Chapter 12

Institutions, Integrity Systems and Market Actors

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As is well-known, the collapse of the US corporation, Enron, had a devastating effect on shareholders and employees.¹ And in its wake came the revelations of a litany of unethical practices, including conflicts of interests, such as that of CFO Andrew Fastow, auditing failures, corrupt (if not necessarily unlawful) practices, such as the creation of so-called Special Purpose Entities calculated to mislead shareholders in relation to actual performance, and so on. Moreover, the Enron collapse was only one among a number of recent corporate corruption scandals, including WorldCom and the giant accounting firm Arthur Andersen and, in the Australian context, One.Tel and HIH. The HIH Royal Commission found that, as the company lurched towards collapse, it engaged in corporate excesses involving travel, entertainment, charitable donations, and executive gifts.² These excesses stripped over AU\$32 million out of its assets. Staff were given gold watches, and a tip of AU\$5700 was paid at

¹ Peter C Fusaro and Ross M Miller, *What Went Wrong at Enron* (2002).

² See Seumas Miller, 'Corruption' in *Stanford Encyclopedia of Philosophy* (Winter, 2005), for an account of corruption and its divergence (at times) from illegality.

³ 'HIH Regulator Deceived', *The Australian* (Sydney), 24 January 2003; Farid Vares, 'The Buck Will Stop at the Board? An Examination of Directors' (and Others) Duties in Light of the HIH Collapse' (2002) 16 *Commercial Law Quarterly* 12.

a dinner attended by the CEO and HHH executives at Port Douglas.⁴ Just weeks before the collapse, AU\$180 000 was paid to a Melbourne football club which was in some financial difficulty. The HHH collapse has sparked a lively debate into the ethical responsibility of company directors and the role of corporate regulators. The Australian Prudential Regulation Authority, among other corporate regulators, claims that it was profoundly misled by HHH, and thus it, in turn, had inadvertently misled the government about the seriousness of the crisis facing the company. The federal opposition has questioned how the collapse was not anticipated by the regulatory authorities, given the amount of material showing that HHH was in trouble up to two years before the collapse.

The corporate collapses and corruption scandals of the late 1990s and early 2000s in the US, Australia and elsewhere appear to be part of a recurring cycle.⁵ Recall the corporate scandals of the 1980s in the US and elsewhere.⁶ That period was notable for a stock market crash, a junk bond collapse, the bankruptcy of numerous highly-leveraged clients, the prevalence of the unlawful practice of insider trading, and the fining and imprisonment of the likes of Michael Milken and Ivan Boesky. Milken paid fines in excess of US\$600 million, Boesky over US\$100 million.⁷ Self-evidently, these corporate collapses were extraordinarily damaging economically, but apparently they might also be ongoing; perhaps the question is not whether there will be a recurrence, but rather when it will take place. If so, then these corporate collapses and corruption scandals might not be aberrations, but rather symptoms of underlying systemic deficiencies in corporate law and regulation, and perhaps of structural deficiencies in the corporate sector itself, notably in the financial services area. Perhaps, therefore, it is worth trying to take a bird's-eye view of the contours of the macro-institutional setting in which particular corporate collapses and corruption scandals have taken place, and doing so from an ethical perspective.

In this chapter I focus on the ethical, as opposed to legal, financial or political, dimensions of this problem and, in particular, on

⁴ Port Douglas is an expensive tropical resort some 1500 miles away from Sydney, where HHH was based.

⁵ Frank Clarke, Graeme Dean and Kyle Oliver argue as much in *Corporate Collapse: Accounting, Regulatory and Ethical Failure* (revised ed, 2003).

⁶ See, eg, Trevor Sykes, *The Bold Riders* (1984).

⁷ James B Stewart, *Den of Thieves* (1992) 20.

ethics at the macro-institutional level. In the first section I sketch a normative theoretical account of social institutions; in the second section I outline some of the key features of what I will refer to as an integrity system for institutions; and in the third and final section, in light of my accounts of social institutions and integrity systems, I offer some speculations concerning some of the ethical problems confronting the corporate sector in general, and the financial services sector in particular.

In this chapter I argue that the basic normative question that needs to be asked of a business corporation, or financial market, is the same as for any other social institution, namely: What collective good(s) does it exist to provide? I further argue that, normatively speaking, social institutions including business corporations and markets exist for ultimate — and not merely proximate — purposes or ends, namely, to provide collective goods, for example material goods, the coordination of buyers and sellers of material goods. Here Adam Smith's invisible hand mechanism is salient. The outcome of the workings of the invisible hand is the ultimate purpose of this institutional mechanism: the pursuit of financial gain, the proximate end. Finally, I argue that in the case of the financial services sector, in particular, the prior fundamental ethical question as to the ultimate institutional ends of this sector remains unanswered. Yet without an answer to this question, an integrity system for the financial services sector — and a regulatory system insofar as it is concerned with institutional (ethical) integrity, as it surely must be — is quite literally without one of its basic purposes: it does not know what ethical ends it is seeking to embed in its target institution, ie in the financial services sector.

But we are getting ahead of ourselves. Our first task is the provision of an account of social institutions. In fact, the term, 'social institution', is somewhat unclear both in ordinary language and in the philosophical literature. However, contemporary sociology is rather more consistent in its use of the term. Typically, contemporary sociologists use the term to refer to complex social forms that reproduce themselves, such as governments, universities, hospitals, business corporations, markets and legal systems. A typical definition is that proffered by Jonathan Turner: 'a complex of positions, roles, norms and values lodged in particular types of social structures and organising relatively stable in patterns of human activity with respect to fundamental problems in producing life-sustaining viable societal structures within a given

environment'.⁸ Again, Anthony Giddens says: 'Institutions by definition are the more enduring features of social life'.⁹ He goes on to list as institutional orders modes of discourse, political institutions, economic institutions and legal institutions.¹⁰

At this point it might be asked why a theory of social institutions in general, and a theory of market institutions in particular, has, or ought to have, any philosophical interest; why not simply leave such theorising to the sociologists and/or the economists? One important reason stems from the normative concerns of philosophers: concerns about what ought to be, as opposed to what is, or has been. Here I note that what ought to be is not a fanciful notion, but rather a partial extrapolation from what is and, ultimately, a statement of what realistically could be. Philosophers, such as John Rawls,¹¹ have developed elaborate normative theories concerning the principles of justice that ought to govern social institutions. Famously, Rawls argued that social institutions ought to be structured in such a way as to benefit the least well-off. Advocates of free market economics have argued that this is just what deregulated markets do, and have pointed to the freeing up of the Chinese and Indian economies as evidence of this. Whatever the truth of such claims, my point is that even the most staunch free-marketeters have normative or ethical commitments: they are committed, in particular, to the ethical value of the social institution of private property, the moral force of contractual obligations, and the human right of individual freedom. Viewed from this perspective, the disputes between free-marketeters and social democrats are normative disputes concerning, for example, the circumstances under which considerations of social justice or overall social benefit (the public good) ought to limit the freedom of individuals or organisations to contract or engage in economic transactions. Consider in this connection the arguments in favour of and against the recent global surge in private equity mergers and acquisitions. Note also that in the contemporary setting of a rapidly globalising world, including the development of a wide range of global institutions, the parameters of social justice concerns and of the public good can no longer simply be taken to be national boundaries. The

public good of global institutions, such as the global economic and financial systems, includes the well-being of those living in the impoverished nations of the world.¹²

In addition to normative theorising in relation to principles of distributive justice and the like at the macro-institutional level, philosophers in the area of business ethics have addressed specific ethical failures, such as bribery, conflicts of interest, and so on. Remarkably, most of this normative theorising, including by Rawls, has been done in the absence of a developed (general) theory of the nature and point of the very entities (social institutions) to which the principles of justice in question are supposed to apply, and, in particular, in the absence of developed theories (special theories) of the nature and point of business corporations, and financial and other markets.¹³ (I take it that advocates of corporate social responsibility are not offering a worked out normative theory, so much as giving expression to (doubtless, reasonable) ethical concerns.¹⁴) Surely the adequacy of one's normative account of the justice or otherwise, of any given social institution, or system of social institutions, will depend at least in part on the nature and point of that social institution or system. Moreover, such theorising is highly germane even to specific ethical questions in business or finance ethics. For example, it is difficult to determine whether or not some alleged conflict of interest is ethically acceptable or

¹² For an account of global economic justice in sympathy with the kind of view being propounded in this chapter, see Joseph Stiglitz, *Globalisation and Its Discontents* (2002).

