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Mind the gap: virtue ethics and financial crisis

Article (Accepted version) (Refereed)

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The financial crisis has led to calls for increased regulation of the financial sector. In many respects this is uncontroversial because increased regulation should promote the behaviours we want to see, while limiting the behaviours we do not. This article takes issue with the idea that regulation, and guidelines, promote ethical behaviour in the way that we want them to. Firstly, judgement is often required to implement guidelines and regulations, which allows room for unethical behaviour. Secondly, we want financial professionals to behave ethically even when there are significant incentives not to; so, verifying compliance with regulations and guidelines when such incentives are absent isn't a good gauge of the ethical status of financial professionals.

The example of the valuation of the assets (Net Asset Value) of hedge funds illustrates these issues well. There are many rules governing how NAVs should be calculated, and while we can verify that a fund is abiding by the rules, the ability to manipulate the NAV remains. Furthermore, the incentive to do so is often only present during a crisis (usually to understate losses). Therefore, verifying compliance during 'normal' times is of little help in judging whether a manager will behave ethically when we most need him to. I first argue that the gap between compliance with regulations and ethical behaviour is best filled by the adoption of a virtue ethics approach, as discussed by Spalding & Oddo (2011), and Graafland & van de Ven (2011). I then discuss the implications of adopting such an approach for the financial industry's codes of conduct, such as the CFA Institute's 'Code of Ethics and Standards of Professional Conduct' (www.cfainstitute.org). Adopting a virtue ethics perspective would require a significant change in the emphasis of such codes.

Background: NAV calculations and why they matter

Investors can give their money to funds, (including mutual funds, hedge funds and exchange traded funds), and these funds invest this money in a variety of financial instruments, such as equities, debt, derivatives, commodities and currencies. The Net Asset Value (NAV) is the total value of a fund's assets, minus any liabilities. It is usually divided by the number of shares that the fund has outstanding, so is expressed as an NAV per share. It is calculated daily, weekly, or monthly. The NAV is important because it tells an investor how much their investment in a fund is worth. It is calculated by taking the 'fair value' of all the assets (usually financial investments) in a portfolio.

The Alternative Investment Management Association (AIMA), is an international organisation representing the alternative investment industry. They publish a "Guide to Sound Practices for Hedge Fund Valuation" which outlines how fair value, and a fund's NAV should be calculated. The guide begins with the accounting standards and regulations (primarily the Alternative Investment Fund Managers

Directive which came into force in the EU in 2013), but extends these in various ways. In Europe, fair value is defined in the International Financial Reporting Standards as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants" (AIMA Guide pg. 45). The US Generally Accepted Accounting Principles adopt a similar definition, which is "the price that would be received to sell an asset or paid to transfer a liability" (AIMA Guide pg. 45). This paper will not consider the valuation of liabilities: so liabilities will not be discussed further. Assets, according to both the US and European accounting standards, should therefore be valued at a price that a seller would receive for those assets.

In the case of listed equities---shares listed on major stock exchanges-- determining fair value, and by extension, calculating the NAV, is a relatively simple matter. The fair value of listed equities is the price at which other investors are bidding for those equities on a recognised stock exchange. Determining fair value is not so easy for other assets. The Financial Accounting Standards Board divides assets into three levels:

Level 1 assets: Fair value is calculated by taking quoted prices in active markets for identical assets. This includes listed equities.

Level 2 assets: Fair value is calculated by taking quoted prices for similar assets in active markets or quoted prices for identical or similar assets in markets that are not active or the use of inputs other than quoted prices included within level 1 that are observable directly or indirectly. This includes listed equities that do not trade very often. If a security last traded two weeks ago the prices available for it today can vary widely, and may depend on the amount of the security an investor is trying to buy or sell. Brokers may give different prices for the security, and if so, agreeing a fair value can be difficult.

Level 3 assets: Fair value is calculated by taking unobservable inputs which represent the entity's own assumptions of inputs that approximate those market participants would use. This includes private investments, for which there is no market. The 'entity' in this case is often the manager of the fund. (AIMA Guide. pg. 45)

The NAV tells an investor what their investment is worth. For this reason, it is important that NAV calculations are accurate. For the majority of mutual funds and exchange traded funds, NAV calculation is a relatively simple matter, but for hedge funds this process can be considerably more complicated. Hedge funds often invest in Level 2 and Level 3 assets and the flexibility in pricing these assets gives rise to a conflict of interest for the manager of a fund. It is in the manager's interests to have a higher NAV, because this suggests the fund has performed better than if it had a lower NAV.

