial ethics has been largely absent from the financial discourse. She also argues that the two main reasons for the neglect and outright dismissal of financial ethics are Ethical Relativism and the findings of Modern Finance Theory.

Blair and Barbiani's chapter shifts the focus to the recognised role of standards in enhancing ethical culture and questions whether the new architecture may be producing inconsistencies and confusion due its complexity. Their work considers the interaction between industry-based and regulatory-driven initiatives and identifies the limits posed by the existence of different instruments aimed at regulating conduct, with distinct implications in terms of enforceability. While the significance of the role of standards has been broadly recognised, what remains unclear is whether the new framework created to enhance their role is being shaped adequately, or whether it is producing inconsistencies and confusion due to its complexity.

This chapter also focuses on the rise of a regulatory framework enhancing ethical values such as honesty, integrity and fairness. The new emphasis shows a move towards the recognition of the importance of these values, but, at same time, the process of placing them in the regulatory framework also raises new questions: how is it possible to expect people to respect these values and translate them into ethical conduct? And, also, how can we ensure that people develop a common and clear understanding of them?

Lastra and Sheppard consider how after the Great Financial Crisis, one of the relevant issues that has emerged in the design of financial regulation is the question of the *telos* or end of financial law.

Drawing on the Aristotelian tradition and the notion of the common good, they identify the principles of justice, prudence (underlying both macro- and micro-supervision) and integrity (underlying the conduct of business regulation) as key foundations of the relevant regulatory framework, one in which the interests of bankers and financial market participants (in particular, those in senior management) are realigned with the interests of society.

The second part of the book delves into the regulatory and self-regulatory framework governing ethical behaviour to investigate its efficacy as well as its potential to nudge institutions towards sustainable finance.

In this section, the chapter by Hunt et al. highlights how regulation and self-regulation could and should bolster a shift towards ethical finance which pays attention to sectors of society normally excluded from banking services. This in turn means, first, 'nudging' ethical niche banks towards self-sustainability choices, and, second, helping all other banks to pilot a transition towards more socially responsible and inclusive banking.

Rouch gives substance to a concept recently advocated by regulators and academics alike, namely the idea that financial institutions need a social licence to operate. Yet, can that be found in the law, regulation or standards? By using a 'written standards map' of financial sector laws, rules and codes of practice, this contribution considers the extent to which each category of written standards could be thought of as being part of a social licence; how they might express the substance of a social licence and how they might help to realise its aspirational dimension.

Standards applicable to the sector often come from professional bodies, such as the Chartered Banker Institute and from newly created bodies, such as the Fixed Income, Currencies and Commodities Markets Standards Board (FMSB).

The CEO of the Chartered Banker Institute, Simon Thompson, brings in the practitioner's perspective on the establishment, challenges, development and implementation of professional standards. However, he also covers the almost unchartered territory as to whether banking as a whole can or should be considered a profession.

Wood's contribution clarifies how the rule of law applies to money, finance and banks, where the principles often seem so remote from ordinary rule of law principles.

Finally, the Chair of the FMSB, Mark Yallop throws us back to a remote past to discuss some historical cases of market abuse. This puts the current debate into a wider context by discussing the serious limitations in using regulation and legislative measures to cure the problem and how newly introduced standards and markets codes can help alleviate it.

The third part of the book deals with some inherent limitations of the law in counteracting unethical behaviour. The scope is also enlarged to include ethical matters that may arise at sovereign level.

For instance, Buchheit discusses the tensions faced by a lawyer defending an insolvent state with regards to the fairness of intergenerational debt.

The author draws from his own experience as a leading lawyer in sovereign debt litigation to acknowledge how identifying the client in a sovereign engagement raises issues of fundamental political philosophy. In particular, it calls into question the relationship of a government to its citizens and what duties, if any, are owed by one generation of citizens to succeeding generations.

In this regard, discussion revolves around several questions, such as 'which citizens?', the existing body of citizens or future citizens as well? May a lawyer ethically assist a government in borrowing so much money that successor generations of citizens in the country must either default on the repayment of those loans or significantly impair their own standard of living in order to honour the debts? Or is the moral choice to withhold assistance today, even if it means increasing the suffering of the current citizens, in order to hasten the day when they and their successors can throw off the incubus? Finally, accepting that some degree of government corruption exists in most countries, what are the ethical implications for lawyers seeking to advise those sovereign clients?

Plato-Shinar's contribution deals with the thorny issue of the applicability of fiduciary duties to the banking sector. Fiduciary duties are the strictest duties that exist in the realm of private law. The fiduciary must act in the best interests of his principal, and prioritise these interests over every other interest – including his own. Hence, the reluctance to apply a fiduciary duty to banks, whose goal is to make profit. However, the fiduciary duty of banks should not be construed as an altruistic duty, but rather as a legal instrument designed to ensure a basic level of professional ethics in the activities of the banks. Based on this perception, the chapter calls for imposing a wide fiduciary duty on banks towards retail customers, due to the disparity of power between the parties and the fear that the bank could exploit its power to the detriment of the customer. The chapter examines the implications of establishing the fiduciary duty as a general guideline for the behaviour of the banks, and outlines the recommended format for ethical and legal implementation of such duty.