¹³ Rawls' theory principally applies to a set of institutions that comprise a society. However, there are transnational institutions. Moreover, it may be that his principles of justice are acceptable at the level of a set of societal institutions but not (say) at the level of a type of social institution, eg the university. My concern in this chapter is principally with the normative theory of types of social institution and, specifically, with market institutions.

¹⁴ Nor is so-called 'stakeholder theory' a theory in the required sense: rather it first identifies an indeterminate set of groups with financial interests in, or who otherwise might be affected by, corporations, eg shareholders, employees, customers, etc. Second, it assumes that such 'stakeholders' ought, to some extent, or in some respect, have their interests taken into account in decision-making by, or in relation to, the corporation; ie, stakeholder 'theory' gestures at an indeterminate set of moral claims that 'stakeholders' might make in relation to corporations. However, such an indeterminate list and associated vague moral claims do not qualify as a theory; at best they constitute raw data that itself stands in need of normative theorising. Certainly, 'stakeholder theory' is no substitute for a normative theory of the nature and point of the corporation. For an account of stakeholder theory, see Kenneth E Goodpaster, 'Business Ethics and Stakeholder Analysis' (1991) 1 *Business Ethics Quarterly* 53.

⁸ Jonathan Turner, *The Institutional Order* (1997) 6.

⁹ Anthony Giddens, *Constitution of Society: Outline of the Theory of Structuration* (1984) 31.

¹⁰ Ibid.

¹¹ John Rawls, *Theory of Justice* (1972).

not, independent of a normative theoretical account of the nature and point of the relevant social institutions and/or of their constitutive institutional roles. An auditor auditing a company's accounts has a conflict of interest if the auditor has shares in the company he or she is auditing; but this would not necessarily be so for a plumber contracted to unblock the company's drains and who also happens to hold shares in the company. How so? To answer this question the nature and point of the institutional role of the auditor in the context of the corporate sector needs to be specified.

I SOCIAL INSTITUTIONS

Social institutions need to be distinguished from less complex social forms such as conventions, social norms, roles and rituals. The latter are among the constitutive elements of institutions.¹⁵ Social institutions also need to be distinguished from more complex and more complete social entities, such as societies, polities or cultures, of which any given institution is typically a constitutive element. A society or polity, for example, is more complete than an institution since a society — at least as traditionally understood — is more or less self-sufficient in terms of human resources, whereas an institution is not. Thus, arguably, for an entity to be a society it must sexually reproduce its membership, have its own language and educational system, provide for itself economically and — at least in principle — be politically independent.

Social institutions are often organisations. Moreover, many institutions are *systems* of organisations. For example, capitalism is a particular kind of economic institution, and in modern times capitalism consists in large part in specific organisational forms — including multinational corporations — organised into a system. Further, some institutions are *meta-institutions*: they are institutions (organisations) that organise other institutions (including systems of organisations). For example, governments are meta-institutions. The institutional end or function of a government consists in large part in organising other institutions (both individually and collectively); thus governments regulate and coordinate economic systems largely by way of (enforceable) legislation. Note that in the modern world many global

social institutions transcend in various respects the boundaries and jurisdictional and/or enforcement reach of the meta-institutions, for example governments, that regulate and coordinate their activities. Consider here the jurisdictional problems of holding Union Carbide to account in respect of the Bhopal Gas Disaster of 1984 in which over 20000 nearby slum-dwellers lost their lives and over 100000 suffered permanent, severe ill-health as a consequence of inadequate safety measures at Union Carbide's plant.¹⁶

Having informally marked-off social institutions from other social forms, let us turn to a consideration of some general properties of social institutions. Here there are four salient properties, namely, function, structure, culture and sanctions.

Roughly speaking, an institution that is an organisation or system of organisations consists of an embodied (occupied by human persons) structure of differentiated roles. These roles are defined in terms of tasks and rules regulating the performance of those tasks. Moreover, there is a degree of interdependence between these roles, such that the performance of the constitutive tasks of one role cannot be undertaken, or cannot be undertaken except with great difficulty, unless the tasks constitutive of some other role or roles in the structure have been undertaken or are being undertaken. Further, these roles are often related to one another hierarchically, and hence involve different levels of status and degrees of authority. Importantly, these roles are related to one another, in part in virtue of their contribution to the *end(s)* or *function(s)* of the institution; and the realisation of these ends or functions normally involves interaction between the institutional actors in question and external actors. These ends or functions are diverse. An overarching end of the criminal justice system, for example, is the administration of justice, and a particular end of the professional role of auditor is the provision of true and fair financial records.¹⁷

¹⁶ Amnesty International, *Clouds of Injustice: Bhopal Disaster 20 Years On* (2004). While Bhopal was a case of negligence rather than intent to do harm, in terms of actual loss of life and damage to health this was a much worse disaster than 9/11, eg 3000 died in the attack on the Twin Towers. However, the response to the Bhopal disaster on the part of US authorities, in particular, was far from adequate.

¹⁵ The following teleological model of social institutions is elaborated in more detail in Seumas Miller, *Social Action: A Teleological Account* (2001). See also Seumas Miller, 'Social Institutions' in *Stanford Encyclopedia of Philosophy* (Winter, 2006).

¹⁷ This claim might be regarded as controversial. However, normatively speaking, it is difficult to see what the end of auditing could be, if not to provide a true and fair record: see, eg, Tom Campbell, 'True and Fair to Whom: A Philosophical Approach to Auditing' in Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (2005) ch 5. At any rate, if this is rejected as the normatively appropriate end or purpose of auditing, then, let

The constitutive roles of an institution and their relations to one another can be referred to as the *structure* of the institution. Institutions in this sense are dynamic, evolving entities; as such, they have a history, the diachronic structure of a narrative, and (usually) a partially open-ended future. Moreover, institutions interact with one another, competitively (eg competing firms in the same industry), cooperatively (eg police organisations, law courts and prisons), and, in some cases, by virtue of a relationship of authority (eg business firms and law courts). In some instances, institutions need to be structured so as have a degree of independence in the context of interaction, for example, law courts and corporations. Inevitably, interaction brings with it relationships of influence, if not power, and not simply one-way relations from the formal institutional authority, for example law courts, to the formal institutional subordinate, for example a business corporation.¹⁸

Aside from the formal and usually explicitly stated, or defined, tasks and rules, there is an important implicit and informal dimension of an institution, roughly describable as institutional *culture*. This notion comprises the informal attitudes, values, norms, and ethos or 'spirit' that pervades an institution. Culture in this sense determines much of the activity of the members of that institution, or at least the manner in which that activity is undertaken. So while the explicitly determined rules and tasks might say nothing about bending or breaking the rules — or even forbid such activity — or about being driven by the need to generate favourable quarterly reports, these attitudes and practices might in fact be pervasive; they might be part of the culture (as appears in fact to have been the case at Enron). Naturally, there can be competing cultures within a single organisation: the culture comprised of attitudes and norms that is aligned to the formal and official complex of tasks and rules might compete with an informal and 'unofficial' culture that is adhered to by a substantial sub-element of the organisation's membership.