In the EU, the Alternative Investment Fund Managers Directive makes the investment manager responsible for calculating the NAV, and states that they should ensure that valuations are "proper and independent" (AIMA Guide, pg. 7). The AIMA and the Standards Board for Alternative Investments (SBIA) augment the regulations and have both published recommended guidelines for fund managers. These guidelines make clear the importance of separating the function of managing a fund's investments from calculating the NAV. In other words, the person (or people) responsible for making investments should not also be responsible for calculating how much those investments are worth. The SBIA state that hedge funds should appoint an independent administrator (a separate firm), which is responsible for calculating the NAV. However, the standards note that this is not always possible when assets are difficult to value. When this is the case, the SBIA suggest that the pricing function is separated from the management function within the firm. Furthermore, the valuation team should not be remunerated based on the performance of the fund. Where the fund management team are responsible for pricing, their input should be fully documented. It is also recommended that an external party evaluates the effectiveness of the valuation process. These guidelines are an attempt to ensure that the NAV is calculated in a reasonable manner (The Alternative Investment Standards, pg. 10-14). AIMA also emphasise the importance of objectivity in NAV calculations, noting that an independent valuation expert can be hired to value investments that are difficult to price. AIMA also suggest that a fund provides investors with a document which describes in detail the way in which the NAV is calculated (their suggested format is in Appendix 4 of their guide).

The SBIA and AIMA guidelines have been revised numerous times since their original publication to reflect changes in legislation, and to strengthen the guidelines to limit the potential for mispricing. AIMA recommend that the methodology for valuing assets is put into writing, and approved by a fund's governing body (usually a board of directors). The governing body should also ensure that the valuation of assets in independent of the fund manager. Any involvement of the investment manager should be disclosed to investors. Where investment managers are involved in pricing assets, these functions should be separated within the investment management firm to limit the potential for conflicts of interest. The valuation of investments should be checked against independent pricing sources wherever possible. The SBIA and AIMA guidelines are therefore very similar, and emphasise accountability, thorough documentation, and the independence of pricing sources to limit conflicts of interest.

Due Diligence: Assessing the NAV calculation process

When an investor wants to invest in a hedge fund they usually go through a process known as 'due diligence'. Due diligence means checking the information a manager has provided, including on the

NAV calculation process. AIMA also provide a list of questions that should be asked, to help investors with due diligence. This section describes the process by which the NAV calculation methodology is checked.

The most important question is that of who takes responsibility for calculating the NAV and, specifically, obtaining prices for the underlying securities. The most straightforward case is when the administrator is responsible for calculating the NAV, and gets prices from a recognised exchange. This is the case when a fund is invested in Level 1 assets.

If a fund is invested in Level 2 or Level 3 assets, things become considerably more complicated. Ideally, these securities will be priced by the administrator. In some cases, the administrator can take quotes from brokers to price these securities. Brokers are intermediaries who quote bid and offer prices for specific types of securities. A potential investor will want to know that the administrator is going to brokers directly, rather than accepting prices given to them by the fund manager. However, in cases where there are few brokers quoting prices the fund manager is likely to have a close relationship with the brokers the administrator contacts. In theory, it is possible for the manager and broker to agree a price for 'pricing purposes'. However, the administrators will often price the same, or similar, securities for different funds, so they may notice significant differences between quotes for the same security for different funds and query these prices. A potential investor will also need to check that the fund manager has not directed the administrator to specific brokers; it is preferable for the administrator to pick which brokers to ask for prices. A well-structured, and transparent pricing process, along with a responsible board of directors, and competent, independent administrator, should therefore considerably limit the scope for the mispricing of assets.

However, a fund may also invest in securities for which there is no readily available price. These include private investments, and bespoke investments, including some derivatives, or very illiquid bonds. AIMA note that in these sorts of cases the investment manager may indeed have "the best insight with respect to the valuation of particular instruments" (AIMA Guide, pg. 30). In these cases, the fund manager may price these on the basis of a model of the expected cashflows for the security, prices for similar securities, or other models. AIMA say "Such tools, common in private equity valuation, are based on sound economic principles. However, many of the parameters used in such models are subjective, and the resulting valuation can vary widely depending upon a particular investment manager's perspective of the current market risk premia and the probability distribution of future cash flows." (AIMA Guide, pg. 31) In other words, when a fund invests in Level 3 assets, there is flexibility in pricing some of these investments. A fund manager may, in good faith, calculate a fair value that turns out to be too high because they are optimistic about the future returns of the investment, or a fund manager might misprice such assets intentionally. The board of directors, and the appointment of an independent valuation expert, and transparency about the pricing process with investors all go some way towards mitigating this risk. A potential investor will also often seek to verify the reasonableness of the models used for pricing.

