

# *The Future of Financial Regulation: Enhancing Integrity through Design*

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## *Abstract*

The design of effective and flexible regulatory and corporate governance rules, principles and norms to address the interlinked and intractable problems in both the financial and real economies has become a global policy imperative. It is unclear, however, whether the flurry of policy innovations will be effective, largely because of a continuing failure to address the critical normative question; namely, what is the purpose of financial regulation? The article is divided into three parts. First, the credit crisis is put in context and its impact on regulatory practice and techniques is investigated. Second, given stated policy aims to embed integrity into those practices and techniques, the efficacy of adopting and adapting deontological, utilitarian, virtue-based and contextual approaches to capital market regulation are evaluated. Third, the paper maps the trajectory of reform and concludes that, despite the rhetorical commitment to embedding integrity through design, the dynamics of regulatory reform are foreclosing its introduction.

## **Introduction**

The global financial crisis is the latest, and most catastrophic in recent times, in a series of boom-bust-regulate-deregulate-boom-bust cycles. As the impact moves progressively and decisively from the financial into the real economy, the enormous political, conceptual, and socio-economic costs associated with a failure to resolve the question of the role of the corporation and markets more generally in society comes into clear view. The design of effective and flexible regulatory and corporate governance rules, principles and norms to address the interlinked and intractable problems in both the financial and real economies has become a global policy imperative. Moreover, the extent of government intervention required to stabilise financial markets has fundamentally transformed conceptual and practical dynamics. The power and influence of government within the regulatory matrix has been augmented considerably, and the unresolved question is what it will do with this power. The political wrangling in the United States over executive pay suggests, rhetorically at least, a much more interventionist approach.<sup>1</sup> More encouragingly, perhaps, in his inaugural address, US President Barack Obama emphasised the need for the inculcation of a

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<sup>1</sup> See Stephen Labaton, 'Overseer to Set Executive Pay at Rescued Companies', *The New York Times* (New York), 11 June 2009, A1. Note, however, that this decision came after the Treasury Secretary released ten of the largest banks from the governance and remuneration restraints imposed as a consequence of temporary funding provided by the Troubled Asset Relief Program (TARP).

new 'era of responsibility.'<sup>2</sup> This echoed earlier calls by the British Prime Minister, Gordon Brown, for moral restraint within financial centres (if only for instrumental reasons).<sup>3</sup> Beyond London and New York, the extent to which the crisis has metastasised with such ferocity has substantially strengthened calls for an integrated response to nullify what the Australian Prime Minister, Kevin Rudd, has called 'extreme capitalism.'<sup>4</sup> Although many would disagree with the polemical framing, there can be no question that we have reached an inflexion point for both the theory and practice of financial regulation.

There is recognition that reform requires much greater coordination and integration at the global level, if only for protection of national self-interest.<sup>5</sup> The G20 summits in London in April 2009 and Pittsburgh in September 2009 have begun to lay the foundations for a new international regulatory architecture covering all systemically important financial institutions and markets (including, significantly, hedge funds which, through judicious structuring, have to date been effectively unregulated), as well as systemically important financial instruments (such as securitisation and credit derivatives). The European Union has proposed the establishment of the European Systemic Risk Council, headed by the president of the European Central Bank.<sup>6</sup> In addition, a European System of Financial Supervisors would provide a vehicle for coordination between national regulatory agencies. Although details regarding the governance structure and enforcement powers remain scant, the European Commission President, José Manuel Barroso, has stressed that 'better supervision of cross-border financial markets is crucial for ethical and economic reasons.'<sup>7</sup> His point is a fundamental one: although there has been criminal activity on the margins, the global financial crisis is the result of 'perfectly-legal', if ethically questionable, practices.<sup>8</sup>

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<sup>2</sup> President Barack Obama, 'Inaugural Address' (Speech delivered at West Front, US Capitol, Washington DC, 20 January 2009).

<sup>3</sup> Gordon Brown, 'The Global Economy' (Speech delivered at the Reuters Building, London, 13 October 2008).

<sup>4</sup> See Kevin Rudd, 'The Global Financial Crisis' (2009) 42 *The Monthly* 2; see also Kevin Rudd, 'The Children of Gordon Gekko', *The Australian* (Sydney), 6 October 2008, 12. The British Prime Minister has developed this theme, arguing that the G20 needed to 'discuss whether we need a better economic and social contract to reflect the global responsibilities of financial institutions to society': Gordon Brown, 'Speech to G20 Finance Ministers' (Speech delivered at the G20 Finance Ministers Meeting, St Andrews, Scotland, 7 November 2009). Brown's call for a 'transaction tax' to generate a global fund to insure against future failures has been rejected by the United States and Canada: Larry Elliot, 'Why the West Needs a Transaction Tax', *Sydney Morning Herald* (Sydney), 10 November 2009, B6.

<sup>5</sup> Secretary Timothy Geithner, US Department of the Treasury, 'Statement by Secretary Geithner at the G8 Finance Ministers Meeting' (Media Release, TG-170, 13 June 2009). Geithner argued, at 14:

'because markets are increasingly global, the financial rules of the game we are responsible for at the national level need to converge toward higher standards. Risk and leverage will always tend to migrate to where the constraints are weakest. We need a level playing field globally, or the effectiveness of our national safeguards against risk will be undermined.'

<sup>6</sup> European Commission, 'Commission Outlines Plans for Closer Financial Supervision at European Level' (Media Release, Brussels, 27 May 2009).

<sup>7</sup> *Ibid* 2.

<sup>8</sup> See Doreen McBarnet, 'Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis' in Iain MacNeil and Justin O'Brien (eds), *The Future of Financial Regulation* (2010, forthcoming). The framework utilised, based on close observation, builds on a considerable body of empirical work on creative compliance: see Doreen McBarnet, *Crime Compliance and Control* (2004). For application to the audit community, see Doreen McBarnet and Christopher Whelan, *Creative Accounting and the Cross-Eyed Javelin Thrower* (1999).

The unrelenting focus on the punishment of individual malefactors serves to obscure a much more fundamental problem. Corporate malfeasance and misfeasance on the scale witnessed cannot be readily explained by individual turpitude. Moreover, a retreat to rules will not necessarily guarantee better ethical practice or inculcate higher standards of probity. Indeed, the passage of rules may itself constitute a serious problem. It creates the illusion of change.

There is a dynamic interplay between the culpability of individual actors and the cultural and ideological factors that, not only tacitly condone, but also actively encourage, the elevation of short-term considerations over longer-term interests. This requires that we expand our focus beyond formal rules (which can be transacted around) or principles (that lack the definitional clarity to be enforceable). It is essential to evaluate how these rules and principles are interpreted within specific corporate, professional epistemic communities and how these influence and are influenced by regulatory practice.<sup>9</sup> Notwithstanding statements made by the former chairperson of the Federal Reserve, Alan Greenspan, that it is impossible to have a perfect model of risk,<sup>10</sup> and that it is difficult to legislate for ethics,<sup>11</sup> it has become essential that the integrity deficit in regulatory frameworks be addressed.

Sustainable reform requires a thorough excavation of the causes of the global financial crisis, an evaluation of whether the crisis was exacerbated by the failure to apply existing sanctions<sup>12</sup> (irrespective of whether this was, in turn, informed by regulatory capture, ennui or ignorance), and the design of new instruments and mechanisms for cross-

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<sup>9</sup> This requires sophisticated mapping of regulatory domains: see Christopher Hood, Henry Rothstein and Robert Baldwin, *The Government of Risk: Understanding risk regulation regimes* (2004) 8. It also requires a deep ethnographic investigation of actual practice and how innovation is both conceived as a social good and therefore legitimated. The classic example is insurance: see Viviana Zelizer, *Morals and Markets: The development of life insurance in the United States* (1979). A similar dynamic applies to the emergence of financial derivatives. A social network comprising former regulators, academics and leading practitioners changed perceptions of the moral utility of options from a dubious gamble to a respected financial instrument: Donald MacKenzie and Yuval Millo, 'Negotiating a Market, Performing Theory: The Historical Sociology of a Financial Derivatives Exchange' (2003) 109(1) *American Journal of Sociology* 107. This process can generate a powerful ideological paradigm: see Jonathan Nash, 'Framing Effects and Regulatory Choice' (2006) 82 *Notre Dame Law Review* 313; see generally, Tony Porter and Karsten Ronit, 'Self-Regulation as Policy Process: The Multiple and Criss-Crossing Stages of Private Rule-Making' (2006) 39 *Policy Sciences* 41; see also Tony Prosser, 'Regulation and Social Solidarity' (2006) 33 *Journal of Law and Society* 364, where Prosser noted, at 372, that most conflicts in regulation are about fundamental values. What is at issue, therefore, is the extent to which obligation is conceived self-referentially in narrow technical terms or more expansively, taking into account that individual transactions, whilst legal, may at the same time erode market integrity: Thomas Clay Arnold, 'Rethinking Moral Economy' (2001) 95 *American Political Science Review* 85.

<sup>10</sup> Alan Greenspan, 'We Will Never Have a Perfect Model of Risk', *Financial Times* (London), 17 March 2008, 13.

<sup>11</sup> Alan Greenspan, 'Capitalizing Reputation' (Speech delivered at the 2004 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, 16 April 2004).