In addition to structure, function and culture, social institutions necessarily involve sanctions of various kinds. Social institutions involve *informal* sanctions, such as moral disapproval following on non-conformity to institutional norms. However, formal sanctions, such as punishment, are also a feature of institutions.¹⁹

some other preferred purpose be substituted. Either way my point in relation to institutional and occupational ends, purposes or functions will be unaffected.

¹⁸ See Lauren B Edelman, 'Overlapping Fields and Constructed Legalties', in this book.

¹⁹ Jon Elster, *Cement of Society* (1989) ch XV.

Social institutions have a multifaceted normative dimension. Moral categories that are deeply implicated in social institutions include human rights and duties, contract-based rights and obligations, and rights and duties derived from the production and consumption of collective goods. Take police institutions. Police are typically engaged in protecting people from being deprived of, for example, their human right to security of the person or their institutional right to property. Now consider business. Most business organisations do not have the protection of human rights as a purpose, nor should they. On the other hand, moral rights are an important *side constraint* on business activity. Business organisations should not engage in activities that violate the human rights of workers or other members of the community: for example, clothing manufacturers should not exploit children as underpaid workers in underdeveloped countries.

A further point about markets and business organisations is that, normatively speaking, they have both *proximate* ends and *ultimate* ends. The proximate end of market actors might be to maximise their financial self-interest or the firm's profits or shareholder value — the means to these ends being the production of goods for consumption or the provision of services. However, such proximate goals are not the ultimate ends of markets or of the social institution of the modern corporation. Qua social institutions, markets and corporations ought to (and in fact do, albeit imperfectly) serve larger purposes than this, such as to contribute to the material well-being of human societies. Whether this larger purpose is the material betterment of the least well-off (as Rawls suggests) or to maximise the overall benefit (as utilitarians suggest) is a matter for reasoned argument. Moreover, the fact that some prior institution existing outside the market is privatised, indeed legally incorporated, would not undermine this fundamental proposition concerning social institutions. A prison, for example, does not cease to have as an ultimate end the deterrence of criminality and protection of ordinary citizens from dangerous persons merely because it becomes privatised. Rather — again, normatively speaking — a proximate end, for example maximising shareholder value or making a profit, has in effect been (rightly or wrongly) 'designed-in' to a pre-existing institution as a means to better realise its ultimate purpose. To claim that the ultimate purpose of the institution of the modern corporation — a product, if ever there was one, of institutional design — is, for example, simply and only to maximise profits or shareholder value, is (on this

ends-based, ie *teleological*, account of social institutions) to confuse proximate with ultimate purposes.²⁰ Thus the proximate end of corporate financial service providers in capital markets might be to maximise shareholder value, but the ultimate purpose is something beyond this, for example to make capital available at reduced costs to productive firms.²¹

Let us now focus on institutional moral rights. There are at least two species of institutional (moral) rights. There are *individual* institutional (moral) rights and there are *joint* (institutional) moral rights. Joint moral rights are moral rights that attach to individual persons, but do so jointly. For example, in the context of the social institution of property rights, the joint owners of a piece of land might have a joint right to exclude would-be trespassers, and one single owner of a piece of land might have a right to exclude would-be trespassers, but only on condition that another single owner of a second piece of land likewise had such an exclusion right. Joint rights need to be distinguished from universal individual human rights (as opposed to individual *institutional* rights). The right to life is an example of a universal individual human right. Each human being has an individual human right to life. However, since one's possession of the right to life is wholly dependent on properties one possesses as an individual, it is not the case that one's possession of the right to life is dependent on someone else's possession of that right.

Sometimes the end realised in joint action is not merely a collective end, it is also a collective *good*. (By *collective* good I simply mean that the good is collectively or jointly produced; I do not mean to imply that it is collectively or jointly consumed — it might be, and often is, individually consumed.) If so, then a joint right may well be generated. What is the relationship between joint moral rights and collective goods? The good is a realised collective end; and the participants in realising that collective end, ie the contributors to the production of that good, possess a joint right to this collective good. It is easy to see why these persons, and not some other persons, would have a right to such a good: they are the ones responsible for its existence, or

continued existence. In this connection consider the shareholders, members of the board of directors, managers and workers (shareholders, officers and employees) in a factory that produces cars that are sold for profit. Board members, managers, shareholders and workers in the factory have a joint right to be remunerated from the sales of the cars that they have jointly produced. It is also clear that if one participating agent has a right to the good, then — other things being equal — so do the others. That is, there is interdependence of rights with respect to the good. Now notice that the board members, managers, shareholders and workers — and indeed the car company itself — depend for their skills, knowledge, security, transport and so on, on other social institutions, including educational and policing institutions, legal and political institutions, transport and communication infrastructure, etc. Accordingly, the moral rights to the collective goods produced by the car company include rights that attach to members of the wider society; this moral fact is reflected in tax regimes, including corporate tax, albeit often inadequately. Evidently, many corporations often pay less tax than is fair or reasonable by virtue of 'creative accounting' and/or their ability to exploit offshore tax havens, for example in poor countries desperate to attract investment. Notice further that these joint moral rights are not equivalent to, or reducible to, moral rights based on legal contracts. A contract might or might not reflect a person's contribution to the production of a collective good, depending on a host of contingencies (notably relationships of power). Consider in this connection the extraordinarily generous executive compensation packages on offer in some corporations.

Social institutions are in part defined in terms of their collective ends. Moreover, as we have just seen, when such collective ends are also collective goods then this gives rise to joint moral rights to those goods. That is, 'functional' properties (collective ends) give rise to deontic properties (joint rights) under certain conditions — especially the condition that the collective end in question is also a good.

Let me now give more detailed attention to the moral duties or obligations that attach to institutional roles, and the sources of such institutional obligations. Obligations, like rights, are deontic properties. In our above example of a factory, workers and manager obviously have duties, including moral duties that go hand-in-hand with their rights, for example a worker's moral duty to do a reasonable day's work or a manager's (director) fiduciary duties to shareholders not recklessly to

²⁰ For an historically informed account of the purposes of corporations and, in particular, regulation of corporations see Melvin J Dubnick, 'Sarbanes-Oxley and the Search for Accountable Corporate Governance' in this book.

²¹ John Coffee suggests as much in his paper, 'Law and the Market: The Role of Enforcement' (Paper presented at the Dynamics of Capital Market Governance Forum, Australian National University, Canberra, 14 March 2007).

put at risk their money. But shareholders also have duties and responsibilities, and not simply rights. For example, they have responsibilities not to invest their money in corporations that are generating profits by bribing public officials to gain lucrative contracts, instead of by virtue of a superior economic performance.

Just as is the case with rights, the obligations attached to institutional roles flow in part from the purposes or ends of the institution. Moreover, the purposes or ends of the institution themselves derive — ultimately — from social needs (and not simply aggregated individual desires). Consider the individual human and society-wide needs for adequate food, clothing, shelter, health, and so on. No single member of a social group could provide for any of these needs, but if they act jointly they can do so. But needs, as opposed to desires, generate moral obligations. So the various needs of social groups that can only be adequately met by the joint action of members of the same or other groups generate collective responsibilities on the part of these groups to jointly so act. Moreover, where such collective responsibilities can most effectively be discharged by establishing institutions and institutional roles (whose institutional duties consist of providing for these needs), such as agricultural, clothing, building, and pharmaceutical industries (and associated institutional roles), then members of the social group who have the collective responsibility, also have a derivative responsibility to establish such institutions and see to it that they realise their institutional purposes. For example, governments have a responsibility (where required) to establish such institutions and to regulate such institutions (once they are established) to ensure that they are realising their institutional purposes. When institutions and their constitutive roles have been established on some adequate moral basis, such as, say, the social need for adequate housing, or (derivatively) the need for housing loans, then those who undertake these roles necessarily put themselves under obligations of various kinds — obligations that attach to, and are in part constitutive of, those roles. Let us consider three different categories of such role obligations.