They will also want to see a structured, and independent, process for mediating disputes over valuations. Additionally, a potential investor may ask for full disclosure of a fund's portfolio so that they can check the availability of prices for themselves. Nevertheless, when dealing with these sorts of assets it is impossible to mitigate the risk of mispricing entirely. For example, an independent valuation expert is likely to be less familiar with the investments than the fund manager and will only be called upon to perform a valuation periodically.

To conclude this section, the AIMA and SBIA guidelines relating to NAV calculation are extensive and outline how best to ensure that the assets held by a fund are indeed priced at 'fair value'. The due diligence process is extensive, and aims to mitigate the risk that a fund manager is mispricing their NAV. Nevertheless, these guidelines do not prescribe exactly how each investment is to be priced (this is an impossible task due to the evolving nature of investments) and, for some investments, room for judgement on the part of a fund manager remains. A fund manager may, therefore, be in compliance with all the guidelines, but use the room provided by this subjectivity to misprice investments in their portfolio. When faced with a fund investing in such assets, a potential investor will need to come to a conclusion about the fund manager's trustworthiness. The second half of this paper discusses how this is possible.

Due diligence is insufficient: Dynamic Decisions Fund

Successful completion of a due diligence process does not ensure that a fund manager will remain honest. The critical question for an investor is whether a fund manager will remain honest when they have an incentive to behave dishonestly. Verifying that behaviour is ethical in 'normal' times may not be indicative of how a person will behave when they have an incentive to behave dishonestly. This section uses a case study to illustrate this point. The third section of this paper will discuss how to fill the gap between the guidelines and ethical behaviour.

The Dynamic Decisions Capital Management was a hedge fund launched in London in December 2004. The fund was founded by Alberto Micalizzi, an academic from Bocconi University and Imperial College. Micalizzi's funds performed well until the financial crisis. According to the Financial Services Authority (FSA- the UK financial regulator) Decision Notice, the Dynamic Decisions Growth Premium Master Fund suffered "catastrophic losses amounting to approximately 85% of its NAV in volatile conditions following the collapse of Lehman Brothers." (FCA, 2014, pg. 3). The Decision Notice adds that, rather than informing investors of these losses, these "losses were deliberately concealed from investors and other interested parties by Mr Alberto Micalizzi […] In order to conceal the losses from investors, Mr Micalizzi entered into a series of contracts" (FCA, 2014, pg. 3-4). In other words, when faced with substantial losses due to the collapse of Lehman Brothers, Micalizzi tried to hide these losses from investors and reported an NAV that was inaccurate. Prior to the financial crisis there are no suggestions that Micalizzi was behaving any anything other than an honest manner. Micalizzi was fined £3,000,000 by the FCA. This was reduced on appeal to £2.7 million in 2014.

The strategy of the Dynamic Decisions Growth Premium Master Fund was a liquid pairs trading strategy, which involved buying and selling equities on major exchanges. The portfolio manager (Micalizzi) tried to find two related stocks which were misvalued in relation to one another. He would then buy the undervalued one and short the overvalued one, on the assumption that the prices would move back into alignment. Because the misvaluations in cases like these are often small, the fund used leverage (borrowed) money to amplify returns. It was not, therefore, a fund for which it was difficult to calculate an NAV. The tribunal decision notice states that "In marketing material dated September 2008, for example, an overview of investment strategy and risk management policy spoke of stocks being accessed from a "highly liquid universe" of the S&P500 and the EuroStoxx 600" (Micalizzi v The Financial Conduct Authority, pg. 13). The fund did have an independent administrator, PNC Global Investment Servicing (Europe), which was subsequently subsumed within Bank of New York Mellon, and a board of directors.

Between 1 January 2008 and 30 September 2008, the NAV of the fund increased from $352 million to $437 million (Micalizzi v The Financial Conduct Authority, pg. 15). In October 2008, the fund recorded a profit of $5.25 million on its investments. It had lost $84.94 million on the pairs trading strategy, but recorded a $90.2 million profit on a bond. In November and December, losses on the main strategy were similarly offset against gains on a bond. The bond was an untraded bond which is summarised in the appeal documents in the following way "we do not consider that the bond was at any time a genuine financial instrument capable of providing any financial return or capable of being converted into a commodity." (Micalizzi v The Financial Conduct Authority, pg. 18). The financial regulator, the FCA, argued that Micalizzi knew from the beginning that the bond was not genuine, but the appeal court decided that he did not initially realise that it wasn't genuine. This was why they reduced the fine from £3 million to £2.7 million. However, the appeal court also found that "any reasonable due diligence would have given rise to serious questions as to the genuineness of the bonds" (Micalizzi v The Financial Conduct Authority, pg. 93). The appeal court decision document later states that Micalizzi showed a lack of integrity with regard to his "indifferent attitude" about whether the bonds were genuine or not (Micalizzi v The Financial Conduct Authority, pg. 95). The structure of the bond has no relevance to the argument in this chapter so will not be reviewed in detail here. It is sufficient to note that, even if genuine, it would have been a Level 3 asset.