<sup>12</sup> Classically, this could be caused by 'regulatory capture': see George Stigler, 'The Theory of Economic Regulation' (1971) 2(1) *Bell Journal of Economics and Management Science* 3; see also Richard Posner, 'Theories of Economic Regulation' (1974) 5(2) *Bell Journal of Economics and Management Science* 335. It can also be traced to ennui or ignorance, and to the progressive erosion of regulatory authority, a critical factor in the period 2004–07 in the United States: Justin O'Brien, *Redesigning Financial Regulation: The politics of enforcement* (2007).

border cooperation.<sup>13</sup> The policy challenge is to build corporate governance and financial regulation in ways that emphasise duties and responsibilities as well as corporate rights. The appropriate first order question, therefore, is not *how* we regulate, but *for what specific purpose?* Restoring the confidence of investors is critical to the success of the various government initiatives worldwide to address the crisis. This cannot be achieved on a sustainable basis unless the structural changes address the ethical dimensions that form the core of the research agenda advanced here.

The article is divided into three parts. First, the credit crisis is put in context and the impact on regulatory practice and techniques is investigated. Second, given stated policy aims to embed integrity into those practices and techniques, the efficacy of adopting and adapting deontological, utilitarian, virtue-based and contextual approaches to capital market regulation is evaluated. Third, the article maps policy responses and concludes that, despite the rhetorical commitment to embed integrity through technical design, the dynamics of regulatory reform are foreclosing its introduction, in part because of a continuing failure to address the critical normative question; namely, what is the purpose of financial regulation?

## The Credit Crisis in Context

Recent estimates by the International Monetary Fund put the total cost of the multifaceted collapse at USD4 trillion,<sup>14</sup> the vast majority of which can be attributed to the systemic failure of corporate and governmental regulation in the United States, the geographic epicentre of the crisis. Many of its leading bankers have been forced to resign, castigated for destroying their institutions through a combination of hubris, greed and regulatory gaming – that is, technical compliance with, but derogation from, the underpinning principles of corporate disclosure obligations.

The crisis was not caused simply by a failure of rules-based regulation. In the United Kingdom, the Financial Services Authority has seen its vaunted risk-based approach to

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<sup>13</sup> International Organization of Securities Commissions (IOSCO), 'IOSCO Finalises Policy Responses to the Financial Crisis' (Media Release, Tel Aviv, 11 June 2009). See Jane Diplock, 'IOSCO Annual Conference Opening Ceremony' (Speech delivered at 34<sup>th</sup> Annual Conference of IOSCO, Tel Aviv, 10 June 2009). In this speech, Diplock, chairperson of the IOSCO Executive Committee and chairperson of the New Zealand Securities Commission argued, at 11:

'We need to understand what direction to take in order to reaffirm IOSCO's pivotal role in the international financial architecture. To do that, we must take account of the lessons every country represented here has learned from the crisis. We need to focus more on identifying risks in financial markets, especially those within the purview of securities regulators.'

Significantly, the chairperson of the Australian Securities and Investments Commission, Tony D'Aloisio, has gone further, suggesting that the crisis necessitates a re-examination of the philosophical underpinnings of regulatory practice, see Tony D'Aloisio, 'The Regulatory Landscape 2009–2010: ASIC and APRA' (Speech delivered at the Finsia Financial Services Conference 2009, Sydney, 28 October 2009).

<sup>14</sup> International Monetary Fund, *Global Financial Stability Report: Responding to the financial crisis and measuring systemic risk*, World Economic and Financial Surveys (April 2009), xi, xv and 30 ('USD4.1 trillion').

regulation fall into as much disrepute as the country's leading banks, whose de facto forced nationalisation has added to the humiliation of London. Similar dynamics are apparent in countries as culturally, politically and economically divergent as Iceland and Ireland.<sup>15</sup> Each has seen its banking system disintegrate, with profoundly destabilising effects on the real economy. In Iceland, there are now calls for the establishment of a truth commission.<sup>16</sup> In Ireland, tens of thousands of people have taken to the streets to protest against public sector spending cuts and the costs associated with bailing out the banking sector, in particular the rescue of Anglo Irish Bank, a deeply flawed institution that has become talismanic of poor corporate governance practice.<sup>17</sup> Ostensibly, more cautious regulatory frameworks within the European Union have proved equally deficient. The 'passport system' allowing banks to operate across borders with supervision vested in their home jurisdiction was a demonstrable failure, as witnessed by the collapse of regional German banks operating in Dublin. Regulatory arbitrage over the implementation of directives relating to the finance sector reinforced these problems.<sup>18</sup>

After taking into account specific national factors, it appears that three interlinked global phenomena are at play: flawed governance mechanisms, including remuneration incentives skewed in favour of short-term profit-taking and leverage; flawed models of financing, including, in particular, the dominant originate-and-distribute model of securitisation, which promoted a moral hazard-culture; and regulatory structures predicated on micro-institutional risk reduction which created incentives for capital arbitrage and paid insufficient attention to systemic macro-credit risk. These factors combined to create an architectural blueprint for economic growth in which innovation trumped security. Financial engineering, in turn, created fiendishly complex mechanisms that ultimately lacked

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<sup>15</sup> International Monetary Fund, 'Crisis Creates Testing Times for Europe's Policymakers', *IMF Survey Magazine*, 10 June 2009 <<http://www.imf.org/external/pubs/ft/survey/so/2009/CAR061009A.htm>>.

<sup>16</sup> Àsgeir Jónsson, *Why Iceland?: How One of the World's Smallest Countries Became the Meltdown's Biggest Casualty* (2009) 203; see also Michael Lewis, 'Wall Street on the Tundra', *Vanity Fair* (April 2009), <<http://www.vanityfair.com/politics/features/2009/04/iceland200904>> at 4 November 2009.

<sup>17</sup> Martin Wall and Stephen Collins, 'Change to Cuts Strategy Ruled Out as Protests Seek "Fairer" Way', *Irish Times* (Dublin), 7 November 2009, 1. For a discussion of the broader issues raised by the failure of the Irish banking system, see generally Fintan O'Toole, *Ship of Fools: How Stupidity and Corruption Sank the Celtic Tiger* (2009) 210, in which the commentator noted caustically that one consequence of the decision to nationalise Anglo Irish Bank was that 'the state was making its citizens responsible for an institution whose books were the most inventive work of Irish fiction since [James Joyce's] *Ulysses*'. There is, however, increasing recognition within the Irish banking sector that expressing regret for what has happened is insufficient without major governance reform: Brian Kavanagh, 'Crisis is Banks' Responsibility, Says Head of Permanent', *Irish Times* (Dublin), 7 November 2009, 16. In this article, Kavanagh quoted the Chief Executive of the Irish Permanent Building Society and President of the Institute of Bankers, David Guinane, who stated, at [2] and [5], 'As bankers we must recognise first and foremost that this crisis has been caused by the failure of our sector to fully understand and manage the risks inherent in our business... We must also show our gratitude for what has been done to stabilise the Irish banking system, despite the increasingly difficult fiscal environment.' Further, the article, at [7], refers to Guinane's observations that the banking sector needs to demonstrate its ongoing commitment 'to dealing generously and imaginatively with customers who are in difficulties - as we in this industry were treated with generosity and imagination in our difficulties'.

<sup>18</sup> Dale Murphy, *The Structure of Regulatory Competition: Corporations and Public Policies in a Global Economy* (2004), 107. At 107, Murphy argued that competition to retain fungible capital can result in a 'competition in laxity': 107. For application to the reinsurance industry, see O'Brien, above n 12, 171–200.

structural and ethical integrity. Asymmetric information flow, variable capacity — or willingness — to use internal management systems, market mechanisms or regulatory enforcement tools, led to a profound misunderstanding of national and international risks associated with the rapid expansion of structured finance products such as securitisation. Deepening market integration ensured that risk, while diversified geographically, remained undiluted. As Nobel Laureate Joseph Stiglitz stated in an excoriating testimony to Congress, ‘securitisation was based on the premise that a “fool was born every minute”. Globalization meant that there was a global landscape on which they could search for those fools—and they found them everywhere’.<sup>19</sup>

From northern Norway to rural New South Wales, local councils bought products on the basis of misplaced trust in the efficacy of internal controls; the strength of independent directors to hold management to account; the attestation provided by external auditors; legal due diligence; the assurances of those providing corporate advisory services; including conflicting reports of various rating agencies and; ultimately, the robustness of the overarching regulatory system at either national or international levels. In short, financial markets became, as the London-based economist Roger Bootle has noted, ‘too big, too greedy, too easily drawn to the fabrication of illusory wealth, and too focussed on the distribution of the proceeds, rather than on the financing of wealth creation’.<sup>20</sup> The progressive visualisation of those flaws has led to a massive loss of confidence in the accountability mechanisms designed by, or demanded of, key actors in financial markets.<sup>21</sup>

The critical issue facing regulatory authorities across the world is how to deal with a model of capitalism based on technical compliance with narrowly defined legislation and a working assumption that unless a particular action is explicitly proscribed, it is deemed politically and socially acceptable. This degree of ethical failure is neither new nor

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<sup>19</sup> Evidence to House Committee on Financial Services, ‘Regulatory Restructuring and the Reform of the Financial System’, United States Congress, Washington DC, 21 October 2008, 4 (Joseph Stiglitz). For a discussion of ‘an ideological agenda [which] has pushed excessive reliance on capital adequacy standards’, see Joseph Stiglitz, ‘Principles of Financial Regulation: A Dynamic Portfolio Approach’ (2001) 16 *World Bank Research Observer* 1. In that report, Stiglitz argued, at 2, that ‘despite its long history, financial market regulation is poorly understood’ and suggests that strong regulation is needed to address ‘failures in the banking system [which] have strong spillovers, or externalities, that reach well beyond the individuals and firms directly involved’.