Perhaps there are professional roles that anyone can undertake if he or she so wishes. Presumably the role of professional writer is one of these. On the other hand, it would be morally outrageous for someone to set up as a surgeon without any proper training. Whether or not it is morally acceptable for someone to undertake a professional role without demonstrable competence in that role turns partly on the purpose of the

role (how important is it to discharge the role), and partly on the extent of the harm an incompetent professional in the role is likely to do to clients or customers. Obviously anyone who holds a senior position in a large institution, such as a corporation, a bank, or a university, is capable of doing great good, but also of inflicting enormous harm on people who entrust their careers, money or whatever to that organisation. Arguably, therefore, it is a serious moral fault to undertake such a role without demonstrable competence. Most role obligations presuppose competence. Accordingly, many breaches of role obligations are not instances in which the role occupant lacks competence. It is possible for someone who is, say, a competent banker, nevertheless to be negligent in the giving and approving of loans and in the monitoring of various banking activities for which he or she is responsible. The claim here would not be that bankers were incompetent to undertake the roles they undertook, but rather that they did not exercise that competence when in those roles. Similar points can be made in respect of lawyers, auditors, doctors, and so on.

Once again, the moral significance of recklessness and negligence will vary from one professional context to another. It is no doubt foolish, but it is not morally wrong, for a gambler to be reckless or negligent with his or her own money. But the question that needs to be asked is whether or not ongoing recklessness and negligence is morally problematic — as opposed to being merely foolish — for a banker. The answer is presumably that it is. Just as an inability competently to undertake the professional role of a doctor, welfare worker, lawyer, director, banker, and so on is likely to cause enormous harm to patients, clients, depositors, shareholders, so recklessness in the provision of medical services, auditing services, legal advice, or loans, is likely to cause enormous harm to these people. The point here is that these professional obligations are also moral obligations. They are the professional role in question. They are also moral obligations in part by virtue of the magnitude of the harm to clients that is likely to ensue if these professional obligations are not properly discharged in the overall context of the institution of the bank having been established, persons having entrusted their savings to these banks, and so on.

A final issue here concerns the ascription of responsibility within an institutional framework. As we have seen, in an institutional framework outcomes are typically the result of many actions by many

people. Accordingly, there is a tendency for individuals to fail to see themselves as responsible for the outcomes of the collective activity of the institution. This tendency is especially prevalent in a professional context of negligence, incompetence and non-adherence to established procedures. These responsibilities—which, as we have seen, are moral as well as professional—do not cease to be real merely because they are ignored. In the first place, each individual member of a collective entity, such as a committee or board of directors, has a responsibility to follow established procedures. For example, an individual banker ought not to approve large loans without the appropriate supporting documentation. In the second place, the notion of collective responsibility entails that the decisions of the collective as a whole are the responsibility of each individual member, whether that member in fact influenced those decisions or not. For example, if the driving force behind a dubious loan proposal is some individual member of a board of directors, this does not absolve other members of the board of responsibility for the outcome of the loan being approved. In the third place, no individual member of a collective such as a committee or board of directors is absolved of his or her moral responsibilities merely because those around him or her are failing to discharge theirs. If there is the possibility of individual members opposing irresponsible conduct or resigning, then those individuals who choose not to take either of these courses of action are morally responsible for the actions of the collective.

We can conclude that the ethical dimension is quite central to 'normal' professional practice. The professions are not simply activities that are driven by the possibility of financial and other rewards to those individuals who engage in them, they are also activities in part governed by professional responsibilities that are also moral responsibilities. In light of the above discussion, we are entitled to conclude that there are multiple sources of deontic properties, such as rights and obligations, and that they include the following ones.

Firstly, as we have just seen, collective ends—that are also collective goods—generate joint moral rights and duties under certain conditions. So the normative dimension of institutions involves more than deontic properties, and some deontic properties are presupposed by this normative dimension. Specifically, it involves the ethical or moral worth of the ends or purposes of institutions, ie the kinds of human goods that institutions produce or fail to produce. Accordingly, the

definition of an institution will typically include a description of the human good that it purports to produce. For example, universities ought to produce knowledge and understanding, economic systems ought to produce material well-being, and so on. Secondly, institutional structures, including hierarchical structures, give rise to rights and duties, for example, a CEO instructs a subordinate to undertake a financial task. Thirdly, promises generate obligations to perform the promised actions. This is relevant to institutional actors insofar as they enter into contracts, undertake oaths of office, and the like. Moreover, part of the moral and/or legal basis of some institutions, such as corporations and governments, might consist in part in contracts or elected government and its citizens or between regulators and those they regulate. Fourth, various natural properties that persons have, for example, human needs, generate moral rights, namely human rights and correlative duties. Typically, human rights act as side constraints on the actions of institutional actors.

This multiplicity of sources of deontic properties suggests a pluralist explanatory account of the deontic properties of institutional actors, including market actors. Moreover, on a teleological account of social institutions, participants in an institution pursue a collective good, and this gives rise to deontic properties (rights and duties). However, this (normative) teleological explanation of deontic properties needs to be supplemented by recourse to the other above-mentioned sources of deontic properties, for example promises (including contracts), and human rights. The two points to be stressed here are as follows. Firstly, normatively speaking, social institutions including business corporations and markets exist for ultimate—and not merely proximate—purposes or ends, namely, to provide collective goods, for example material goods, the coordination of buyers and sellers of material goods. As mentioned above, here Adam Smith's invisible hand mechanism is salient. The outcome of the workings of the invisible hand is the ultimate purpose of this institutional mechanism; the pursuit of financial gain, the proximate end. Secondly, again normatively speaking, the managers, shareholders, employees, derive in part from the collective ends, ie collective goods, that are the *raison d'être* for the existence of that social institution.

So the fundamental normative question that needs to be asked of a business corporation, or financial market, is the same as for any other social institution, namely: What collective good(s) does it exist to provide? Once an acceptable answer to this question is provided then a host of subsidiary normative questions arise including the following ones: Who is possessed of a jointly held right to this good and on what moral basis? What are the duties of these rights bearers?

II INTEGRITY SYSTEMS

While regulatory frameworks and integrity systems typically overlap — and ought to be mutually reinforcing — they are not identical notions, theoretically speaking; albeit regulatory systems are often understood as including what I am referring to as integrity systems.²² A regulatory framework is a structured set of explicit laws, rules or regulations governing behaviour, issued by some institutional authority and backed by sanctions. It often serves to ensure compliance with minimum ethical standards (namely those enshrined in a law, rule or regulation), but this is not its only purpose. There are many laws, rules and regulations that have little or nothing to do with ethics. An integrity system, by contrast — at least as I am using the term — is an assemblage of institutional entities, roles, mechanisms and procedures, the purpose of which is to ensure compliance with minimum *ethical* standards and promote the pursuit of *ethical* goals. Nevertheless, integrity systems obviously heavily rely on regulations and laws.

In practice, integrity 'systems' are a messy assemblage of formal and informal devices, processes and roles, and they operate in often indeterminate and unpredictable ways. The term 'integrity', as used in the expression 'integrity system', is also problematic in that it appropriates a moral notion normally used to describe individual human agents and applies it to organisations and other large groups of individuals. Roughly speaking, individual human persons have integrity if: (1) they possess the full array of central moral virtues, such as honesty, loyalty, and trustworthiness, and (2) they exercise rational and morally informed judgment in their adherence to the virtues, including when their self-interest might dictate otherwise. By contrast with the notion of an individual person's integrity, integrity used in the context in

which we are employing it here (of an 'integrity system' for institutions) applies to the members of organisations and occupations, and also to the structure, function and culture of organisations.²³ The integrity of an organisation or occupational group is in large part dependent upon the individual integrity of its members, and therefore an integrity system is in large part focused on developing and maintaining the individual integrity of these members. Nevertheless, these organisations and groups are not simply the sum of their members, and so determining the integrity levels of an organisation or group is not simply a matter of summing the levels of integrity of the individuals who happen to be its members at a particular time.

