

The Wall Street Ethics Letter

"A Profession is a Performance for the Public Good"

February 2009

Why This Letter

by David E. McClean, Publisher

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The financial service industry touts the virtues of the free markets and capitalism. How odd it is, then, that it does such a poor job defending them. Indeed, not only does it not defend them, it seems to go through cycles during which it seems to do all it can to actually undermine them. If the free market system and capitalism are so valuable – however imperfect they may be – it is time for the industry to act accordingly. This means a change of values, a change by which clients and customers and core missions come first.

There is nothing new about scandal and moral crisis on Wall Street. In fact, they are expected. There are a few reasons for this, but one in particular comes to mind. It has to do with the very reason most people pursue jobs in the financial services industry to begin with. The answer most often given, whether by new brokers or MBA “quants,” is the same – “To make money, and lots of it, and as fast as I can.” Now there are those who would argue that there is nothing wrong with that. *They would be wrong.* There is a lot wrong with that. If the sole guiding rationale of an industry is making lots of money as fast as possible, that industry begins to look very much like the oldest profession. Ask the members of that oldest profession why they do what they do, and they will give you that exact same answer.

Financial services businesses are not exempt from the management logics and theories that apply to other businesses. As I tell my business ethics students at the various colleges and universities where I teach, there are three myths about business. The first is that the goal of business is profits. The second is that there is a bright line that divides the private and the public areas of life (such that the moral rules of one have no application to the other), and the third is that “business ethics” is an oxymoron. No less a thinker than the late management guru Peter Drucker supported me on my three myths doctrine.

The financial services industry is not above or exempt from the basic business principles that apply to other industries. It is time that those of us in the industry stop accepting the “Wild West” and “Greed is Good” lore that is so pervasive within it, and start to behave like the good stewards of our customers’ and clients’ interests that we claim to be. We claim to be professionals. A profession is a performance for the public good. Our industry has, in recent years, performed against the public good in too many ways. The public, elected officials, and our clients and customers are now assessing whether our claim to the label “professional” is a claim to be accepted only with a grain of salt. There is work to do if we wish to reclaim the public’s trust. We had better get to it.



Recommended:

Enough: The True Measures of Money, Business and Life

by John Bogle

Feature Article

Letter to a Young President: Advice on Fixing the Cultures of Greed in American Business

(Excerpted from a recent paper delivered at Fordham University)

Dear President Obama:

After the Civil War, Abraham Lincoln, one of your heroes, warned, using words that for a variety of reasons seem eerily applicable to our own moment:

We may congratulate ourselves that this cruel war is nearing its end. It has cost a vast amount of treasure and blood. . . . It has indeed been a trying hour for the Republic; but I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. As a result of the war, corporations have been enthroned and an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people until all wealth is aggregated in a few hands and the Republic is destroyed. I feel at this moment more anxiety for the safety of my country than ever before, even in the midst of war. God grant that my suspicions may prove groundless.

The slogan "We have a 20th century regulatory regime for a 21st century market" is just that, a slogan.

Of course, anyone can find quotes from famous men and women to help buttress one's position. So I direct your attention to the latest facts that breathe new life into Lincoln's warning. His rhetoric about feeling more anxiety for his country than ever before was apt, and not mere hyperbole. It can be restated, almost word for word, now, with a clear relevance. We should all fear for our country, a country that is young, still budding

But let us now turn to the facts. It is a fact that the government of Iceland is all but insolvent, and its financial system a shambles, due to a credit contagion started in the United States. It is a fact that over five trillion dollars have been pledged as guarantees or directly injected into the United States financial system in one way or another – the most massive singular government intervention in the private sector in the history of the country, perhaps in the history of the world. It is a fact that trillions of dollars of value has evaporated from the capital markets in one year alone, leading to pervasive insecurity among our citizens. It is a fact that pension funds, university endowments and individual retirement plans have been decimated in recent months. It is a fact that tens of thousands of Americans and men and women in other countries have been put out of work, as their employers were unable to find the short-term credit needed to meet payrolls and replenish inventories. It is a fact that millions of people in this country will have faced home foreclosure by the end of this year, and that many of these people are marginalized members of our society who will have lost the meager savings that they were able to scrape together after long years of work and thrift. It is a fact that our country, rightly praised