<sup>20</sup> Roger Bootle, *The Trouble with Markets: Saving capitalism from itself* (2009) 239; see also Emma Connors, ‘Future Fund Chief Sees Day Of Reckoning for Banks’, *Australian Financial Review* (Sydney), 14 January 2009, 38. At 38 Bootle quoted Australian Future Fund chairperson David Murray, who observed:

‘Everybody got carried away by the concept of a “millionaire’s factory” which was not culturally good. Where you don’t want your brightest, or at least too many of them, is in jobs which spend time interpreting or arbitrating rules. This is not really effective work and a lot of investment banking is that type of deal structuring, which is not very constructive. It produces over-engineered stuff that is the first to break when anything goes wrong.’

<sup>21</sup> For a trajectory of corporate governance reform, see Kevin Keasey, Helen Short and Michael Wright, ‘The Development of Corporate Governance Codes in the United Kingdom’, in Kevin Keasey, Steve Thompson and Michael Wright (eds), *Corporate Governance: Accountability, enterprise and international comparisons* (2005) 21; for a global perspective, see generally Jennifer Hill, ‘Evolving “Rules of the Game” in Corporate Governance Reform’ in Justin O’Brien (ed), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 29–54.

unexpected. A striking feature of corporate and regulatory responses to the financial crisis, however, is the paucity of institutional memory. At both Congressional hearings in Washington and in testimony provided to the Treasury Select Committee in Westminster, banking executives claimed that the crisis was the result of a ‘perfect storm’ or ‘financial tsunami’; the conflation of factors beyond control.<sup>22</sup> Similar defences, were used during the conflicts of interest investigations that accompanied the collapse of Enron, WorldCom and Tyco in the accounting scandals at the turn of the 21<sup>st</sup> century.<sup>23</sup> To a large extent this reflects a continuing failure to put in place and monitor — on an ongoing basis — what Montefiore has termed ‘the proper mechanisms for the transmission of institutional memory.’<sup>24</sup> This can be traced to the ideological terms of reference and social norms that underpinned the operation of financial capitalism.<sup>25</sup> It is this component, which privileged the individual over the social, the pursuit of profit over obligation, which formed the most

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<sup>22</sup> Evidence to House Committee on Oversight and Government Reform, ‘Hearing on the Causes and Effects of the Lehman Brothers Bankruptcy’, US Congress, Washington DC, 6 October 2008 (Richard Fuld Jr). This choice of metaphor was also deployed by Alan Greenspan to deflect responsibility for the financial crisis away from the US Federal Reserve Bank: see Evidence to House Committee on Oversight and Government Reform, ‘Hearing on the Role of Federal Regulators in the Financial Crisis’, United States Congress, Washington DC, 23 October 2008, 1 (Alan Greenspan). Many of the British bankers involved in the crisis appeared before the United Kingdom’s Treasury Select Committee. The former Chief Executive of HBOS, Andy Hornby, accepted that the bonus culture played a part in exacerbating systemic risk: see Evidence to Treasury Select Committee, ‘Hearing on Banking Crisis,’ Parliament of the United Kingdom, Westminster, 10 February 2009, 277 (Andy Hornby). For specific compliance failure within HBOS, see Evidence to Treasury Select Committee, ‘Memo to Treasury Select Committee,’ Parliament of the United Kingdom, Westminster, 10 February 2009 (Paul Moore). In his evidence, Moore, HBOS’ former head of compliance, explained at [2.9]:

‘What my personal experience of being on the inside as a risk and compliance manager has shown me is that, whatever the very specific, final and direct causes of the financial crisis, I strongly believe that the real underlying cause of all the problems was simply this — a total failure of all key aspects of governance. In my view and from my personal experience at HBOS, all the other specific failures stem from this one primary cause’.

<sup>23</sup> Newspaper profiles were also used to again deflect responsibility: Eric Dash and Julie Creswell, ‘Citigroup Saw No Red Flags Even As It Made Bolder Bets’, *The New York Times* (New York), 23 November 2008, A1. In this article, Dash and Creswell quoted an April 2008 interview, in which Robert Rubin, former Chairperson of Citigroup’s executive committee, stated:

‘In hindsight, there are a lot of things we’d do differently. But in the context of the facts as I knew them and my role, I’m inclined to think probably not.’

This reprised an argument made in Rubin’s autobiography on the financial reporting scandals at the turn of the 21<sup>st</sup> century; see Robert Rubin and Jacob Weisbeg, *In An Uncertain World: Tough choices from Wall Street to Washington* (2003) 337. Rubin argues, at 337, that:

‘The great bull market masked many sins, or created powerful incentives not to dwell on problems when all seemed to be going so well — a natural human inclination’; for internal conflicts within the Clinton administration over the regulation of financial markets, see Joseph Stiglitz, *The Roaring Nineties: A new history of the world’s most prosperous decade* (2003) 159–62.

<sup>24</sup> Alan Montefiore, ‘Integrity: A Philosopher’s Introduction’ in Alan Montefiore and David Vines (eds), *Integrity in the Public and Private Domains* (1999) 10; see also J Patrick Dobel, ‘Public Trusteeship: The Responsibilities of Transparency and Legacy’ in Justin O’Brien (ed), *Governing the Corporation: Regulation and corporate governance in an age of scandal and global markets* (2005) 317.

<sup>25</sup> Financialisation is a distinct model of capitalism. See generally, Gerald Epstein (ed), *Financialization and the World Economy* (2005); *contra* Malcolm Lewis and John Farnsworth, ‘Financialisation and the Ethical Moment: Levinas and the Encounter with Business Practice’ (2007) 2(2) *Society and Business Review* 179. See more generally, Ismail Erturk et al (eds), *Financialization at Work: Key texts and commentary* (2008).

interesting aspect of Kevin Rudd's attack on the neo-liberal agenda.<sup>26</sup> These were indeed essential contributing factors to the creation and maintenance of the latest manifestation of irrational exuberance.<sup>27</sup>

In the search for responsibility and solutions, it is essential that self-reflection extend to the academy that failed to internalise (or, more accurately, ignored) insights from classical economics on how markets can be (and often are) corrupted by a lack of restraint. Adam Smith's disdain of the joint-stock corporation is (almost but not quite) as well known as his fleeting and largely flippant reference to the 'invisible hand' metaphor.<sup>28</sup> Indeed, the need for governmental intervention to engineer aspiration over mere duty informs his more philosophical writing, particularly *The Theory of Moral Sentiments*.<sup>29</sup> The rise of the corporation magnified the need for impartial adjudication. As Edward Mason noted as early as 1958, the corporation had a profound impact on the 'carefully reasoned' laissez-faire

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<sup>26</sup> Kevin Rudd, 'The Global Financial Crisis', above n 4. See also Mikhail Gorbachev, 'It's Time for a Second American Revolution in the Spirit of Perestroika,' *Sydney Morning Herald* (Sydney), 10 June 2009, 15, who, at 15, caustically noted:

'If all the proposed solutions and action now come down to a mere rebranding of the old system, we are bound to see another, perhaps even greater upheaval down the road. The current model does not need adjusting; it needs replacing.'

Gorbachev further explained, at 15:

'In the West, the break-up of the Soviet Union was viewed as a total victory that proved that the West did not need to change. Western leaders were convinced that they were at the helm of the right system and of a well-functioning, almost perfect economic model. Scholars opined that history had ended. The dogma of free markets, deregulation and balanced budgets at any cost was force-fed to the rest of the world. But then came the economic crisis of 2008 and 2009, and it became clear that the new Western model was an illusion that benefited chiefly the very rich.'

<sup>27</sup> For the original formulation, see Alan Greenspan, 'The Challenge of Central Banking in a Democratic Society' (Speech delivered at the Annual Dinner and Francis Boyd Lecture of The American Enterprise Institute for Public Policy Research, Washington DC, 5 December 1996). In his speech, Greenspan asked rhetorically, 'How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?' The remarks provided the title for a seminal analysis into the dynamics of speculative bubbles: see Robert Shiller, *Irrational Exuberance* (2000). Shiller, along with a Nobel prize winning economist at the University of California, Berkeley, have applied similar reasoning to the global financial crisis: see Robert Shiller and George Akerloff, *Animal Spirits: How Human Psychology Drives the Economy, and Why it Matters for Global Capitalism* (2009) 4. Shiller and Akerloff argued, at 4, that the crisis 'was caused precisely by our changing confidence, temptations, envy, resentment, and illusions — and especially by changing stories about the nature of the economy'.

<sup>28</sup> Adam Smith, *The Wealth of Nations* (1776).