In the first place, the individuals who comprise institutions, including the so-called professions, are role occupants, and the responsibilities and virtues required of them are somewhat different from, and in some respects greater than, those required of ordinary individual persons not occupying such roles. So, for instance, scrupulous attention to numerical detail might be a constitutive virtue of the role of an accountant, but not of the role of a husband.²⁴ Moreover, what counts as a professional responsibility or virtue, both in terms of technical and ethical competencies, varies greatly across different professional and occupational groups. While, arguably, the 'zealous advocacy of one's clients' interests' might be a critical virtue to the role of a lawyer or barrister in an adversarial legal system, it is not a critical virtue for the engineer. One important task, then, for any specific profession is to determine what precisely the constitutive virtues of the individual role occupant are, and devise strategies to ensure that these virtues are developed and maintained in the members of that profession.

In the second place, the integrity of an institution is not simply a matter of the integrity of the individual role occupants who comprise it. For the integrity of an institution is partly a matter of the structure, function and culture of the institution. Consider structure, both legal and administrative. In an institution possessed of integrity the administrative processes and procedures in relation to, for example, promotion or complaints and discipline, would embody relevant ethical principles of

²³ For an elaboration of an integrity system for occupational groups, see Andrew Alexandra et al, *Professionalisation, Ethics and Integrity*, Report for the Professional Standards Council (2006).

²⁴ On the role of auditors, and on recent shortcomings, see Tom Campbell and Keith Houghton (eds), *Ethics and Auditing* (2005).

²² See, eg, Christine Parker, *The Open Corporation* (2002).

fairness, procedural justice, transparency, and the like. Now consider function or ends. In an institution possessed of integrity the organisational goals actually being pursued would align closely with the morally legitimate (including ultimate) functions of the institution, such as, for example, the promotion of public safety for an engineering firm, or of the financial health of audited corporations for an auditing firm, rather than purely commercial and other proximate goals, such as profit.

Moreover, in the case of markets and business corporations more generally, realising the ultimate, as opposed to proximate, institutional purposes is a fundamental ethical concern. Here there is a need to address an array of questions including the contribution of the business, market or industry to human material well-being. For example, the 'contribution' to human health of the tobacco industry is self-evident, but so is the international pharmaceutical industry's if, as appears to be the case, it is neglecting the development of drugs for poverty related diseases afflicting millions in favour of drugs for the minor ailments of much smaller numbers of the relatively rich. Again, the real costs, for example environmental costs, of specific industries need to be factored into institutional cost-benefit analyses of the extent of the realisation of proximate and ultimate ends. In the case of the financial services sector in particular, there appears to be a prior fundamental ethical question in need of an answer: namely, what are, ie what ought to be, the ultimate institutional ends of this sector? Is it to provide capital to any person or organisation that will maximise shareholder value? Arguably this is (again) to confuse proximate with ultimate ends. At any rate, without an answer to this question, an integrity system — and a regulatory system insofar as it is concerned with institutional (ethical) integrity, as it surely must be — is quite literally without one of its basic purposes: it does not know what ethical ends it is seeking to embed in the target institution(s). I return to this theme in the next section. Finally, consider culture. In an institution possessed of integrity, the pervasive ethos or spirit, ie the culture, would be one that was, for example, conducive to high performance, both technically and ethically, and supportive in times of need, but intolerant of serious incompetence or misconduct.

Integrity systems exist to promote institutional ethical integrity and combat institutional corruption. In order to succeed they first need to identify the nature and causes of the ethical failures, including at the levels of structure, function and culture. Second, it is necessary to devise institutional mechanisms, if they do not already exist, to identify the loci

of what will be taken to be individual and collective moral responsibility. This amounts to institutionalising ethical responsibility. Importantly, this process does not necessarily involve identifying a pre-existing source of ethical responsibility; it can, and often does, involve creating a locus of institutional responsibility to deal with an identified ethical problem. Perhaps initially, no one was aware of conflicts of interest problems in some corporations, for example, lawyers in incorporated legal practices. However, once the problem is identified, some institution or institutional role occupant (or occupants), for example a solicitor-director, needs to be created to deal with this issue. That person or persons can now be held institutionally responsible for this ethical problem. Here it is important to note the possibility of collective moral responsibility, ie of a number of persons (the members of the board of directors, the managers, the employees, the shareholders, the members of an external regulatory agency) being held to be jointly ethically (and institutionally) responsible. Notice that the person or persons in question are now not only institutionally, but also ethically, responsible. Third, given that the loci of individual and collective ethical responsibility have thus been identified, if not created, the matter of accountability then arises in relation to the ones with ethical (and institutional) responsibility. Such accountability can take the form of a set of rules, mechanisms of compliance and processes for adjudication of alleged non-compliance, and, if necessary, processes for punishment. However, ethical failure does not necessarily translate into legal or even administrative liability. Whether or not it does so is a matter of the seriousness of the infraction, the efficacy of such liability, and so on. This is one of the reasons an integrity system does not necessarily mirror a regulatory system, even an internal institutional self-regulatory system.

In looking at options to promote integrity and combat ethico-professional failures, it is very easy to leap to a particular kind of solution, for example, rule-based or principle-based systems of regulation, even a single 'magic bullet' solution (like increasing penalties or giving more intrusive powers to investigative agencies), and doing so without considering the full array of implications, including the demonstrable (as opposed to hoped for) benefits (which of these measures has been tested and, as a consequence, is *known* to work?), and the costs in terms of resources, damage to ethico-professional ethos, and so on. Enforcement mechanisms, for example, are important, especially in relation to ethical offences that are sufficiently serious to be also

criminal offences. However, enforcement is only one part of the solution to ethical problems, ie one component of an integrity system. Again in relation to enforced requirements, rules need to work hand-in-glove with principles. Yet for some problems in some areas, for example conflicts of interest, the emphasis might need to be on principles in the context of procedural requirements, such as an internal but independent mechanism for determination of any putative conflict of interest. In other areas such as disclosure requirements, principles and rules might both need to be met, for example, an auditor's report must be both a true and fair record and comply with technical rules.²⁵

Moreover, 'magic bullet' solutions in particular are sometimes offered in relative ignorance of both the actual nature and causes of the problems they are supposed to address. The truth is sometimes in the detail. For example, in attempting to determine the causes of unethical practices in a given profession there are a number of preliminary questions that need to be addressed. One set of questions pertains to the precise nature of the unethical practice at issue, and the context in which it occurs. Consider legal practitioners operating in the context of incorporated, multidisciplinary legal practices. Are there, for example, some compelling practical facts that explain the unethical practice of conflicts of interest or breaches of confidentiality in this context? What pressures and opportunities might there be for the unethical practice in question? Another set of questions concerns the extent of the corruption or unethical practice: Is it sporadic or continuing, restricted to a few 'rotten apples', or widespread within the area? In answering these questions, what is called for is the provision of evidence-based conclusions.

At other times one cannot see the wood for the trees. In the case of the global financial sector, integrity assurance is in the hands of national governments. However, national governments — and their regulatory agencies — are not simply umpires, they are also players in the financial 'game'. Governments, for example, seek to assist their own industries and businesses at the expense of ones from other countries, for example in relation to 'level playing fields' in trade and other markets. Consider the restrictive trade practices of the EU and US in regard to agricultural products and the consequent harmful effect on African economies in particular.