for exporting prosperity to far flung places, is also now responsible for exporting misery across the globe, as it is the seat of the credit contagion that has spread well beyond Wall Street and La Salle Street. It is a fact that our banks, having already been hit by waves of defaults and asset write downs, will face more, as credit card defaults mount through the year, and unemployment levels rise. And, Mr. President, it is a fact that the reason for all of these other facts is imprudent use of debt and greed on the part of certain American businesses, and even we ourselves. Veblen's notion of "conspicuous consumption" helps to capture the reasons for our present economic crisis. But there is more to it than that.

The enthronement (to use Lincoln's word) of managers and executives as the princes and princesses of the culture, and the remoteness of the shareholder class from the daily functioning of business, are also direct causes for what is unfolding now, and what will continue to unfold unless we effect reforms and change the nation's values, which includes the values of its business cultures. There is something you can do about all of this, given the political capital and prestige you now have as a new, young president who has campaigned on the promise of real change. Let me get right to policy and the use of your office for purposes of edification.

First, we must understand that the current crisis is the result of too much credit in the system. Money, like water, finds resting places. A little money finds few, and floods few, and an abundance of money finds many, and swells the ones they find. The credit process, as you know, is the effective creation of money. What we have seen in recent months is that the process of securitization of mortgage loans led to not only the purchase of more homes by more people, but a steady rise of home prices that went well beyond basic economic logic. That is to say that the prices or values of homes took on a life of their own, detached from economic prudence. As prices were bid up, banks assessed the inflated prices to be justifiable and lent against those new prices. When the prices or values went up again, banks again lent. So long as there was cash available to lend, the prices of homes continued to spiral upward, as the credit markets sustained the unreasonable values by continuing to affirm those values – an affirmation that came by continued availability of credit. Some call this simple supply and demand, but what must be remembered is that real supply and demand were veiled by the availability of unlimited amounts of credit. The potential homeowner could easily "demand" a home carrying an unsustainable price so long as that demand could be satisfied with an endless "supply" of other people's money. . . . And too much credit distorts the logic of supply and demand, since it untethers normal considerations of opportunity cost, the normal ideal that to get something one has to give-up something. Thus, the housing bubble created the illusion that everyone could simply gain. The supposed infinite upward rise in home values would guarantee that there would be liquidity in the housing market, allowing homeowners to sell at will.

There was a possible check on all of this: the lenders themselves. The lenders could have enforced standards of prudence and proper due diligence. But they looked the other way. They looked the other way for two reasons: they were making money in the short run, and they would be able to pass the risks along to others, in this case the GSEs. As you know, the transference of risk while cleaving to reward is referred to as "moral hazard." Not only did the GSEs (Freddie Mac and Fannie Mae) flood the banking system with a steady supply of cash, they also failed to act on the obvious moral hazard that was created by taking lending risk off of the balance sheets of lenders.

. . . So the first policy prescription I would offer is this: take the lead in the passage of new legislation that would require independent verifications of documentation presented by borrowers, whether in the mortgage or other credit markets, and make lending institutions accountable for fraudulent documentation that provides the foundation for lending decisions. This will keep banks and other lenders on the hook for loans even well after they are sent up the line to

the GSEs. You should also require new rules that guarantee the performance of loans for some reasonable period of time, save for where non-performance has to do with legitimate disruptions of income on the part of the borrower – such as unemployment or catastrophic medical costs. However, where such non-performance had to do with factors that should have marked the borrower as high risk, then the originating lending institution should be liable to make good. Such measures would create “burdens” on the system, which is exactly the point. To avoid such burdens, lenders would have to do a better job of due diligence. But already there are signs that the old practices are on their way back. Old habits die hard.