<sup>29</sup> Adam Smith, *The Theory of Moral Sentiments* (1759); see also Lon Fuller, *The Morality of Law* (1964) 5–9. For a contemporary account highlighting the lost legacy of Smith's emphasis on the critical interaction between trust, institutions and motivations in the construction of accountable markets, see Bootle, above n 20, 247. The need for political direction over markets is also evidenced across the spectrum in twentieth century political economy: see Friedrich August Hayek, *The Road to Serfdom* (1944) 29. Hayek argued, at 40:

'To create conditions in which competition will be as effective as possible, to supplement it where it cannot be made effective ... provide indeed a wide and unquestioned field for state activity. In no system that could be rationally defended would the state just do nothing. An effective competitive system needs an intelligently designed and continuously adjusted legal framework as much as any other.'

See also Joseph Schumpeter, *Capitalism, Socialism and Democracy* (1942) 137, who suggested that: 'No social system can work in which everyone is supposed to be guided by nothing except his short-term utilitarian ends ... the stock exchange is a poor substitute for the Holy Grail'; see also Karl Polanyi, *The Great Transformation* (1944) 171, where Polanyi explained: 'The principle of freedom to contract ... is ... merely the expression of an ingrained prejudice in favour of a definite kind of interference, namely such as would destroy non-contractual relations'.

defence that ‘the economic behaviour promoted and constrained by the institutions of a free market system is, in the main, in the public interest’.<sup>30</sup> For Mason, as with Smith before him, this rested on foundations that ‘depended largely on the general acceptance of a reasoned justification of the system on moral as well as on political and economic grounds’.<sup>31</sup> The emergence of major corporations, immune from meaningful controls, along with ‘apologetics’ within the management literature ‘appears devastatingly to undermine the intellectual presuppositions of this system’ without offering ‘an equally satisfying ideology for twentieth century consumption’.<sup>32</sup> As such, ‘the entrepreneur of classical economics has given way to something quite different, and along with him disappears a substantial element in the traditional capitalist apologetic.’<sup>33</sup>

Despite Mason’s misgivings, the economic conception of the corporation as a ‘nexus of contracts’ extended well beyond the boundaries of the economics tradition.<sup>34</sup> Easterbrook and Fischel, for example, maintain that wider social issues are and should remain outside the purview of the market, citing Adam Smith in defence of the proposition that ‘the extended conflict among selfish people produces prices that allocate resources to their most valuable uses’.<sup>35</sup> In this context, the role of corporate law is solely ‘to establish rights among participants in the venture’.<sup>36</sup> For Easterbrook and Fischel, the key normative advantage is that:

[it] removes from the field of interesting questions one that has plagued many writers: what is the goal of the corporation? Is it profit (and for whom)? Social welfare more broadly defined? Is there anything wrong with corporate charity? Should corporations try to maximise profit over the long run or the short run? Our response to such questions is: “Who Cares?”<sup>37</sup>

The contractual promise of a specific corporation is, according to Easterbrook and Fischel, a binding one that ensures certainty. As such it maximises welfare more effectively than

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<sup>30</sup> Edward Mason, ‘The Apologetics of Managerialism’ (1958) 31(1) *Journal of Business* 1, 5.

<sup>31</sup> *Ibid* 6.

<sup>32</sup> *Ibid* 6, 9.

<sup>33</sup> *Ibid* 10.

<sup>34</sup> Frank Easterbrook and Daniel Fischel, ‘The Corporate Contract’ (1989) 89 *Columbia Law Review* 1416, 1426.

<sup>35</sup> *Ibid* 1422.

<sup>36</sup> *Ibid* 1428. However, at 1436, the authors identified circumstances where the corporate contract can be trumped:

‘The argument that contracts are optimal applies only if the contracting parties bear the full costs of their decisions and reap all of the gains. It applies only if contracts are enforced after they have been reached.

The argument also depends on the availability of the full set of possible contracts. If some types of agreements are foreclosed, the ones actually reached may not be optimal.’

This cuts to the heart of the argument that the bailouts distort market fundamentals. The continuing failure to address the question of how to break up institutions deemed too big to fail has eroded the authority and legitimacy of regulatory agencies: see Editorial, ‘When Regulators Fail,’ *Wall Street Journal* (Europe Edition), 4 November 2009, 15.

<sup>37</sup> Easterbrook and Fischel, above n 34, 1446. For the original formulation of an emasculated conception of corporate responsibility, see Milton Friedman, ‘The Social Responsibility of Business is to Increase its Profits’, *New York Times Magazine* (New York), 13 September 1970, 32–3, 122–6.

‘derogation from some ethereal ideal of corporate governance’.<sup>38</sup> To be effective, however, the model requires adherence to the conception of the corporation as a private actor working within efficient markets in which wealth creation provides an unalloyed social benefit.<sup>39</sup> In many ways the construct reached its apogee in 2001 with the publication of Hansmann and Kraakman’s landmark essay, ‘The End of History for Corporate Law’.<sup>40</sup>

The normative claim of ‘the end of history’ thesis was always exceptionally vulnerable to contestation, not least because of its circular reasoning.<sup>41</sup> Furthermore, the foundational assumption of maximising individual utility cuts against the plurality approach to governance that is embedded in contemporary stakeholder and stewardship conceptions of corporate purpose as well as the philosophical core of Smith’s conception of constitutive morality.<sup>42</sup> The credit crisis has now fundamentally undermined the normative assumptions underpinning that conception. Alan Greenspan’s admission that he was ‘partially’ wrong in his deference to the capacity of the market to exercise necessary restraint marks an important but insufficient step forward. Greenspan cautioned lawmakers not to rely on a command and control approach, as ‘whatever regulatory changes are made, they will pale in comparison to the change already evident in today’s markets. Those markets for an indefinite future will be far *more* restrained than would any currently contemplated new regulatory regime’<sup>43</sup> (emphasis in original). Extensive retrenchments across the sector will lengthen the restraining order. This is particularly important in New York, where one study suggests that as many as 78 000 jobs could be lost.<sup>44</sup> While the securities industry (which accounts for 5 per cent of total city employment and 2 per cent of earnings) has borne the public brunt of announced and planned job losses, the collapse of confidence has caused a wider spill-over effect on professional and business services, including legal and accounting corporate advisory, as well as advertising.<sup>45</sup> A similar reality is dawning in London.<sup>46</sup>

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<sup>38</sup> Easterbrook and Fischel, above n 34, 1446.

<sup>39</sup> For the original formulation, see Eugene Fama, ‘Efficient Capital Markets: A Review of Theory and Empirical Work’ (1970) 25 *Journal of Finance* 383.

<sup>40</sup> Henry Hansmann and Reinier Kraakman, ‘The End of History for Corporate Law’ (2001) 89 *Georgetown Law Journal* 439.

<sup>41</sup> Kent Greenfield, ‘September 11<sup>th</sup> and the End of History for Corporate Law’ (2001) 76 *Tulane Law Review* 1409, 1426. For earlier critiques of law and economic tradition, see Victor Brudney, ‘Corporate Governance, Agency Costs, and the Rhetoric of Contract’ (1985) 85 *Columbia Law Review* 1403; see also Eric Orts, ‘The Complexity and Legitimacy of Corporate Law’ (1993) 50 *Washington and Lee Law Review* 1565.

<sup>42</sup> Adam Smith, *Theory of Moral Sentiments*, above n 29.

<sup>43</sup> Evidence to House Committee on Oversight and Government Reform, United States Congress, Washington DC, 23 October 2008, 1 (Alan Greenspan), above n 22, 4. For a discussion of blame, see John Reed, ‘Crisis Has Resulted from Honest Misjudgments by Finance Sector’, Letter to Editor, *Financial Times* (London), 21 October 2008, 12; *contra* Duncan McDonald, ‘Crisis Caused By Negligence and Incredible Stupidity’, Letter to Editor, *Financial Times* (London), 24 October 2008, 8.

<sup>44</sup> Jason Bram, James Orr and Rae Rosen, *Employment in the New York-New Jersey Region: 2008 Review and Outlook* (New York, Federal Reserve Bank of New York, 22 October 2008) 5.

<sup>45</sup> *Ibid* 4. The above figures are sourced from data collected in 2007. The report further noted, at 5, ‘each securities job is estimated to generate 2.3 other city jobs by spurring demand for business and professional services ... and real estate, as well as other services such as hotels and restaurants.’ For extension to legal community, see Alan Feuer, ‘A Study in Why Major Law Firms Are Shrinking,’ *The New York Times* (New York), 7 June 2009, MB1.

Temporary changes in market conditions, however, can no longer mask the gaping conceptual holes in regulatory frameworks exposed in both jurisdictions.

The critical challenge is to resolve the existential conflict ‘between a public law, regulatory conception of corporate law on the one hand, and a private law, internal perspective on the other’; between ‘a body of law concerned solely with the techniques of shareholder wealth maximization [and] a body of law that embraces and seeks to promote a richer array of social and political values.’<sup>47</sup> This conflict has been nicely put by President Obama:

There’s always been a tension between those who place their faith in the invisible hand of the marketplace and those who place more trust in the guiding hand of the government — and that tension isn’t a bad thing. It gives rise to healthy debates and creates a dynamism that makes it possible for us to adapt and grow. For we know that markets are not an unalloyed force for either good or for ill. In many ways, our financial system reflects us. In the aggregate of countless independent decisions, we see the potential for creativity — and the potential for abuse. We see the capacity for innovations that make our economy stronger — and for innovations that exploit our economy’s weaknesses.