Even when the answers to the above-mentioned questions have been provided, there will arise further questions in relation to any remedies proposed. For example, any contemplation of mechanisms to redress ethico-professional misconduct that will require the expenditure of energy and resources needs to be justified in terms of the seriousness and extent of the misconduct to be successfully combated. Consider here the claims that the post-Enron regulation in the US, the *Sarbanes-Oxley Act of 2002*,²⁶ has had costs that are greater than the benefits it has provided — and, of course, the counter-claims. More importantly, such remedies need to be efficacious, and efficacious over the longer term. Pious rhetoric accompanied by tough regulation does not necessarily deliver the required long-term results. Nevertheless, if *Sarbanes-Oxley* is working, then surely the costs that it imposes in terms of reporting and disclosure requirements, audit committees with financial experts and independent directors etc, are justified. Certainly, the costs of an *effective* regulatory system in relation to corporate malfeasance would have to be enormous if they were to outweigh the benefits. Understanding the causes of ethico-professional misconduct and failures and the tailoring of remedies to address them will involve considering and distinguishing between three sorts of motivation for compliance with moral principles and ethical ends.

One reason for compliance is the fear of punishment; hence the use, or threatened use, of the so-called 'big stick'. So, for example, person A does not defraud organisation B because A fears that he or she will get caught and locked up. A second reason for compliance arises from the benefit to oneself. Hence the possible utility of the so-called 'carrot' approach. So, for example, B pays B's workers reasonable wages because by doing so the workers are healthy, work productively, and B makes good profits. These two reasons are essentially appeals to self-interest. Taken in combination, they constitute the 'stick-carrot' approach much loved by many contemporary economists. However, there is a third reason for compliance. This is moral belief or desire to do what is right. A refrains from fraud because A believes that it is morally wrong to steal.

There are also important connections to be highlighted and promoted between 'self-interest' and 'moral belief and sentiment', so that these conceptions are more in balance and integrated and less at

²⁵ Clarke, Dean and Oliver, above n 5, 320.

²⁶ Pub L No 107-204, 116 Stat 745 (2002) ('*Sarbanes-Oxley*').

odds. First, of course, the appeal to moral sentiment must be balanced by the appeal to self-interest. If, for example, it is at great cost to one's self to be honest or fair, then one may have sufficient reason not to be honest or fair. Indeed, the reason need not be purely self-interested, but also count as moral. Suppose that, faced with retrenchment, an employee commits fraud in order to provide for his family, his reasons here include ones from both prudence and morality.

It is evident that widespread and ongoing compliance typically requires appeals to self-interest (sticks and carrots) but also appeals to moral beliefs. Ideally, integrity systems should have penalties for those who do not comply, should enable benefits to flow to those who do comply, and should resonate with the moral beliefs of the people thus regulated. For example, laws and regulations should be widely thought to be fair and reasonable. Thus, an institutional design that proceeds on the assumption that self-interest is the only human motivation worth considering, fails. It fails because it overlooks the centrality of moral beliefs in human life, and therefore does not mobilise moral sentiment. On the other hand, an institutional design that proceeds on the assumption that self-interest can be ignored, and that a sense of moral duty on its own will suffice, also fails; it fails because self-interest is an ineradicable and pervasive feature of all human groups. Moreover, deserved reputation has a pivotal role to play in the convergence of self-interest and ethical concerns. Here I am not so much speaking of reputation for performance (including economic performance) as of reputation for ethical integrity, albeit performance and integrity are connected and to some extent overlap.

Let me explain what might be referred to as a virtuous triangle. High reputation is much sought after by occupational groups and firms alike, and a low one to be avoided at all costs. Consider the collapse of the giant accounting Arthur Andersen following on their loss of reputation. Accordingly, there is an opportunity to mobilise this reputational desire in the service of promoting ethical standards. Here the aim is to ensure that organisational and professional reputation aligns with actual ethical practice, ie that an organisation, group or individual's high or low reputation is deserved. The way to achieve this is by designing appropriate integrity systems. Key elements of an integrity system track compliance with rules such as accountability. The additional thought here is that key elements of an integrity system should track features of organisation and occupational groups that determine or

should determine reputation. Most explicitly, reputational indexes could be constructed whereby an ethics audit awards scores in relation to specific ethical standards. Deserved reputation represents an important nexus between self-interest and concern about others, and so, for our purposes here, between the self-interest of firms and occupational groups and concern about consumers, clients or the public generally. Here there are three elements in play: (1) reputation; (2) self-interest; (3) ethical requirements, such as particular ethico-institutional standards, but also more general desiderata such as client/consumer protection. Hence my reference to a virtuous triangle. The idea is that these three elements need to interlock in the following way.

First, reputation is linked to self-interest; this is obviously already the case — individuals, groups and organisations desire high reputation and benefit materially and in other ways from it. Second, reputation needs to be linked to ethics in that reputation ought to be deserved; as already mentioned, the integrity systems are the means to achieve this. Third, and as a consequence of the two already mentioned links, self-interest is linked to ethics; given robust integrity systems that mobilise reputational concerns, it is in the self-interest of individuals, groups and firms to comply with ethico-institutional standards. I should also reassert that self-interest is not the only or ultimate motivation for human action; the desire to do the right thing is also a powerful motivator for many, if not most, people. Accordingly, the triangle is further strengthened by the motivation to do right.

Integrity systems can be thought of as being either predominantly reactive or predominantly preventive.²⁷ Naturally, the distinction is somewhat artificial, since there is a need for both reactive elements, eg, a complaints and discipline system, as well as preventive elements, eg, codes of practice, ethics training and transparency of processes, in any adequate integrity system. Integrity-building strategies involve reactive systems as well as preventive systems. Within preventive systems there are mechanisms that promote ethical behaviour, there are corporate governance mechanisms with, for example, anti-fraud or corruption functions, and there are various transparency and disclosure mechanisms.

Moreover, it seems clear that an adequate integrity system cannot afford to do without reactive as well as preventive systems; and

²⁷ Derived in part from Seumas Miller, Peter Roberts and Ed Spence, *Corruption and Anti-Corruption* (2005) ch 7.

that preventive systems need to have all the elements detailed above. This suggests that there are two important issues. The first is the adequacy of each of the elements of the above systems, for example how adequate are the complaints and discipline processes including the investigative capacity? Or, how effective are the mechanisms of disclosure? The second issue pertains to the level of integration and complementarity between the reactive and the preventive systems; to what extent do they act together to mutually reinforce one another? We should therefore think of (better) integrity systems as holistic in character, and conceive of specific integrity-building mechanisms as elements of a unified, integrated, holistic integrity system the elements of which reinforce, rather than conflict with, one another.

III CORPORATIONS, FINANCIAL MARKETS AND MARKET ACTORS

Notwithstanding the general features of integrity systems for institutions adumbrated above, any given integrity system for an institution must be tailored to the needs of that particular institution. Arguably market actors, including financial service providers, present a number of relatively distinct problems when it comes to devising integrity systems to ensure ethical practice and the pursuit of ethical ends. At any rate, this assumption is a source of the following speculations concerning the integrity system or systems for these groups.

In the first place, and as noted above, market actors do not have an ethical purpose as their proximate end; rather they have some commercial end, such as profit maximisation. The ultimate end is one provided for by the invisible hand. Market actors pursue (individual and collective) self-interest and — by virtue of the workings of the invisible hand — the material well-being of the society is provided for. In this respect market actors are unlike, say, doctors or hospitals. The latter can reasonably be required to have the promotion of life and health at the forefront of their concerns, ie as their proximate as well as ultimate (professional and institutional) ends. Economic self-interest, especially when linked to social status and power, is a powerful driver, and establishing markets in previously non-market economies and deregulating previously heavily regulated market economies, has unleashed a great deal of hitherto dormant human energy. Moreover, the modern corporation as an institution, and the development of global

financial markets, has enabled the mobilisation of vast capital sums in the service of this human energy. (They have, of course, in turn relied heavily on scientific and technological developments.) One only has to visit Shanghai today and remember what it was like 20 years ago to appreciate the power of market forces (especially government-assisted market forces).