What is relevant for this paper is that Micalizzi tried to hide the losses on his main strategy by investing in the bond. A number of purchase agreements were entered into on different dates to buy the bond, one of which was backdated. The appeal court document states that "In our judgement the only possible explanation for such backdating is that Mr Micalizzi, being aware of the losses that had been incurred on the main strategy, determined to conceal these losses by booking Purchase Agreement 1 at the end of October 2008, taking credit for the unrealised profit attributable to the discount from the face value of the bonds. This behaviour was dishonest." (Micalizzi v The Financial Conduct Authority, pg. 95-96). Micalizzi also misled investors about the NAV of the fund. He failed to communicate the losses on the main strategy to investors and the appeal court summary document says "This conduct of Mr Micalizzi is more, therefore, than lacking in integrity. It was dishonest. Mr Micalizzi deliberately misrepresented the position to investors, and failed to provide them with information as to the true position, even when it was clear that they had been misled by the original information. Such conduct can only be dishonest." (Micalizzi v The Financial Conduct Authority, pg. 97).

In summary, when faced with severe losses in his fund in September 2008, Micalizzi failed to inform investors of these losses. Instead, he invested in a bond, which was not genuine, and backdated part of this investment so that it offset losses in the main strategy. Both of these actions are unethical. However, it is not the case that Micalizzi was simply a man who habitually behaved unethically. The appeal court conclude that "This is, we accept, a sorry state of affairs for a man who, in other walks of his life, has apparently impressed with his integrity and honesty, as appears from references from third parties which Mr Micalizzi produced to us. But that cannot deflect from our clear findings that, at the time in question, and in connection with the Fund and the Bonds, Mr Micalizzi's conduct was dishonest in many instances and overall lacked integrity. (Micalizzi v The Financial Conduct Authority, pg. 100)

What we have, in this case, is a person who acted ethically, or at least, who we have no reason to suspect of acting *u*nethically, until September 2008. Due diligence regarding the NAV calculation was made relatively simple because of the liquid strategy of the fund. A potential investor performing due diligence on his fund would, and presumably did, find that everything was in order. Nevertheless, when the fund lost money, Micalizzi acted unethically. The problem for investors is that due diligence, prior to September 2008, seems not to have provided any evidence about the likely future behaviour of Micalizzi. To rewrite the familiar disclaimer on financial products: past ethical behaviour is no guide to future ethical behaviour.

One objection is that perhaps the due diligence process is unable to detect unethical behaviour. This is not the case. The problems at the Dynamic Decisions Fund were first reported to the FCA as a result of continuing due diligence on the fund. The Directors of the fund asked KPMG to provide a risk assessment on the bonds in November 2008. KPMG informed the FCA of concerns that they had about the bond. Investors also raised questions, which led to meetings in February and March 2009 between Dynamic Decisions Capital Management and the FCA. The fund's compliance officer resigned. By December 2008 one of the investors in the fund (Natixis) wanted to withdraw their money from the fund because, based on discussions with the fund manager, they believed, amongst other things, that the fund was in breach of its investment guidelines, and they were concerned about the level of the fund's exposure to the bond (Micalizzi v The Financial Conduct Authority, pg. 53-60). Natixis subsequently did their own research on the bond and concluded that the bond's reported value was inaccurate. Natixis reported Dynamic Decisions to the FCA on 12 February 2009. Morgan Stanley, one of the prime brokers, concluded after a meeting with Macalizzi that the "relationship with the funds would be terminated as soon as it could be" (Micalizzi v The Financial Conduct Authority, pg. 74). Furthermore, they alerted the administrator and fund's directors to their concerns. Ongoing due diligence therefore did lead to the discovery of Micalizzi's actions. While this is somewhat reassuring, it is of no consolation to investors who lost money in Micalizzi's funds.

What can provide reassurance that a fund manager will behave ethically over time as regards the NAV calculation process? It appears that due diligence works, but can only discover what has already taken place. This example illustrates that what is of critical importance is how a manager will behave in difficult situations where unethical behaviour is appealing. The following section argues that adopting a virtue ethics approach can go some way towards improving the chances of future ethical behaviour, in the face of incentives to behave unethically.