We are called upon to put in place those reforms that allow our best qualities to flourish — while keeping those worst traits in check. We’re called upon to recognize that the free market is the most powerful generative force for our prosperity — but it is not a free license to ignore the consequences of our actions.<sup>48</sup>

There can be no doubting Obama’s rhetorical flair. Unfortunately, it leaves unresolved the question of how to design mechanisms that allow for a more precise calibration of ethical content. This redesign requires combining the technical with the normative, both in our investigation of the causes of the crisis and in our evaluation of policy responses. The zeitgeist has moved decisively from governing to governance, from governance to accountability and from accountability to integrity. If the concept is to have meaning beyond rhetoric, it is essential to parse its multifaceted dimensions as both cause (that is, its absence) and putative cure for solving endemic market failure in capital market governance from an applied ethics perspective.

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<sup>46</sup> Alistair MacDonald and Cassell Bryan-Low, ‘Turmoil Batters London’s Status as Financial Center’, *Wall Street Journal* (New York), 22 October 2008, A1.

<sup>47</sup> David Millon, ‘Theories of the Corporation’ (1990) *Duke Law Journal* 201, 202; see also Christopher Stone, ‘Corporate Vices and Corporate Virtues: Do Public/Private Distinctions Matter?’ (1981) 130 *University of Pennsylvania Law Review* 1441, 1442. For an explanation of the normative case for breaking down the artificial boundaries, see Hugh Collins, *Regulating Contracts* (1999) 59. Collins stated, at 53, the need for the ‘productive disintegration of private law’.

<sup>48</sup> President Barack Obama, ‘Remarks by the President on 21<sup>st</sup> Century Financial Regulatory Reform’ (Speech delivered at Press Conference, White House, Washington DC, 17 June 2009).

## The Challenge and Opportunity of Integrity

Policy makers and practitioners across the world have acknowledged that there is a pressing need for the development of a regulatory and corporate architecture based on principles of integrity.<sup>49</sup> What remains unclear is what this nebulous concept means in practice and how to rank competing, potentially incommensurable, interpretations of what constitutes appropriate behaviour. Can one say, for example, that acting within the confines of the law evidences integrity? This cannot be a satisfactory answer given the ethical void experienced in both fascist and totalitarian societies, each governed by legal (if morally repugnant) frameworks.<sup>50</sup> The scale of ethical failure witnessed in the global financial crisis demonstrates the inherent limitations of black-letter law as a sufficient bulwark even within the liberal democratic state. It is equally unsatisfactory to root integrity lexicographically in the application of consistent behaviour. Consistently engaging in deceptive and misleading practice may demonstrate ‘wholeness’ or ‘completeness’ but it cannot be a constituent of integrity. Integrity therefore requires of us not only duty (that is, compliance with the law; consistent and coherent actions), but also principles that contribute to (and do not erode) social welfare (that is, treating people, suppliers and stakeholders with fairness and respect). Seen in this context, enhancing integrity through higher standards of business ethics is a question of organisational design. The aim, in short, is to give substance to what constitutes — or should constitute — appropriate principles of aspiration for the profession.

Business ethics research tends to calcify around one of four main theoretical approaches: deontological, consequential or utilitarian, virtue-ethics and contextual ethics. The deontological approach derives from Immanuel Kant’s categorical imperative, namely ‘act only according to that maxim whereby you can at the same time will that it should become a universal law.’<sup>51</sup> Reliance on short-term profiteering would, if universalised (and condoned by regulatory and political authorities), destroy the credibility of the market and is ultimately self-defeating. In deontological terms, the crisis was evidence of systemic unethical tendencies. Moreover, deceptive or misleading conduct debases moral capacities (indeed it may well also be illegal if the action can be demonstrated to contravene Trade

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<sup>49</sup> Integrity has also long been recognised as an important intangible asset or liability in strategic management studies: see Muel Kaptein and Johan Wempe, *The Balanced Company: A Theory of Corporate Integrity* (2002) 145–52. Kaptein and Wempe noted, at 146–9, that organisational structure and culture generate the execution of specific corporate practices in a reflexive manner.

<sup>50</sup> This is the classic focus on a legendary debate in contemporary legal philosophy of what constitutes law. The positivist approach suggest law is merely what is in statute book: a historical record made by properly constituted legislatures; see for example, HLA Hart, *The Concept of Law* (1961). Others have argued that properly constituted law cannot be vouchsafed unless it is underpinned by an explicit moral component; see Fuller, above n 29, 245–53, particularly his explanation of the problem of the ‘grudge informer’; see also Barry Macleod-Cullinane, ‘Lon L Fuller and the Enterprise of Law’ (1995) 22 *Legal Notes* 1, 3; see generally David Luban, ‘Rediscovering Fuller’s Legal Ethics’ (1998) 11 *Georgetown Journal of Legal Ethics* 801. A third approach suggests that propositions of law are true if they figure in or follow from principles of justice, fairness, and procedural due process that provide the best constructive interpretation of agreed legal practice; see Ronald Dworkin, *Law’s Empire* (1986).

<sup>51</sup> Immanuel Kant, *Grounding for the Metaphysics of Morals* (James W Ellington trans, first published 1785, 1993 ed) 30 [trans of: *Grundlegung zur Metaphysik der Sitten*].

Practices legislation). The third categorical imperative is to ensure that corporate actions have societal beneficence; a formulation that lies at the centre of Smith's landmark *Theory of Moral Sentiments*.<sup>52</sup> In Kantian terms this can only be vouchsafed if the organisation acts and is seen to act within defined ethical parameters. The global financial crisis clearly demonstrated how the search for yield, at any price, trumped prudence and societal obligation.

Even if one views the global financial crisis from the less demanding utilitarian perspective, the consequential impact — unintended, to be sure — makes both the activity itself and the underpinning regulatory framework equally ethically suspect. Here it is essential to differentiate between the product and the clearly inappropriate uses to which it was put to work. There is nothing unethical about securitisation per se. However, from an ethical perspective it is a deficient defence for chief executive officers to claim ignorance of either how these products were structured or how unstable the expansion of alchemistic engineering had made individual banks or the system as a whole.<sup>53</sup> It is now recognised, for example, that the originate-distribute-relocate model of financial engineering significantly emaciated corporate responsibility precisely because it distanced institutional actors at every stage of the process from the consequences of their actions. Likewise, given the huge social and economic cost, it is insufficient for policy makers merely to profess shock at the irresponsibility of banks, insurance companies and ratings agencies.<sup>54</sup> The failure to calculate the risks and design or recalibrate restraining mechanisms at the corporate, regulatory and political levels grossly exacerbated how the externalities were borne by the wider society.

The third major approach to evaluating the ethical dimension of corporate activity is perhaps more demanding. It is also more fruitful in terms of refashioning corporate and regulatory action. While the policy response to scandal has traditionally been to emphasize personal character, much less attention has been placed on how corporate, professional, regulatory and political cultures inform, enhance or restrain particular character traits.<sup>55</sup> The focus of virtue-based analysis is not on formal rules (which can be transacted around) or principles (that lack the definitional clarity to be enforceable). Rather, it focuses on how these rules and principles are interpreted in specific corporate, professional or regulatory practice. This is ultimately a question of individual and collective character, or integrity. In a narrowly defined context, it could be argued that the corporate form itself is inimical to virtue. There is prescience to Alasdair MacIntyre's argument that the 'elevation of the

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<sup>52</sup> Above n 29.

<sup>53</sup> See, eg, the testimony cited in n 22 above. Moreover, the failure to address material risk is a potential breach of s 404 of the *Sarbanes-Oxley Act of 2002* 15 USC 7262. In other jurisdictions, such as Australia, such a failure may amount to misleading, deceptive or unconscionable conduct and could potentially result in prosecution under the *Trade Practices Act 1974* (Cth) and the *Corporations Act 2001* (Cth).

<sup>54</sup> See Brown, 'The Global Economy', above n 3; Greenspan, 'We Will Never Have a Perfect Model of Risk', above n 10; Obama, 'Remarks by the President on 21<sup>st</sup> Century Financial Regulatory Reform', above n 48.

<sup>55</sup> For exceptions, see Richard Sennett, *The Culture of the New Capitalism* (2006) and Richard Sennett, *The Corrosion of Character: The personal consequences of work in the new capitalism* (1998).

values of the market to a central social place' risks creating the circumstances in which 'the concept of the virtues might suffer at first attrition and then perhaps something near total effacement.'<sup>56</sup> This builds on earlier insight which suggested that 'effectiveness in organizations is often both the product and the producer of an intense focus on a narrow range of specialized tasks which has as its counterpart blindness to other aspects of one's activity.'<sup>57</sup> Compartmentalization occurs when a:

distinct sphere of social activity comes to have its own role structure governed by its own specific norms in relative independence of other such spheres. Within each sphere those norms dictate which kinds of consideration are to be treated as relevant to decision-making and which are to be excluded.<sup>58</sup>

For MacIntyre, the combination of compartmentalisation and focus on external goods, such as profit maximisation, corrodes the capacity for development of internal goods, which should be developed irrespective of the consequences.<sup>59</sup>

It is incumbent upon regulatory authorities (formal and informal) to identify and break down the compartmentalization imperatives at corporate and professional levels and integrate the form and purpose of business ethics into a wider social contract. It is in this context that the fourth key dimension of business ethics theory comes into play: the contextual material and ideological environment in which social norms play out.<sup>60</sup> It is mistaken to assume that social norms, once accreted, remain static, impervious to environmental corrosion.<sup>61</sup> As noted above, a critical feature of the global financial crisis

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<sup>56</sup> Alasdair MacIntyre, *After Virtue: A study in moral theory* (1984) 196.