However, from an ethical point of view, the *institutionally structured* self-interested orientation of market actors — including corporations — may well give rise to an immediate problem. How is this institutionally structured impetus and habit of pursuing economic self-interest to be contained within reasonable limits and channeled in appropriate directions? Presumably, this is in part to be achieved by means of some mix of self-regulation and external regulation. However, it is also predicated on the guiding ethico-conceptual frameworks (as opposed to prevailing ideologies) and related self-understandings of these market actors. At any rate, this brings us to a second set of problems.

It is one of the principal tasks of those who design and oversee the market system, including governments and — under the direction of governments — regulators, to ensure that the ultimate purposes of markets (and, therefore, market actors) are in fact achieved, ie to contain and channel the pursuit of economic self-interest. Perhaps there is a lack of clarity in the collective minds of governments and regulators in relation to their role in this regard. Politicians these days sometimes talk as if the market is an intrinsic good, ie good in itself and independently elaborated above, markets need to be conceived in purely instrumentalist terms; they are simply a means to an (ultimate) end (even if this is not the end to be pursued by the market actors themselves).

Moreover, if one looks, for example, at the objectives of many regulators one typically finds only limited aims, for example to reduce crime and protect consumers, and procedural concerns, for example to promote competition and efficiency.²⁸ There is little or no reference to what I have been referring to as the ultimate ends of markets, ie the

²⁸ Eg, the Australian Competition and Consumer Commission is concerned among other things with the traditional professions but appears to have little or no focus on the distinctive ethical ends of the traditional professions, such as legal practitioners, as compared with other occupational groups: see Alexandra et al, above n 23. Incidentally, I am not here blaming regulators; they can only carry out the tasks governments give them.

outcome the invisible hand is supposed to bring about. Rather, the image of regulation is one in which regulators are umpires whose sole job is to impartially enforce the rules of the game. But in games, the pleasure of playing aside, there is only one end, namely winning, and this is an end pursued by the players, not the umpires. But here the analogy between markets and games breaks down: markets, unlike games, have an end beyond 'winning'; they have ultimate, as opposed to proximate, ends. In the case of markets, 'winning', for example making a profit, is only a proximate end, and, as such, a means to a further and larger purpose, namely the material well-being of the society (both national and, in the case of international financial markets, global).

Further, there is the problem mentioned above of the ambiguous role of national governments and regulators when it comes to global markets, including global financial markets. National governments and their regulators are to some extent partisan, and (understandably) seek to look after the economic interests of their own industries and businesses, including their financial service providers. Moreover, in the absence of a uniform set of global regulations and a single global regulator with real authority, regulators operating at a national level can be played off against one another by multinational corporations. In the case of the global financial sector, regulation and integrity assurance are ultimately in the hands of national governments. However, national governments — and their regulatory authorities — are not simply umpires, they are also players in the financial — and, more generally, corporate — 'game'. For example, the UK government — and its financial regulator (the Financial Services Authority) — cannot be expected to regulate entirely impartially in the interests of ethical ends and principles, given the substantial interest the UK government has in ensuring that the UK corporate and financial sector retains and increases the benefits accruing to it from global financial markets.

A third set of problems confronting the establishment of an integrity system or systems for some market actors, perhaps especially corporations and financial service providers, pertains to the professions. Lawyers and accountants have important roles to play in the integrity systems of corporations, including financial service providers. For example, auditors conduct audits in order to determine financial propriety and performance, and enable disclosure thereof to regulators and shareholders. However, in many cases auditors and auditing firms appear to have become themselves predominantly market actors, driven

principally by the proximate goal of economic self-interest. Arguably, they have (perhaps unconsciously) sought to mask this — and limit their exposure to civil litigation — by taking refuge in compliance with technical procedural requirements, such as the accounting rules, in preference to a moral commitment to substantive ethical principles, in as true and fair record.²⁹ At any rate, the status of auditors as independent professional adjudicators of, for example, financial health has been significantly compromised. To this extent an important element in the integrity system for corporations has been weakened.

Perhaps there is a fourth problem pertaining to various specific unethical practices, such as insider trading and conflicts of interest; one that derives in part from the de-coupling of ultimate ethical purposes from the self-understanding of market actors, and from the regulation of market actors by governments and their regulatory agencies. The unethical practices in question are not *mala in se* — they are not bad in themselves. Consider insider trading. Insider trading is not bad in itself, as, for example, murder is bad in itself. Rather insider trading is only morally problematic in a particular institutional context. Now assume that one holds the view, putting it crudely, that markets exist only to further the self-interest of market actors, for example to maximise profit or return to shareholders. Why not, then, engage in some insider trading, given that it is in one's self-interest, ie it is financially very rewarding and it is not easily detected? It might be replied that one should not do so because one is breaking the rules, indeed the law. But unlike murder, insider trading is not morally wrong in itself. Compliance with the law is reinforced by strong moral sentiment, but equally compliance is reduced in the absence of strong moral sentiment. And so, if the practice is not bad in itself, the attitude may take hold; if one can get away with it, why not do it?

Perhaps fair competition is the ethical issue here? But competition in the corporate sector is inevitably unfair; appeals to fairness may (reasonably enough) carry little moral weight. Rather the substantive moral objection to insider trading is presumably that in the long run if enough people practice it, then it undercuts the ultimate, not

²⁹ Clarke, Dean and Oliver, above n 5, 319.

³⁰ In addition, it might be that auditors are not well-prepared to detect fraud: see Nicholas M Hodson, 'Why Auditors Don't Find Fraud', in this book.

simply the proximate, ends of the corporate sector.³¹ Without compliance with a set of rules or laws that promote competition, the market will not deliver the outcomes promised by the invisible hand. However, this ultimate purpose of markets is not in the forefront of the minds of market actors, preoccupied as they are, and need to be, with the proximate ends of generating profit or maximising shareholder value.³² This is perhaps especially the case in the financial services sector. For this sector is arguably at a double remove from the ultimate purposes of the market as a whole. In accordance with the invisible hand it seeks to provide finance to firms that in turn — and again in accordance with the invisible hand — generate the products actually required for the material well-being of the wider society. But if this ultimate purpose is lost sight of — in the self-understanding of market actors and in the policy making of/regulation by governments and regulators — then perhaps insider trading is bound to be viewed by market actors as much less serious an ethical (as opposed to legal) offence than in reality it is.

A fifth set of issues arise from various perverse incentives that can exist in local and global markets, including financial markets. Competition, including competitive markets, can and do provide discipline to market actors. However, this is not necessarily or always the case. Consider the so-called tragedy of the commons in which everyone pursuing their self-interest destroys the environment. Again consider bribery. It might be the case that, for most corporations in some sector, bribing officials is necessary in order to be competitive, given that even a small number of other corporations will engage in this practice. Compliance with a legally enforced ethical principle might be in a market actor's self-interest, but only if the enforcement mechanisms are such that everyone (or most) complies. Similarly, there might be competitive pressure to invest in unethical corporations, given the highly lucrative returns, and given that one's competitors are doing so. Again, when liability does not appropriately track ethical responsibility this can lead to perverse incentives. An incentive structure, for example,

³¹ In fact some have argued that insider trading should not be a legal offence, since if it was allowed it would not have harmful consequences.

³² On the other hand, I do not accept the proposition that market actors need not have any understanding nor pay any heed to the larger ultimate purposes of markets. The latter attitudes on the part of market actors can lead to an attitude of, for example, breaking the law if one can get away with it.

in which market actors are allowed, indeed encouraged, to take great financial risks with other people's money in order to achieve enormous financial benefits for themselves (and not simply for the investors and shareholders), yet can do so without commensurate legal and financial liability attaching to themselves in the case of things going wrong, is surely tailor-made for corruption. Accordingly, there is a need for institutional re-design of a kind that either decreases the potential financial benefits to such market actors, or increases their liability, or introduces some mixture of both.