Virtue and the Challenge of Investment Fund losses

The previous section showed that Micalizzi was, initially, behaving ethically with regard to the calculation of the NAV of his fund. Due diligence on the NAV calculation process was not sufficient to demonstrate that Micalizzi would behave ethically in the future. In fact, he did not. The catalyst for this change in behaviour was the losses his fund suffered after the collapse of Lehman Brothers. The question for those wanting to promote ethical behaviour in finance is: How can we encourage ethical behaviour when there are significant incentives to behave unethically?

The appeal court documents describe Micalizzi's behaviour as dishonest, and lacking in integrity. If we are seeking to encourage people to be honest we first need to understand what it is to be honest, and how an inclination towards honesty is affected by circumstances. Wells and Graafland define honesty in the following way:

> At the heart of honesty is a commitment to impartiality, involving appropriate respect for the legitimate interests of others and the consideration of what an impartial spectator would consider right for someone in your position to say and do. Dishonesty consists in a self-serving partiality that systematically disrespects one's interlocutors and relationship partners, that disrespects their autonomy by considering them in a purely instrumental way, for example, by failing to tell one's commercial partners information they have a right to know. Honesty therefore goes beyond truth telling or 'not-lying' to include such general qualities

> as sincerity and frankness which make trusting cooperation possible. But it also concerns the particular orientation and concerns that should follow the roles, relationships and promises that one enters into. One should become disposed to automatically consider the legitimate interests of one's commercial partners—whether they be customers, employees, or collaborators—and provide the information and service that they have a right to expect. (Wells and Graafland, 2012, pg. 338-9)

This definition fits the Micalizzi case because his behaviour failed to take into account the legitimate expectation of other investors that they would not be misled about the performance of the fund. Furthermore, an impartial spectator would have expected him not to attempt to cover up his losses. A further advantage of this definition of honesty is that it suggests a link between honesty and the ability to cooperate effectively, which is necessary for the functioning of financial markets.

Why do people behave dishonestly when they have not previously done so? Wells and Graafland argue that competitive markets reward honesty, because transactions between participants depend on mutual cooperation, and trust. However, intense competition, with frequent replacement of market participants, can undermine tendencies towards honesty. This is because, when participants are trading with ever changing counterparties, reputational information is difficult to establish and quickly goes out of date.

This does not appear to be the reason why Micalizzi behaved dishonestly. Although he may have faced intense competition from other funds, it is not clear that this competition became more intense, or that market participants were frequently replaced. It is impossible to know exactly what motivated Micalizzi to act as he did, and the remainder of this paper will avoid speculation about his motives. Nevertheless, the idea that intense competition, or other situational factors affect whether people behave ethically, is worth exploring further. Mervyn King, the Governor of the Bank of England (King 2009) believed that the majority of people in the financial industry are "good men and women" but the problem during the financial crisis was "a matter of the incentives they face". If situational factors make it more difficult to behave honestly, then there is a gap between what the rules and norms say we should do, and what we do in fact do when faced with situations that compromise our ability to behave honestly. Furthermore, there seems to be little we can do to mitigate this, except for trying to limit the occurrence of these difficult situations.

The literature on financial ethics suggests a number of situational factors that increase the propensity for unethical behaviour. Behaving unethically in this context means behaving with disregard for the rules and norms that people know they should uphold, and which they have upheld in the past. People who behave dishonestly or unethically most of the time are a different problem. Alzola (2012) summarises the literature on situational limits on honest behaviour. He says that a person's mood can affect their propensity to help someone in need, that we are more likely to help someone in need when on our own (as opposed to being a member of a group), that we are less likely to help people when we are in a hurry, and that we are more likely to cause a person harm when instructed to do so by a person in authority than acting on our own. In a business context, perceptions of a firm's ethical culture, the attitudes of other employees and managers, informal incentives and the effects of leadership can all influence decision making (2012, pg. 381-383). Kim, Monge and Strudler (2015) discuss the phenomenon of 'bounded ethicality', which is when people's capacity to act in accordance with their stated moral values is compromised by psychological limitations (2015, pg. 341). They discuss an experiment which suggests that auditors were unable to estimate a company's financial worth impartially, even when they were committed to impartiality, and provided with a financial reward for being impartial. This study suggests that the role assigned to people can affect their impartiality. Although auditors were aware that their behaviour was influenced by their role as auditor for a particular company, they underestimated this influence and did not sufficiently adjust for it (2015, pg. 343). Lawrence and Kacmar (2017) try to analyse the psychological factors that lead to unethical behaviour. They suggest that job insecurity causes emotional exhaustion, which encourages unethical behaviour. They argue that emotionally exhausted people act unethically either to benefit themselves, or to benefit the firm they work for. They write, "Such activities might include providing false information to clients to ensure the organisation meets its quarterly goals" (2017, pg. 46). It is reasonable to suppose that during the financial crisis people working in the financial sector did feel that their jobs were less secure, and that they were also emotionally exhausted. These are the sorts of conditions in which we might expect people to behave dishonestly.