<sup>57</sup> Alasdair MacIntyre, 'Why Are the Problems of Business Ethics Insoluble,' in Bernard Baumrin and Benjamin Friedman (eds), *Moral Responsibility and the Professions* (1982) 358.

<sup>58</sup> Alasdair MacIntyre, 'Social Structures and their Threats to Moral Agency' (1999) 74 *Philosophy* 311, 322; see also John Dobson, 'Alasdair MacIntyre's Aristotelian Business Ethics: A Critique' (2009) 86 *Journal of Business Ethics* 43. For an application of the need to avoid compartmentalisation from a practising law perspective, see Sandra O'Connor, 'Commencement Address' (Speech delivered at Georgetown University Law Center, Washington DC, 27 May 1986). In her address to graduates, O'Connor stated, at 1, 'Lawyers must do more than know the law and the art of practicing it. They need as well to develop a consciousness of their moral and social responsibility ... Merely learning and studying the Code of Professional Responsibility is insufficient to satisfy your ethical duties as a lawyer'; see also Anthony Kronman, *The Lost Lawyer: Failing ideals of the legal profession* (1995) 16, where the author laments a lost ideal of the 'lawyer-statesman' in which reputation was defined by an individual identity that comprised both practical wisdom and technical mastery.

<sup>59</sup> Alasdair MacIntyre, 'Social Structures and their Threats to Moral Agency', above n 58.

<sup>60</sup> For the need to bifurcate and map the distinction between the universality of moral sentiment and the particularity of application, see David Marshall Smith, *Moral Geographies: Ethics in a world of difference* (2000) 14.

<sup>61</sup> The importance of context now informs the work of prominent behavioural economists: see Shiller and Akerloff, above n 27. For an analytical framework highlighting the lost importance of social norms as an underpinning construct, see Oliver Williamson, 'The New Institutional Economics: Taking Stock, Looking Ahead' (2000) 38(3) *Journal of Economic Literature* 595, 597. Williamson noted, at 597, that analysis of this 'level one' component of social theory is conspicuous by its absence with regulatory studies. The other three levels comprise institutional arrangements viewed primarily through property rights and positive political theory, governance mechanisms through transaction cost economics and resource allocation frameworks generally examined through agency theory.

was the fact that much of what occurred was legal.<sup>62</sup> Indeed earlier empirical work conducted by this researcher in late 2006 and early 2007 highlighted just how corroded restraining mechanisms had become in the cities of London and New York and how unstable the underpinning framework had become.<sup>63</sup> The unresolved questions are why this occurred and how it can be ameliorated. The search for answers and the putative solutions necessitate that we pay much more attention to the normative dimension of the regulation of capital markets. This, in turn, suggests that regulatory effectiveness cannot be vouchsafed merely by reforming the institutional structure, nor without articulating precisely what is meant by business integrity and accountability within specific contexts. This entails a need to articulate the parameters of what constitutes ‘smart regulation,’ which lacks a normative dimension.<sup>64</sup>

The central argument of this article is that we require a synthesis between an appreciation of context, the need for virtuous behaviour and the importance of deontological rules and consequential principles of best practice within an overarching framework that is not subverted by compartmentalised responsibilities.<sup>65</sup> The policy problem is not the relative importance of virtue but whether it can be rendered operational in a systematic, dynamic and responsive way, with specific benefits to business.<sup>66</sup> Accountability is, therefore, as noted above, a design question at both corporate and regulatory levels which, to be effective, needs to be mutually reinforcing and capable of dynamically addressing the calculative, social and normative reasons for behaving in a more (or less) ethically responsible manner.<sup>67</sup>

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<sup>62</sup> See above n 8.

<sup>63</sup> Justin O’Brien, ‘Charting an Icarian Flightpath: The Implications of the Qantas Deal Collapse’ in Justin O’Brien (ed) *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 295–338.

<sup>64</sup> John Wright and Brian Head, ‘Reconsidering Regulation and Governance Theory: A Learning Approach’ (2009) 31 *Law and Policy* 192, 197–8.

<sup>65</sup> One suggested approach derives from an integrative social contracts theory approach, which set out corporate and reciprocal arrangements and expectations. Micro-social contract norms must be compatible with hyper norms; that is, norms sufficiently fundamental that they can serve as a guide for evaluating authentic but less fundamental norms: see Thomas Donaldson and Thomas Dunfee, *Ties That Bind: A social contracts approach to business ethics* (1999) 115.

<sup>66</sup> For an application to business as an intangible asset, see Joseph Petrick and John Quinn, ‘The Challenge of Leadership Accountability for Integrity Capacity as a Strategic Asset’ (2001) 34 *Journal of Business Ethics* 331. For the original formulation of the model, see Joseph Petrick and John Quinn, ‘The Integrity Capacity Construct and Moral Progress in Business’ (2000) 23 *Journal of Business Ethics* 3. The current chairperson of the Securities and Exchange Commission has implicitly recognised the need for constitutive engagement, stating ‘We might sit on opposite sides of the table in any given matter, but I believe that all of us — regulators, attorneys, and business people alike — all share the common goal of ensuring that our capital markets work — and work fairly and effectively’: see Mary Shapiro, ‘Address to the Practising Law Institute’s 41<sup>st</sup> Annual Institute on Securities Regulation’ (Speech delivered at Practising Law Institute, Securities Regulation Seminar, New York, 4 November 2009).

<sup>67</sup> Soren Winter and Peter May, ‘Motivation for Compliance with Environmental Regulations’ (2001) 20 *Journal of Policy Analysis and Management* 675; see generally Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the deregulation debate* (1992). For a study suggesting that the power of outsiders to emphasise effective internal controls is dependent upon the existence of a perception within the company that performance is being monitored, see Vibeke Lehmann Nielsen and Christine Parker, ‘To What Extent Do Third Parties Influence Business Compliance?’ (2008) 35 *Journal of Law and Society* 309. Nielsen and

It is axiomatic that when a complex trading model disintegrates, the clarion calls for action inevitably target the regulator. The scale of the credit crisis requires us to transcend an increasingly sterile debate over whether it is preferable to privilege rules over principles.<sup>68</sup> Rules need to work ‘hand in glove’ with principles within an interlocking system of incentives and disincentives. In some areas, compliance with rules might be more important than alignment with principles. On the other hand, for some problems in other areas, for example potential conflicts of interest, the emphasis might need to be on principles in the context of verifiable procedural requirements, such as an internal but independent mechanism for determination of any conflict of interest. In other areas, such as disclosure requirements, principles and rules might both need to be met. More generally, principles may require ongoing testing to ensure consistency and coherence in terms of application. How to ensure that rules and principles mutually reinforce one another — rather than compete with one another — is central to regulatory effectiveness. It has long been recognised that strong moral and ethical codes are required to ensure economic viability.<sup>69</sup> Moreover, the falsification of the efficient market hypothesis has been accompanied by a belated acceptance that pursuit of (deluded) self-interest is not only corrosive, but when taken to its logical conclusion, diminishes accountability.<sup>70</sup> Sustainable reform necessitates examining which factors contribute to the reinforcement or degradation of social norms.<sup>71</sup> Unless this dimension is addressed it is highly unlikely that lasting behavioural change can be expected. The unresolved issues are what form these national standards should take, how to enforce compliance with rules, and, more importantly, how to enhance the ambition of aspiration. Here evidence from Australia provides room for cautious hope.

Australia’s business conduct regulator, the Australian Securities and Investments Commission (ASIC), has completed a strategic review of its operations. Five key priorities have been identified: firstly, a focus on outcomes; secondly, the development of initiatives to help retail investors manage and protect wealth; thirdly, the introduction of new investigative techniques to reduce systemic problems; fourthly, the reduction of red-tape in administration; and finally, an emphasis on facilitating inward and outward investment by

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Parker’s study utilises survey data from 999 large Australian businesses. For broader theoretical issues, see Melvin Dubnick and Justin O’Brien, ‘Retrieving the Meaning of Accountability in Financial Market Regulation’ (Paper presented at the 2009 Annual Meeting of the American Political Science Association, Toronto, 3–6 September 2009).

<sup>68</sup> The debate is a perennial one within regulatory studies: see Julia Black, *Rules and Regulators* (1997); see also Hill, above n 21, 29. It is also deeply unsatisfactory: see Justin O’Brien, ‘Managing Conflicts: The Sisyphean Tragedy (and Absurdity) of Corporate Governance and Financial Regulation Reform’ (2007) 20 *Australian Journal of Corporate Law* 317.

<sup>69</sup> Douglass C North, *Structure and Change in Economic History* (1981) 47. North suggested, at 47, that moral and ethical codes are the ‘cement of social stability’.

<sup>70</sup> See Shiller and Akerloff, above n 27, 5–6. For a regulator’s perspective on the implications of the failure of the efficient markets hypothesis, see D’Aloisio, above n 13.