My second policy suggestion is that mortgage brokers should be qualified through new uniform licensing, required to abide by a code of ethics that contains statutorily mandated provisions, operate under stipulated procedures, and have their licenses subject to revocation based upon a number of factors that include public complaints, dishonest conduct, or regulatory infraction, among other things. Mortgage brokers that collude with borrowers to provide false documentation, or that induce borrowers to provide false documentation, should face a life-time bar from that business, and any related businesses. As part of this standard, mortgage brokers should have their offices subject to regular examination by a designated examining authority. The bar to becoming a mortgage broker is abysmally low, and persons who were one day working on loading docks or behind the wheels of rigs were drawn into the easy money that this so-called industry offers.

My third policy suggestion concerns the reinstatement of standards of risk mitigation for banks and bank holding companies. What the country, any country, needs are institutions willing to lend to qualified borrowers. For some bankers, this is a boring *raison d'être*, but critical nonetheless – as this generation is finding out. Banks that deploy too many resources for non-traditional lending activities should be barred from doing so in the future. Any risk investments beyond a certain level that is prudent should be done only through affiliates so that the risks associated with such activities may be isolated. For example, had Citigroup isolated some of its risky investments, the health of its core lending business could be more easily assessed and not threatened by its non-lending activities. It comes after the fact of near bankruptcy that Citigroup, for example, has decided to isolate its risky ventures from its traditional lending business. It is possible to segregate the risks in business, and the risks of ventures and investments should have been better segregated in the banks, even those that have not suffered the worst of the crisis. We cannot forget that the charters that the banks hold come to them as privileges, privileges granted by the public, for the public good. If that means that banks are no longer permitted to invest or take risk positions beyond what is absolutely necessary to conduct lending activities, then so be it. It is not clear that Glass-Steagall (the Depression era law that separated traditional deposit and lending activities from investment banking and more speculative activities) would have staved off all of what has happened in recent years, but the apparent need for better segregation conjures recollection of the types of harms that Glass-Steagall was established to prevent. It is a free country, and businesses should be permitted to do whatever they choose, so long as it is legal and moral, but banks were not established to act as private hedge funds, taking huge and risky investments onto their books or otherwise exposing themselves to them. They were granted their charters to provide credit, credit necessary to finance the needs of society, and to custody and safeguard the public's money savings. Hopefully, we will not have to revisit this point several decades hence. But human memory is, tragically, short.

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I suppose my largest policy suggestion, Mr. President, has to do with establishing an Office of Market Risk Oversight (“OMRO”). Just as it is difficult for organizations to police themselves, it is now clear that organizations will overlook even massive systemic and enterprise risks for the sake of short-term gain. This is the personal revelation that the former Objectivist Chairman of the Federal Reserve disclosed to us, as he watched one institution after another fall into crisis, and then simply fall. Fed Chairman Greenspan assumed that the self-preservation instinct would lead financial institutions to control their risks. He was wrong, for a variety of reasons that we need not explore here. It is, however, worth pointing out one reason. Too many executives of financial services firms are more loyal to themselves than to the institutions or customers they serve, despite their rhetoric to the contrary, and so are willing to sacrifice those institutions in favor of personal remuneration. These executives do not only fail to serve as stewards – which is what the etymology of the word “executive” suggests they are (agents of the principals for whom they work) – but behave more like parasites on these institutions and the institutions’ customers. The financial services industry has for far too long been a money party, a place to go for no other reason than to become rich. And these executives are blind to the interests of other stakeholders who depend upon them.

After each large scandal, it has been the rank and file employee who has suffered the brunt of decisions made in the imperial suites of the upper floors. What’s worse, too many executives have lost all sense of their role as quasi-public economic leaders, all sense that the arc of civics approaches closer to the arc of commercial interest the larger the footprint that is left by the firm on the society. And, as we now know, if we did not know before, banks and insurance companies and securities firms are critical to the public good – just as when badly managed they are pivotal to the downward spiral of the macro-economy. Of course, this is true for firms in other industries as well.