At first sight, these studies suggest that consistent honest behaviour is difficult to achieve, particularly during stressful times. While people may behave honestly most of the time, and know that they should behave honestly, certain situations overwhelm their capacity to 'do the right thing'. The only way out appears to be to limit the frequency of these situational factors. In other words, to limit emotional exhaustion, and job insecurity. Unfortunately, this is unlikely to be successful because the financial industry, at least as it is at the moment, is characterised by quick decision making, frequent crises, and a stressful working environment. But there is another approach we can take. The following section argues that there are a number of strategies available for limiting the impact of situational effects by changing the way that people react to them.

Bridging the gap

Kim *et al* say that, in most psychological studies of bounded ethicality, not all subjects act against their moral obligations. They say, "Bounded ethicality may indeed be a pernicious influence, but there is no reason to think that it is an influence that competent people can't handle" (2015, pg. 350). Their suggestions for handling such influences include "publicly sharing intended ethical choices with impartial third parties" and fostering the ability to recognise when we are operating in a difficult environment, and dealing with ethical choices in a more deliberate manner. (2015, pg. 349).

Azola (2012) advocates developing 'values' as a way to mitigate the situationist challenge. He says:

> "If I value 'honestly' that entails that I want to be the sort of person who really wants to return the wallet I find in the street to its owner, even if the wallet is full of money that I desperately need. I do not want to be just someone who merely acknowledges a duty to return the wallet. To have a strong character is also a matter of cultivating the appropriate emotions. I will feel good rather than angry about giving the wallet back. Admittedly, even a person of strong character will be influenced by the environment. But a virtuous person will perceive situations correctly." (2012, pg. 386)

For Azola, cultivating a virtuous character enables people to overcome negative situational influences. However, there is more to virtue ethics than promoting ethical behaviour in response to specific situations. On the traditional, Aristotelian, conception of virtue ethics, living a virtuous life goes hand in hand with human flourishing. The traditional virtues are prudence, courage, moderation, justice and piety (Kamtekar, 2004, pg. 486). 'Flourishing' is usually understood to mean 'real happiness', or the sort of life that is worth living. Developing a virtuous character is a necessary part of leading a flourishing life. This flourishing may also extend beyond the virtuous person themselves. Flourishing may extend to the recipients of virtuous behaviour, or the community within which the virtuous person lives or works (Garcia, 2009, pg. 961) Virtue ethics is therefore at odds with the idea that judging which behaviours are ethical varies by context. McPherson describes this as the "compartmentalisation of morality into the various social roles we occupy whereby the norms that govern one sphere are viewed independently of the norms governing other spheres (2013, pg. 286). Developing a virtuous character is part of living a flourishing life, and a flourishing life encompasses all aspects of that life.

Virtues are acquired through learning and habituation. If we repeatedly act in certain ways we come to have the underlying virtues "we become just by doing just actions, unjust by doing unjust actions, and so on" (Kamtekar, 2004, pg. 481). Usually under the guidance of someone who helps us to think about ethical dilemmas in a structured way, we begin to form virtuous habits. Learning to perform the correct action is insufficient, we must also become motivated act virtuously, and come to believe that behaving virtuously is good for us. "To learn to do what is virtuous is among other things to come to take the appropriate pleasure in doing it" (Kamtekar, 2004, pg. 481). By learning to live a virtuous life virtue ethics aims to give people the capacity to act ethically in unfamiliar situations. This is because habituation involves deliberating about the ethical thing to do in real, or imagined, situations.

The ACCA agree that character has an important role to play in financial ethics, although they do not use the term 'virtue ethics'. They write, "regulation can ultimately only be a backstop. It can make rules for behaviour up to a point but the regulator is not in the room with the customer, the banker is and hence, it was argued, must have ethical underpinnings" (ACCA, 2014, pg. 5). In other words, while the regulator can make rules, the proper implementation of these depends on the good character of participants in financial markets. Importantly, this does not mean that a person will always succeed in overcoming these influences., but that they are committed to trying to do so. But how can such an approach be implemented in the financial sector? The following section discusses two approaches; the first makes recommendations for the institutions within which people work, and the second discuses ways in which individual virtues might be encouraged.