<sup>71</sup> See Lynn Stout, ‘Social Norms and Other-Regarding Preferences’ in John Drobak (ed), *Norms and the Law* (2006) 13. Stout’s research, at 22, involved a review of ‘studies in human behaviour in social dilemmas, ultimatum games and dictator games’, and postulated that ‘taken as a whole, the evidence strongly supports the following proposition: *whether or not people behave in an other-regarding fashion is determined largely by social context, tempered — but only tempered — by considerations of personal cost*’ [emphasis in original].

differentiating the Australian marketplace from its competitors via an emphasis on business integrity. The objective is to provide clarity over regulatory objectives and the mechanisms used to achieve them. The strategic review may well reconstitute the form and substance of capital market regulation in Australia. Its success, however, will depend on ASIC's ability to facilitate among market participants a willingness to embrace the reform agenda, including, crucially, its conception of business integrity.

ASIC has been particularly vulnerable following three high profile property collapses — Fincorp, Westpoint and Australian Capital Reserve. In each case, investors were provided with a debenture (or promissory note), periodic but higher interest repayments than those offered by the mainstream banking sector, and a return on initial capital at the end of the term. ASIC has attempted to introduce an integrity dimension with a discussion paper on the market for unrated, unlisted investment vehicles. The market in unrated, unlisted bonds accounts is AUD 8 billion and involves 92 investment vehicles.<sup>72</sup> ASIC has been careful to note that risk-levels vary considerably within this group. Its decision to publish the full list of providers in a consultation paper adds significantly to the demonstrated power of reputation.<sup>73</sup> Inevitably, benchmarking performance requires the sector to begin differentiating according to risk profiles. As the investment vehicles seek to retain or grow market share, they are much more likely to provide improved disclosure: articulation of risk-benefit across credit rating, equity capital, liquidity, lending principles, portfolio diversification, valuation of stock, related party transactions and rollovers and early redemption possibilities and penalties, and disclosure of relative ranking, which, if not complied with should be justified. External gatekeepers such as trustees, advisors and auditors should explicitly take disclosure into account when issuing valuations.

There is a risk that enhanced levels of disclosure can obfuscate as well as illuminate, making the sector potentially more resistant to transparency. To counter this possibility, ASIC has suggested that attention must also be placed on, and accountability demanded from, those providing corporate advisory services and the creation and dissemination of technically legal but misleading advertising. These include not just trustees and auditors but also copywriters, production teams, publishers and broadcasters who sell the print, audio-visual and online space. On one reading, this could be construed as a further example of regulatory creep. On the other, it is simply a recognition that the regulator lacks the resources to resolve the problem on its own. The critical implication of this putative framework lies in the assumption that professional groups must acknowledge their own responsibility and be accountable for their actions, meaning, in this narrow sense, acquiescing to external scrutiny of what codes of conduct mean in practice. None of this is

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<sup>72</sup> Australian Securities and Investments Commission, 'Unlisted Unrated Debentures — Improving Disclosure for Retail Investors' (Consultation Paper No 89, Sydney, 23 August 2007).

<sup>73</sup> *Ibid.* See also Australian Securities and Investments Commission, 'Debenture Advertising' (Consultation Paper 94, Sydney, 31 October 2007). The result was the introduction of two new regulatory guides (Regulation 69 on disclosure requirements and Regulation 156 on advertising standards), both of which are available on ASIC's website.

going to be of any use to those bewitched by the potential returns. While investment guides can and should be simplified by their very nature these products are exceptionally complex. Investor education programs are to be encouraged, particularly when couched in terms that highlight the investor's own personal responsibility. Behavioural change, however, needs to be inculcated at a higher level within the product market and it is for this reason alone that the processes advanced by ASIC should be endorsed. Although the unlisted debenture market is relatively insignificant in monetary terms, the reputational damage associated with public perceptions of sharp-practice is enormous. Harnessing this power has enormous benefits, particularly as one seeks to address broader questions of market integrity.

Regulators and those providing intermediating services are repeat players, whose interests are substantially harmed by those who defect from market convention. While the introduction of advanced training and investigative techniques are to be welcomed, in the absence of a catastrophic failure it is unrealistic to expect a regulator to be able to understand the dynamics and, therefore, to design the optimal form of compliance for any given organisation. Even in such a case, it is arguable that the measures introduced may fail to deal with the substantive underlying problem. This partly accounts for the controversy over innovative mechanisms to embed compliance, such as pre-trial diversion in the United States or enforceable undertakings in Australia.<sup>74</sup> This is not to suggest that the corporate probation that the enforceable undertaking permits is indefensible on legal, ethical or public policy grounds. Rather, it is to argue that efficacy is likely to be improved as a result of an agonistic dialogue and that this is unlikely to occur in circumstances in which the regulator imposes solutions. It is, therefore, necessary that the design and implementation of enforceable undertakings is the product of cross-cutting agency taskforces, which are, in turn, advised by high-level working groups. This requires a much more sustained dialogue than has been evidenced to date in Australia. This does not mean ceding regulatory authority. Rather it means that the agency establishes mechanisms that build informal trust networks. This not only enhances the quality of market intelligence, it also reinforces the restraining power of articulated norms. By adopting a less intrusive approach to the construction of corporate compliance frameworks — in return for access to the organisational blueprints, as required for wider demonstration effect — the regulator also fulfils a statutory objective to reduce regulatory burden without necessarily sacrificing effectiveness. Furthermore it does so without revealing that its ultimate sanction — namely,

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<sup>74</sup> For an application to Australia, see Christine Parker, 'Restorative Justice in Business Regulation? The Australian Competition and Consumer Commission's Use of Enforceable Undertakings' (2004) 67 *Modern Law Review* 209; see also Christine Parker, 'Regulator-Required Corporate Compliance Program Audits' (2003) 25 *Law and Policy* 221. For difficulties associated with its application in the United States, see Justin O'Brien, 'Accounting and Accountability Failure: The Impact of the Kaplan Ruling on Corporate Enforcement' (2006) 1 *Compliance and Regulatory Journal* 28; see also Justin O'Brien, 'Securing Corporate Accountability or Bypassing Justice? The Efficacy and Pitfalls of Pre-Trial Diversion' (2006) 19 *Australian Journal of Corporate Law* 161.

licence revocation — is, in practice, impractical precisely because of job losses and impact on already reduced levels of confidence in the probity of the financial system.<sup>75</sup>

## The Trajectory of Reform

The United States had begun the process of overhauling its dysfunctional regulatory system before President Obama, during his inauguration, promised ‘change we can believe in’.<sup>76</sup> The process is likely to generate turf wars in Washington for some time to come and, in the process, be much more evolutionary than revolutionary, characterised by piecemeal advances and setbacks rather than linear progression. The need for reform was highlighted well before the crisis reached such catastrophic levels, most notably in a blueprint for reform offered by the then Treasury Secretary, Henry Paulson.<sup>77</sup>

The Treasury Blueprint<sup>78</sup> suggested a conceptual redesign, replacing a diffused functional with an objectives-based regulatory approach, covering what were termed Federal Financial Services Providers. The redesign addressed the designated goals of regulation – market stability, prudential financial regulation and business conduct. Crucially, however, it omitted sustained comment on purpose. The Blueprint endorsed replicating the technical model of oversight currently used in Australia. According to the Treasury Blueprint, the business conduct dimension would focus on:

providing appropriate standards for firms to be able to enter the financial services industry and sell their products and services to customers ... The establishment of a FFSP charter would result in the creation of appropriate national standards, in terms of financial capacity, expertise, and other requirements, that must be satisfied to enter the business of providing financial services.<sup>79</sup>

In any event, the Obama administration did not grasp the nettle of simplifying the regulatory structure, preferring to encourage coordination between functionally disparate regulatory agencies.<sup>80</sup> As with the original Treasury Blueprint, it has significantly enhanced the

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<sup>75</sup> Licence revocation is the ultimate sanction in the famous enforcement pyramid paradigm: see Ayres and Braithwaite, above n 67.

<sup>76</sup> Barack Obama, *Change We Can Believe In: Barack Obama's Plan to Renew America's Promise* (2008).

<sup>77</sup> Henry Paulson, Robert Steel and David Nason, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* (US Department of the Treasury, March 2008). The document derives from a conference convened in March 2007 and builds on an agenda shaped by the work of the Committee on Capital Markets, a self-appointed commission co-chaired by John Thornton, a former Goldman Sachs executive, and Glenn Hubbard, a former chairperson of the Council of Economic Advisors and Dean of Columbia University Business School.

<sup>78</sup> Ibid 14.

<sup>79</sup> Ibid 19.