An Office of Market Risk Oversight would observe these institutions, and all market actors, at arm’s length. It would employ people competent in risk measurement and management from various perspectives on risk, both quantitative and qualitative. The office of risk oversight would be charged with issuing reports and recommendations to policy makers and the public about what risks it believes to be looming and that might lead to future crises. Such an office would perform a task different than regulation, which is why such an office should not be embedded in any extant regulatory institution. It will sniff out the various macroeconomic risks that exist in the system and provide reports and recommendations so that regulators and policy makers can make better decisions. Where there is public or industry disagreement with the Office’s recommendations or findings, reasoned and healthy debate would ensue.

Finally, you should use your office to point out and attack a major fallacy that executives continue to use to justify their obscene levels of compensation, and shame them for it. This is the fallacy of incentivization. The fallacy goes like this: CEOs and other senior executives make what they do because that is the only way to incentivize them to perform well for stakeholders. This is rubbish. It reduces the reasons to perform well in business to dollars, when human beings enter the business world for numerous reasons, and perform their jobs well for reasons that go well beyond their paychecks. There is the personal satisfaction that comes from creating value, from running an organization that pursues excellence and satisfies customer and client needs, from innovation, and, frankly, for the dignity that work affords. Many academic studies have exploded the fallacy of incentivization, along with the sister fallacy that there is a link between CEO and executive/company performance and levels of compensation. This fallacy is propagated for no other reason than a princely sense of entitlement. And in fact, as you and I well know, the members of these ranks are an incestuous club that bid up one another’s compensation packages as they cross-pollinate, as directors, on the boards of public companies. I do not quite know how I

would translate this fact into policy, but perhaps disclosure requirements mandating the inclusion of some of this information in the public filings of companies might be one way.

There are other policy initiatives I could recommend. But these would be a good start. Quite important is that you not listen to the ideological din from either side of the aisle, from either end of the political spectrum. What the hour requires are proper and surgical responses, not sweeping regulatory changes. The slogan “We have a 20th century regulatory regime for a 21st century market” is just that, a slogan. It has been uttered by persons on the left and on the right. It implies the need for systemic reform, when what are needed are bold but surgical or targeted remedies. A man may die of no more than a small tear in his aorta. Putting tourniquets on his extremities, loading him up with antibiotics, and performing exploratory surgery on his body cavity would not be proper responses, though they may make the physician feel as though she is accomplishing something. It is true that the whole organism may die due to a few small but critical failures in certain systems; but that the whole body is affected is no reason to attack the whole body with cures for other maladies that have not presented, but rather to attack the critical failure that threatens it. . . .

I mentioned your unique role as president, a role that affords you the opportunity to be a voice of edification. Mr. President, the iron is hot. It is time to strike a blow to end the cultures of greed that contaminate not only American business, but all of us. ◀

Using WSEL for Firm Element CE

Broker-Dealers, being required to have ongoing continuing education programs for industry professionals, use various media to satisfy this requirement. The Wall Street Ethics Letter contains useful, thought-provoking articles that will serve to enhance the qualifications of professional employees. Future articles will address such issues as:

- Churning
- Suitability
- Disclosures of Conflicts of Interest
- Market Issues
- Public Policy
- General Ethics
- Religion in the Workplace
- And many more . . .

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What Regulators Should Do Now



During the past several years, we have witnessed many scandals and abuses in and by corporate America and, more specifically, “Wall Street” – that catch-all label for the financial services industry. One hears many demands for “more regulation” in the wake of these scandals and abuses. But what is needed isn’t necessarily *more* regulation, but rather targeted regulation that speaks to the specific issues that lead to scandal and the less sensational abuses of investor and public trust. What follows are four specific regulatory reforms that can be implemented quickly (by mid-2009), and implemented without very much cost or difficulty.

Regulation of Hedge Fund Managers. A few years ago, the courts vacated a new SEC rule that required many hedge fund managers to register with the SEC, leading many hedge fund managers that registered under the rule to de-register (and become, once again, largely unregulated). This

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emphasis from quantitative risk measures
toward qualitative ones

was because the SEC had exceeded its authority in the way it drafted the rule. However, it is not in the public interest that no new rules to regulate these powerful market players have been proposed since then. Hedge fund regulation (whether regulation of the funds themselves or the managers of the funds) will serve to set a tone of accountability in what is now an industry separate and apart from the mutual fund industry, which is *highly* regulated.