More generally, the collective responsibilities of industries to realise their institutional purposes, including the collective responsibilities of financial service providers in capital markets, typically consist of highly dispersed individual responsibilities that attach to individual persons within firms, individual firms within the industry, institutions without the industry, and so on and so forth. The collective responsibility, for example, to lower the cost of capital is not one that can be discharged by any one, or even a small group, of market actors within a given capital market. Given the diffuse character of such collective responsibilities — and its attendant incentive structure — many industries, financial service providers included, will not discharge these collective responsibilities and, as a consequence, these industries will not adequately realise their institutional purposes. Hence the need (and resultant responsibility) on the part of governments in particular to intervene to adjust these incentive structures and, if necessary, to design-in appropriate institutions or sub-elements thereof.

Perverse incentive structures can be addressed by recourse to interventions that reconfigure the incentive structures.³³ Such interventions can take the form of solving jurisdictional problems in global settings, and increasing enforcement options and/or the intensity of enforcement. Thus Joseph Stiglitz suggests that:

Any country in which the corporation (or the substantial owners of the corporation) has assets should provide a venue in which suits can be brought or in which enforcement actions to ensure payment of liabilities can be undertaken. The corporation may incorporate where it wants, but this should

³³ See Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences and Reform* (1999), for a variety of types of prescription, including adjusting incentive structures, in relation to corruption.

not make it any less accountable for its actions in other jurisdictions.³⁴

In addition, he suggests global widening of the possibility of class action in relation to corporate price-fixing. While obviously of great importance, these jurisdictional and enforcement methods are not always sufficient. Other options are themselves market-based, for example reducing supply of a product or service by factoring in real costs (and requiring that they be paid), reducing demand for a product by high sales tax or limiting availability. Some of these options involve ambitious innovations to the market system itself, including the global financial system. For example, Stiglitz has proposed a radical extension of the concept of Special Drawing Rights to create a new global reserve currency that would help stabilise financial markets and also make reserves available for wealth creation projects in impoverished countries, increasing literacy, reducing poverty-related diseases, addressing global warming and other 'ultimate' market ends.³⁵ Still other options are based on the importance of reputation to the self-interest of market actors, for example, ethics reputational indices might be established to seek to draw attention to their unethical practices or orientations. Here, as elsewhere, it might be useful to recall the possible utility of the above-described triangle of virtue with its strategy of mobilising a set of interlocking ethical and self-interested motivations.

A sixth and final cluster of problems derives in part from the foregoing ones, and pertains to education, ethos and ideology. If the prevailing ethos or culture of an organisation, and perhaps even ideology of central elements of a sector, downplays ethical considerations in favour of self-interest, then it should hardly surprise when self-interest overrides compliance with ethical principles, even ones enshrined in the law. This is no doubt especially the case in a context of high temptation and opportunity on the one hand, and low risk of detection and conviction on the other, for example insider trading in some corporate settings. The point here is not that the majority of individuals themselves engage in corrupt or unethical practices, but rather that in certain cultural or ideological contexts they may well refrain from reporting or otherwise preventing a minority from doing so.

Many key elements of integrity systems such as ethics codes, codes of practice, education programs, and the like, do not exist, for the most part, directly to prevent or deter the few people who are wrongdoers the wrongdoing of the few. In this context it is perhaps worth pointing out that most fraudsters are detected and convicted as a consequence of the disclosures of their colleagues.

³⁴ Joseph Stiglitz, *Making Globalization Work: The Next Steps to Global Justice* (2006) 206–8. Stiglitz has other suggestions in this regard.

³⁵ *Ibid* ch 9.

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Private Equity,
Corporate Governance
and the Dynamics of Capital
Market Regulation

editor

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In Memory of Murray Edelman

Preface

As this book was going to press, the Federal Court of Australia handed down judgment in *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd*, one of the most significant cases involving the management of conflicts of interest within investment banking. The regulator claimed that Citigroup had engaged in unconscionable conduct by trading on its own account while performing corporate advisory services for Toll Holdings in its — eventually successful — bid for Patrick, itself one of the most important takeovers in the current boom. The Court dismissed the application, which was designed to clarify whether and to what extent investment banking owed specific fiduciary duties to its clients and, if so, whether these duties could be overridden through contract. Justice Jacobson ruled that the 'law does not prevent an investment bank from contracting out of or modifying any fiduciary obligation.'¹

The ruling was a major setback for ASIC, which had hoped that its aggressive enforcement agenda would serve a wider demonstration purpose. ASIC had invested significant reputational capital in the litigation, only to be trumped by a literal interpretation of the law from a distinguished judge, who opined that the imposition of fiduciary responsibilities was 'a matter for the legislature, not the courts.'² Judicial resolution does not, however, solve the underlying problems identified in the litigation and magnified by the global boom in private equity. The range and intractability of conflicts have deepened, as the dynamics of financial capitalism reconfigure, in profound manner, institutional

¹ NSD 651 (28 June 2006) [601].

² *Ibid* [602].

timeframes, conceptions of corporate duty, and the efficacy of the shareholder-dominated corporate governance paradigm, and throw into stark relief the roles and responsibilities of financial intermediaries.

The issues that this book address are truly global in nature and the solutions advocated are based on the need to transcend narrow technical legal frameworks, irrespective of whether a rules or principles approach to governance is privileged. The book would not have been possible without the generous support of the Australian Research Council's Governance Research Network and the United Kingdom's Economic and Social Research Council World Economy and Finance Program. I wish to thank the respective directors, Charles Sampford and John Drifill, for providing the financing to hold an international workshop at the Australian National University in March 2007, at which earlier versions of these chapters were presented and critiqued. On behalf of the authors, I would like to thank Stephen Bottomley, John Braithwaite, Tom Campbell, John Coffee, Arie Freiberg, Graeme Hodge, Keith Houghton, Ian Ramsay, Paul Redmond and Sally Wheeler for their erudition and support throughout this process. In particular I am grateful to Malcolm Rodgers, Executive Director of Regulation at ASIC, for giving the keynote address to the workshop. My colleagues at the Centre for Applied Philosophy and Public Ethics provided exceptional logistical support and I thank Ian Sharpe and Andrew Long. I also want to record my appreciation to Michael Buckingham and Aparna Rao for their excellent research assistance.

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Justin O'Brien
Canberra, July 2007

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Introduction

The Dynamics of Capital Market Governance

Justin O'Brien

Efficiency and integrity in contemporary financial markets do not correlate without direct intervention. Notwithstanding the rhetorical power of the 'invisible hand' metaphor, the laissez-faire contractual account of governance it ordains is, at base, a political construct. What constitutes the optimal level of intervention is contingent on the variable interaction of material and ideational factors. These include the depth, liquidity and importance of capital markets, interest group organisational power, and international regulatory trends. The extent and direction of change are further affected by the environmental impact of professional norms and behavioural mores on the formal and informal nodes supporting the structural architecture.¹ A critical mediating factor is the ideational terms of reference set by the wider political firmament. The extent to which it internalises market-derived conceptions of utility helps determine risk profile and appetite. The complex interaction of these vectors determines who is given voice, authority and legitimacy within the complex network of organisational forms in the overarching regulatory matrix.²

¹ Neil Fligstein, *The Architecture of Markets: An Economic Sociology of Twentieth-Century Capitalist Societies* (2001); Steven Vogel, 'Why Freer Markets Need More Rules' in Marc Candy, Martin Levin and Martin Shapiro (eds), *Creating Competitive Markets* (2006) 25, 27.

² Leigh Hancker and Michael Moran, 'Organizing Regulatory Space' in Leigh Hancker and Michael Moran (eds), *Capitalism, Culture and Economic Regulation* (1989) 271; for conception of regulatory space as network, see Albert-László Barabási, *Linked: The New Science of Networks* (2002) ('Real networks are not static ... there is a hierarchy of hubs