Virtuous Institutions

Moore (2012) argues that virtuous behaviour needs to be enshrined in the institutions within which people work. He suggests that it is not enough to encourage individuals to be virtuous, and to apply these virtues at work, because it is necessary that the institutional framework within which people operate enables the exercise of virtuous behaviour. There are a number of ways in which institutional frameworks can 'crowd out' virtue (aggressive competition and large bonuses are two oft cited mechanisms), so the challenge is to provide frameworks that 'crowd in' virtue. Moore suggests eight parameters:

First, the organisation must be established with the aim of contributing to the good of the community. He notes that this entails continuous discussion about what the community's good is, and how the firm can contribute to it.

Second, organizations must assess and develop the character of employees. Individual virtues will be discussed in the following section.

Third, organizations must design jobs so that employees have the opportunities to engage fully with the firm and its values. Deskilling of jobs, particularly at the lower end of the pay scale, is likely to reduce employee motivation.

Fourth, executive pay needs to be curbed. Of particular importance is the gap between the highest and lowest paid within a firm.

Fifth, decision making processes should allow employees to have a voice, and certain groups should not be privileged over others.

Sixth, organizations must trust employees and limit monitoring of job performance. Moore notes that trust, and trustworthiness, are usually cemented by reciprocal relationships, which are likely to foster cooperation. However, this conflicts, to a certain extent, with the expectation that financial institutions will apply strict risk management, which entails detailed monitoring of the financial products that a firm is exposed to.

Seventh, organizations must encourage group identity. Moore notes that a sense of group identity has been shown to have a positive effect in social dilemma games involving cooperation.

Eighth, organzations must implement a transparent governance system. Pay scales, decision making processes, should all be taken seriously, argues Moore. (Moore, pg. 309-311)

Graafland and van de Ven (2011) take a similar approach, recommending that financial institutions should be encouraged to pursue long term strategies, and to put service to consumers before their own interests. Institutional reform that fosters greater cooperation, longer term horizons, and more equitable pay are likely to provide employees with environments in which it is easier to behave honestly. However, these suggestions do not get to the heart of the problem that is at the centre of this paper. How can we encourage honest behaviour is those situations when dishonest behaviour becomes appealing? A positive institutional framework can only help, but is it enough?

Dempsey (2015) argues that members of an institution participate in the corporate culture, and therefore bear a degree of moral responsibility for the other members of that institution. His focus is on moral responsibility for corporate wrongdoing. However, his wider assumption is relevant here. Institutions and individuals interact and therefore, in order to have institutions that foster ethical behaviour, these institutions need to be composed of individuals who are committed to acting ethically. The ACCA highlight a particular problem, which they call "the muddle in the middle" which describes the challenge faced by those trying to change a firm's culture. It isn't enough to change behaviour at the top of an organisation- to be fully implemented, cultural change needs to happen at all levels (2014, pg. 5). The role for individuals is clear from the list above. For example, assessing the ethical character of employees can only be done successfully by people who are themselves ethical, and ensuring that some groups are not privileged above others requires those intermediating discussions to behave ethically with regard to inclusiveness. The following section makes a number of suggestions. While suggestions for institutional reform are helpful, and may indeed encourage more ethical behaviour, implementing these reforms, and perpetuating an ethical culture rests on the ethical character of those working in an institution.

Virtuous individuals

To begin with, it is worthwhile thinking about changes that could be made to ethical standards. The CFA Institute set the most widely recognised professional qualification for investment professionals. Their mission statement is "To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society" (see www.cfainstitute.org). A significant part of the course is devoted to ethics, and their "Code of Ethics and Standards of Professional Conduct" handbook is available online. The Code of Ethics states that members of the CFA Institute, as well as those preparing for exams, must:

"Act with integrity, competence, diligence, respects and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the profession, and other participants in the global financial markets." (www.cfainstitute.org)

The other standards are worded in a similar way, outlining how members should behave, and what they should, and shouldn't, do. The emphasis is therefore on behaviour, rather than character. As this article has argued, it is often not sufficient to know what one should or shouldn't do, because the regulations often leave scope for dishonest behaviour, and because it is often difficult to do what we know we should do. One way to encourage behaviour that is consistently ethical is to focus on developing a virtuous character. It is worth considering, therefore, whether the professional standards that people are held to should emphasise 'the kind of person' they should aim to be, rather than the actions they should take. Audi (2012 pg. 288) notes that virtues enable people not just to do what should be done, but with the motivation to do so. He writes, "This motivational power of virtue is crucial for the question of what kind of person, or businessperson, one wants to be—and for the related question, *How do I want to make my money?*" (Audi, 2012, pg. 288 italics in original). The professional standards could be rewritten to say, "Strive to be the kind of person who always acts with integrity… etc"