The burdens imposed under the vacated rule were not onerous, and the public (via the SEC staff) would get some transparency regarding the activities of hedge funds and their managers if a similar rule were introduced today. Many hedge fund managers do not have a problem with at least some regulation, and their investors most certainly would prefer regulation. So what is the hold up? How is it that a “mom and pop” investment advisory business that manages (merely) tens of millions of dollars has to register with the SEC, yet investment advisers that manage billions or tens of billions of dollars are able to avoid registration altogether? Of course, there are technical answers to these questions. But they are answers that defy logic when public policy considerations are included in the discussion.

Codes of Ethics for Brokerages. Brokerages (a.k.a. investment banks and broker-dealers), unlike their registered investment adviser cousins (which manage mutual funds and (some) hedge funds), are not required to have codes of ethics. This is curious, given the number of significant client abuses that take place in the securities brokerage industry each year.

While brokerages may weave ethics education into their professional education initiatives, there is no requirement that they do so. So not only don’t brokerages have mandated codes of ethics, they don’t have mandated ethics education or training either. Given the transaction-based

compensation model (pay-per-trade) that is still in place (a model that has been criticized, sharply, by such industry leaders as John Bogle and Arthur Levitt), the fact that brokers, investment bankers and many research analysts are not held to a written standard of conduct by the firms they work for is scandalous in itself. True, codes of ethics are no panacea (Enron had one), yet they set a tone and some established policies regarding conduct, beyond mere compliance, and actual ethics education would serve as a reminder that certain conduct will not be tolerated.

In addition, brokerages should have Chief Ethics Officers who report directly to (and give recommendations to) the top executive or board of directors (preferably the latter). This should be an office separate and apart from other “Chief” officer positions. Such would allow for an independent hand in reviewing and critiquing firm practices from a purely ethical perspective. The Chief Ethics Officer and Chief Compliance Officer would work in tandem to oversee firm conduct and head-off (not just remedy) abuses.

Credit Default Swaps. In addition to the need for clearing houses for these contracts (already in the works, although there are some false starts), market players, and banks and brokerages in particular, should be required to index to capital the insurance protection they are offering. Firms should not be permitted to write whatever level of protection (insurance) they want to without having to look over their shoulders at their capital positions. The reason that they would not want such indexing to capital has to do with the enormous profits (premiums) they receive from “writing” protection. Indexing to capital will limit those profits. It will also help to reduce the risk that tail events, such as what developed in 2006-2008, will not cause the ruin of large and important institutions. As we have come to appreciate (I hope), that has to matter more than short-term profits.

Risk and Compliance. Finally, senior risk and compliance officers must be given more autonomy and authority within banks and brokerages – autonomy and authority that will permit them to report their concerns directly to the board of directors (if there is one), without interference from business units. Risk officers, in many cases, have a kind of presumed authority in firms, but often get out-manuevered by production personnel (traders, mostly) who live and die by short-term results. Chief Risk Officers should have the authority to shut-down or wind-down trading strategies or market exposures that they believe place the firm at risk in the long-term. This means that these professionals should be “off the desk” – not unduly influenced by the demands (and sometimes ravings) of traders and other producers in the firm. Also, there should be a rebalancing, as shift of emphasis from quantitative risk measures toward qualitative ones (such as conflicts of interest, dubious reporting lines, poorly established authority among business unit personnel, and subjective, professional assessments of conditions that are not captured by quantitative risk models). This means moving toward an Enterprise Risk approach, and away from a mere portfolio risk approach.

These four changes in regulation should be accompanied by a new round of soul-searching among American business executives, and Wall Street executives in particular. For that to happen, they need to understand that there is a tie that binds business to civics – a tie that many (although not all) have been too blind to see. ◀

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