<sup>80</sup> See Department of Treasury, *Financial Regulatory Reform: A New Foundation* (2009). The influential leader of the Senate Banking committee, Chris Dodd, has advocated a much more radical solution, involving the creation of a single banking regulator that takes significant power away from the US Federal Reserve Bank: see Tom Braithwaite and Sarah O'Connor, 'Banks Bill Seeks to Strip Fed of Powers,' *Financial Times* (Asia

authority of the Federal Reserve to supervise all firms that could pose a threat to financial stability. Mirroring European proposals, the Treasury recommended the establishment of a Financial Services Oversight Council charged with identifying emerging systemic risks and improving interagency cooperation.<sup>81</sup> It also advocated the creation of a new Consumer Financial Protection Agency, whose aim would be to 'reduce gaps in federal supervision and enforcement; improve coordination with the states; set higher standards for financial intermediaries; and promote consistent regulation of similar products.'<sup>82</sup>

Elizabeth Warren, a professor of law at Harvard, has neatly summarised the broader argument. She maintains that while household items like toasters are routinely tested, 'financial products go unmonitored for basic safety. When shopping in the complex and constantly evolving financial market, where actual costs and unfavorable terms are regularly concealed, consumers are on their own.'<sup>83</sup> Warren, who has served since 2008 as chair of the Congressional Oversight Panel responsible for monitoring the US Department of Treasury's management of the Troubled Asset Relief Program, had advocated a much more invasive Financial Product Safety Commission. The distinction is not merely a question of semantics. The financial services industry is sanguine about attempts to limit the exposure of ordinary consumers. There is, however, considerable opposition to limit the risk appetite of sophisticated investors.<sup>84</sup> Opposition is based on the premise that disclosure will in itself be sufficient. Clearly this is, if not a false premise, then certainly, an emasculated conception of business responsibility.

Innovation, renewal and stagnation conflict and conflate. This is most apparent in the thorny issue of how to wean the banking sector off its addiction to irresponsible and unsustainable lending and trading practices. Treatment options were clarified with the release on 7 May 2009 of stress tests conducted by the Federal Reserve in conjunction with the Department of Treasury into 19 of the most important banks.<sup>85</sup> Not surprisingly, given the extensive media management that preceded publication, prognosis was favourable. As widely reported, the Charlotte-based Bank of America is the most exposed. The bank is required to enhance capital reserves by \$34 billion.<sup>86</sup> Citigroup, by contrast, one of the

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Edition), 11 November 2009, 1. Braithwaite and Connor observed, at 1, that 'the move ushered into the open a behind-the-scenes-struggle between banks, policymakers and regulators.'

<sup>81</sup> Department of Treasury, 'Financial Regulatory Reform: A New Foundation', above n 80, 3, 10.

<sup>82</sup> Ibid 6–7. The Blueprint recommendation, at 13, explicitly argued that rules set by the agency should be 'a floor not a ceiling' and that it gave US states the authority to impose stricter standards.

<sup>83</sup> Elizabeth Warren and Amelia Warren Tyagi, 'Protect Financial Consumers', *Harper's Magazine* (New York), November 2008, 39 <<http://www.harpers.org/archive/2008/11/0082252>> at 4 November 2009.

<sup>84</sup> See Bob Herbert, 'Chutzpah on Steroids', *The New York Times*, (New York), 13 July 2009, <<http://www.nytimes.com/2009/07/14/opinion/14herbert.html>>.

<sup>85</sup> Board of Governors of the Federal Reserve System, 'The Supervisory Capital Assessment Program: Overview of Results' (Press Release, Washington DC, May 7 2009); see also Board of Governors of the Federal Reserve System, 'The Supervisory Capital Assessment Program: Design and Implementation' (Press Release, Washington DC, 24 April 2009).

<sup>86</sup> Edmund L. Andrews, 'Ailing Banks Need \$75 Billion, U.S. Says', *The New York Times* (New York), 8 May 2009, A1.

weakest major banks, requires only \$5.5 billion.<sup>87</sup> The former investment banks, Morgan Stanley and Goldman Sachs, have fared much better. Morgan Stanley has been cautioned to raise just \$1.5 billion.<sup>88</sup> Goldman Sachs is regarded as adequately capitalised, as is JP Morgan Chase, which has managed the integration of Bear Stearns much more successfully than the hapless management at Bank of America, where empire building led to the disastrous acquisition of Merrill Lynch and Countrywide at the peak of the crisis.<sup>89</sup> Remarkably, as a result of regulatory oversight, there was a failure to identify the need to change senior management. Indeed, the overall picture presented was of relative strength rather than weakness. In total, only \$75 billion was deemed necessary to insulate the banking sector. According to US Treasury Secretary Timothy Geithner, investors should now be reassured that all losses were accounted for and that entrenched management was credible.<sup>90</sup> This suggestion overstates the case.

The content and conduct of the tests and the way in which the results were disseminated leave huge questions about the ultimate purpose and who will stand to gain most of all from this exercise in managing expectations. There are a number of profound methodological flaws. The tests used worst-case scenario baselines that have already been proven optimistic. More problematically, the banks were able to negotiate privately with the Government over how the latter interpreted the results. None of this gives confidence in the veracity of claims that the banking sector, as a whole, is adequately capitalised or would remain so if explicit and implicit guarantees were removed. While much has been made of plans to regulate the over-the-counter derivatives market and impose more stringent caps on executive pay, neither initiative offers fundamental change. The former will provide more transparency but does not necessarily deliver more effective risk management. The value of the latter is undermined by the fact that major banks are outside the purview of governance reform, making for a piecemeal approach that does not deliver meaningful change. Moreover, the focus on executive remuneration, while laudable, derives from imperatives imposed by Congress rather than the White House, which had initially argued that such policies were too invasive. It is indicative that the Federal Reserve, which is emerging from the crisis with significantly enhanced power, remains reluctant to specify remuneration limits.<sup>91</sup> Similarly at an international level, there is little appetite to move beyond mere

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<sup>87</sup> Ibid.

<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid. See also Geithner, above n 5, 14.

<sup>91</sup> The Federal Reserve has called on the largest banks to review their remuneration policies to ensure they are proportionate to risk management and integrated within governance structures, as well as to minimise risk-taking: Eric Dash, 'Fed Tells Banks They Need to Re-Examine their Pay Scales', *International Herald Tribune*, 4 November 2009, 14. The Chairperson of the Securities and Exchange Commission has highlighted improvements to the proxy voting system as a restraining mechanism: see Shapiro, above n 66. Shapiro argued, at 6 'the proxy statement is crucial to our system of corporate governance. It is the only communication a company makes that is specifically addressed to, and intended for, shareholders'. The proposals cover the right to nominate directors, the disclosure of information about qualifications of board members, the structure of board governance, the compensation of consultants and the relationship between a company's compensation policies and overall risk profile. The United Kingdom has adopted a much more aggressive strategy, where the

rhetoric, notwithstanding calls at the meeting of the G20 Finance Ministers at St Andrews for a reinvigorated social pact.<sup>92</sup> The absence of detail suggests that the exercise is merely an exercise in symbolism. As such it represents a missed opportunity to reconfigure the operation of capital markets.

## Conclusion

As with the social and political systems in which they are nested, financial centres depend on integrity. Despite a rhetorical commitment to enhance integrity, many of the chosen policy options remain firmly within the existing technical realm, relying on traditional regulatory tools such as enhanced disclosure, literacy programs and attempts to distinguish between sophisticated and unsophisticated investors. Each has proved inadequate thus far in the search for greater, or more accurately, effective, accountability. Moreover, the issue of what constitutes appropriate levels of disclosure, transparency and accountability, even within these narrow conceptions, not only remains unresolved, but is also subject to intense contestation, which runs across all functional and jurisdictional boundaries. Given the fact that markets can be and often are inefficient, what is required is an acceptance that effectiveness necessitates dynamic and responsive regulatory guidelines, using the entire suite of enforcement mechanisms, ranging from command and control, through enforced self-regulation, to industry-designed and policed codes of conduct that emphasise non-binding social norms.

Identifying and repositioning the precise intersection between law and ethics requires the design and implementation of an integrated set of nuanced strategies. To be effective, the strategies must align the interests of institutional actors to an overarching regulatory 'mission' or 'purpose.' The motivational rationale of specific actors is irrelevant. By building on a foundation of common *stated* values, an agonistic understanding of what constitutes the problematic core is generated, from which deviation lowers reputational standing and access.<sup>93</sup> This framework can only be sustained through an interlocking dissemination network comprising and reinforcing formal and informal nodes. The resulting synthesis has three key practical and normative advantages. First, it reduces real and artificial incommensurability problems between participants in the regulatory conversation (irrespective of whether or not they have been accorded formal surveillance authority). Second, it reduces the retreat to legal formalism, de-escalates confrontation and contributes to behavioural modification across the regulatory matrix. Third, by clarifying accountability

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government mandated a blanket ban on all bonus payments to employees earning more than AUD 80 000 at Lloyds Banking Group and Royal Bank of Scotland Group, two of the largest recipients of government aid: see Munoz and Norman, 'New U.K. Bank Aid: \$51.2 Billion', *Wall Street Journal* (Europe Edition), 4 November 2009, 1, 4.

<sup>92</sup> Brown, 'Speech to G20 Finance Ministers', above n 4.

<sup>93</sup> Eric Posner, 'The Strategic Basis of Principled Behavior: A Critique of the Incommensurability Thesis' (1998) 146 *University of Pennsylvania Law Review* 1185–214. At 1190, Posner emphasised the importance of the incompatibility thesis and subsequently differentiated between warranted and unwarranted reputation.

responsibilities it offers greater certainty for corporations and the market in which they are nested, thus facilitating investment flows. It provides a more meaningful baseline from which to measure and evaluate subsequent regulatory and corporate performance. If, as Gordon Brown has suggested, there is a need for a new 'social contract' between the banking sector and society at global level, it is necessary to be much more explicit about the purpose of financial regulation.<sup>94</sup> It is therefore essential to recalibrate the theory and practice of regulation to incorporate a much more substantive normative component. This article has provided the reasons why.

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<sup>94</sup> Brown, 'The Global Economy', above n 3, 26.