Changing the wording in ethical standards is unlikely to have the intended effects without accompaniment by more practical changes. A number of these have been proposed. Firstly, Kim *et al* (2015) note that publicly sharing ethical commitments can increase the likelihood that people behave as they hope they will. Boatright (2013) reviews the 'Banker's Oath', modelled on the Hippocratic Oath, which has been adopted in the Netherlands. He concludes that the oath cannot be a good guide to behaviour because of the many difficult judgements that must be made by financial participants. Furthermore, taking an oath usually represents a commitment to be a particular type of person; this is the case for medical students and people appointed to public office. (Boatright, 2013, pg. 143 & 145). However, bankers do not become bankers when they take an oath. Boatwright writes, "the professions and public service have many bright lines, while banking is full of grey areas. Even very lengthy, legalistic bank codes are incapable of giving unambiguous guidance on some of the most ethically problematic situations that arise in banking" (2014, pg. 161). He adds that an oath, or code, can provide a starting point for developing sound ethical practice. In concert with other measures, such as a change in focus of ethical codes, it might be that a public declaration (or declaration when one joins a new firm) focusing on the kind of person one will strive to be, could foster an ethically sound environment.

Teaching employees to recognise when they are in a situation that is likely to hinder ethical behaviour might be helpful. Learning to recognise when they are making decisions in a hurry, or when they are stressed, can help to slow down the decision-making process, and mitigate the pernicious effects of situationism (Kim et al, pg. 349). Kim *et al* note that doing this is difficult, but that the impact of situational factors is nevertheless not inevitable. Being able to discuss a particularly stressful situation, or decision with a competent (and ethical) person at the firm might also help this process.

Teaching new employees, or indeed students at business schools, about real ethical dilemmas they may face may lead them to consider their actions more carefully when they face such dilemmas in the real world. Ciulla (2010) suggests that business ethics is taught through history. She argues that by adding historical context to case studies students will gain a better understanding of the recurrent problems people face in a business context, as well as a richer conception of the values and motivations that shape people's behaviour (Ciulla, 2010, pg. 342) For example, taking the case described earlier in the paper, students in business ethics courses might find it helpful to think about the incentives faced by a fund manager whose fund has lost a lot of money, and about the possible positive consequences of dishonesty. Trying to imagine the pressures, and incentives to behave dishonestly, and the reasons why one should still act honestly may help people to behave ethically if they find themselves under similar pressure. Discussing how to ensure that they behave honestly might also be helpful. Audi (2012) makes a similar point when he advocates taking a 'narrative' approach to business ethics. This involves thinking about historically relevant cases, or imagined cases, in evaluating a current ethical decision (pg. 282)

Public recognition of individuals who do not succumb to incentives to behave dishonestly would also help to foster a more ethical environment. Financial regulators, such as the FCA in the UK, publish sanctions and impose fines on members of the financial community. However, it might be useful to highlight noteworthy cases of ethical behaviour. For example, people who behaved ethically when they faced significant incentives not to, or individuals who refused to act unethically when ordered to do so by superiors, or individuals who reported unethical behaviour. Audi writes that "Nearly everyone wants to be considered (for instance) *honest, fair, loyal, just, sincere, kind,* and *generous*. These traits should be developed in moral education" (Audi, 2012, pg. 287)

Conclusion

This paper has argued that regulations, and guidelines, do not, by themselves, ensure that financial professionals behave ethically. This was demonstrated with the example of the NAV calculation process. For some assets, a level of judgement is required to determine the fair value of these investments. The scope for judgement leaves room for intentional mispricing of the NAV. Although investors usually perform thorough due diligence on such investments, these investors also need to form an opinion about the trustworthiness of the fund manager. Trustworthiness is of critical importance in the financial industry because financial professionals often face significant incentives to behave dishonestly. This was illustrated by the case of the Dynamic Decisions Fund.

The second half of this paper argued that adopting a virtue ethics approach can bridge the gap between regulations and guidelines on the one hand, and incentives to behave dishonestly on the other. It argued that, while institutional level changes may be helpful, it is necessary that individuals working in the financial industry are encouraged to develop virtuous characters. A number of ways of doing this were reviewed, including changing the emphasis of the CFA Institute Code of Ethics, teaching employees and students about the ethical challenges they may face in their careers, and rewarding ethical behaviour.

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