In concluding the third part of the book, Zotiades vividly analyses the trading malpractices affecting open-ended funds known as 'late trading' and 'market timing'. The author's aim is twofold: first to shed light on what these practices are (and are not); and second, to review the regulatory response to them in Europe and reflect on its adequacy and on how that response fits with our treatment of other forms of what we now call market abuse. The chapter illustrates how an incomplete perception of these practices, exemplified also by the use of the term 'market timing' to refer to them, has led to loopholes which are still being exploited today.

Part IV investigates the effectiveness of regulatory and supervisory actions in tackling unethical behaviour and lack of individual liability.

Brener's chapter discusses the recently enacted Senior Managers Regime (SMR) in the United Kingdom. The regime originates from the FCA and the PRA and applies to all firms operating in the financial sector. The SMR has three components: the clear allocation of responsibilities on a senior manager (with a mapping of their functions), the corresponding manager's liability in case of regulatory breaches within their functions, and the certification regime.

The aims of the SMR are: to change behaviour in financial services firms by clearly setting out regulatory expectations; making individuals personally accountable; and helping to assuage public anger by taking regulatory actions against those individuals who fail. However, the author argues that the efficacy of the regime may be hampered by the existence of individual psychological limitations and institutional structures. Financial regulation will never be fully effective if there is no substantial change in the culture of financial services in order to ensure that individuals acquire an ethical understanding of their own actions. This requires leadership and action by both the regulators and more importantly the firms themselves. Equally important is the need for professionalism, which is an aid to both improving competence and to developing and sustaining ethical behaviour. All these aspects can be buttressed by the regulators but require firms in the industry to act themselves, as the remedy rests with the industry in the end.

Georgosouli discusses one of the objectives of enforcement, namely credible deterrence. According to current orthodoxy, deterrence is credible when it is visible and visibility calls for enforcement action that is harsh enough to be taken seriously by the industry.

In this chapter, the author argues that the focus on enforcement is misplaced because, when it comes to the question of credibility, at best it tells half the story. The credibility of deterrence is contingent on a multitude of factors. In the chapter, she considers three of them, all of which are closely inter-related: the regulator's capacity to attain a congruence of minds and a congruence of hearts with the regulatees, and the regulator's ability to harness its profile as a credible enforcer.

To conclude Part IV, Goldby critically analyses UK regulators' approaches to breaches of anti-money laundering (AML) reporting obligations by bankers.

The need to ensure a high level of compliance with reporting requirements is key to the achievement of the objectives of AML legislation, however the author argues that failure to use enforcement measures that involve criminal prosecution may be precluding the change in corporate culture required to reduce the prevalence of money laundering through the UK financial system. She concludes by outlining the reasons why reform might be desirable as well as some possibilities for reform.

The last part of the book covers an aspect usually absent in the debate, namely the extent to which regulators behave ethically and how do they deal with apparently conflicting ethical principles in their supervisory actions.

To this end, Baxter examines whether central banks need to be mindful of their ethical culture. This contribution concludes that they face significant adverse consequences if they fail to do so. After establishing the factual predicate that central bank officials do occasionally engage in misconduct, it turns to the related topic of central banks and legitimacy, and offers the view that the objective of legitimacy and the related need for public trust makes it especially important for central banks to pay careful attention to misconduct risk. The chapter identifies some of the techniques that central banks use to mitigate misconduct risk, and the principal measures that may be employed to accomplish this objective.

Monteagudo discusses the specific tension between transparency and confidentiality of central bankers. Transparency is considered a crucial component of central bank independence as a means to make up for its 'democratic deficit'; and central bank intervention during the global financial crisis has reinforced this general perception. International organisations and domestic legislation have developed transparency standards to communicate policy objectives and results, in addition to a general evolution in favour of free access to the information in the hands of public bodies. But the 'transparency revolution' has not swept away central banks' confidentiality mandate, based upon professional secrecy, private rights protection of privacy and trade secrecy, and the need to protect central banks' capacity to continue collecting statistical data.

Discernment on when to be transparent or confidential requires a high level of wisdom and experience; but mostly, it requires a significant dose of ethical considerations to determine when the public interest prevails over the private interest and to explain the reasons for making one or another choice.

The legislation and case law show that the assurance of monetary policy effectiveness (as a public interest) is a significant consideration.

Finally, Russo covers some past concerns that have arisen from enforcement action as well as the importance of an appropriate legal framework to establish public trust in regulators.

The current FCA enforcement framework has been repeatedly amended to reflect and address those concerns. Yet enforcement is not a straightforward process and there may be a difficult balance to strike between different regulatory actions. After discussing this tension and the recent amendments to the Decision Procedure and Penalty Manual and to the Enforcement Guide, the chapter analyses ethical problems associated with enforcement, particularly with respect to settlement and private warnings. It is then argued that FCA efforts to become more transparent and to actively address criticisms certainly represent the right course of action. Regulators enjoy a vast amount of power and discretion, and should be held tightly accountable. They should also be responsive to well-founded concerns.

However, excessive responsiveness has its drawbacks. Furthermore, even though transparency is widely – and in most cases rightly – seen as an indicator of ethical behaviour, doubts may arise as to its efficacy in delivering its intended aims.

Credibility and effectiveness of action by enforcement authorities also require an institutional framework which is supportive of the efforts, of the activities, and of the exercise of discretion by the regulator.