INTEGRITY, RISK AND ACCOUNTABILITY IN CAPITAL MARKETS

REGULATING CULTURE

EDITED BY JUSTIN O'BRIEN AND GEORGE GILLIGAN

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and

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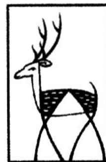

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INTEGRITY, RISK AND ACCOUNTABILITY IN CAPITAL MARKETS

The global economy is yet to recover from the aftershocks of the Global Financial Crisis (GFC). In particular many national economies are struggling to adjust to austerity programs that are a direct result of the toxic effects of the crisis. Governments, regulatory agencies, international organisations, media commentators, finance industry organisations and professionals, academics and affected citizens have offered partial explanations for what has occurred. Some of these actors have sought to introduce legislative and other regulatory initiatives to improve operational standards in capital markets. However, the exposure post-GFC of the scandal surrounding the manipulation over many years of the London Interbank Offered Rate (Libor) highlighted that the most important obstacles to counter the destructive potential of our global finance system are normative not technical. Regulating the culture of the finance sector is one of the greatest challenges facing contemporary society.

This edited volume brings together leading professionals, regulators and academics with knowledge of how cultural forces shape integrity, risk and accountability in capital markets. The book will be of benefit not only to industry, regulatory and academic communities whose focus is upon financial markets and professionals. It is of value to any person or organisation interested in how the cultural underpinnings of the finance sector shape how capital markets actually operate and are regulated. It is a stark lesson of history that financial crises will occur. As national economies become ever more inter-connected and interdependent under conditions of global financial capitalism, it becomes ever more important to know how cultural and other normative forces might be adjusted to militate against the effects of future disasters.

Dedicated to the Memory of James M Landis

One grasps for shadows, the better to comprehend sunlight. One reaches into the past, more clearly to know today and tomorrow. It is the privilege of all who care about education to test the depth and quality of that shadow for there, perhaps more than anywhere, one must try to pierce the brilliance of continuing dawns.

James M Landis
Chairman of the Securities and Exchange Commission,
Washington, DC,
20 March 1937

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Preface

The Global Financial Crisis has demonstrated in startling detail the externalities caused by emasculated conceptions of corporate responsibility. Corporate executives and their professional advisors conspired to push through deals and strategies informed by legal technicalities and accounting conventions. If not in direct violation of the letter of the law, these strategies led to sub-optimal results for both the sustainability of specific corporate models and the professional standing of their advisors. The fact that the statute of limitations has against the most senior executives run in most jurisdictions without the bringing of criminal charges for wilful blindness poses a series of fundamental and unresolved questions. Has the panoply of reform initiatives at national, regional and global level addressed the core normative problem? Alternatively, have we privileged the politics of symbolism, creating the illusion of a robust architecture incapable of withstanding a crisis of similar magnitude? The scandal involving the manipulation of the London Interbank Offered Rate (Libor) offers a perfect case study to explore these questions.

There can be no doubting the magnitude of the scandal. The allegations of misconduct span the globe. Critically, the evidence proffered in settlement agreements to date, involving $2.6 billion in fines, points to the operation of a cartel, an aspect currently under investigation by the European Commission. Of equal significance, the willful misconduct continued long after the onset of the GFC, making future criminal prosecution a distinct possibility. What the investigation contained within this book demonstrates is that Libor and its administration have been carried out within codes of conduct incapable of addressing hubris, myopia and the decoupling of ethical considerations from core business.

As the book was going to press the Parliamentary Banking Standards Commission released its final report. The Approved Person regime that lies at the heart of the Wheatley Review on Libor has been dismissed by the Commission on Banking Standards as a mechanism that created 'a largely illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone.'[1] The lack of accountability for past failings is seen as critical in bringing the banking sector into disrepute. Incremental change, it concludes, 'will no longer suffice.'[2] In a damning assessment of prior regulatory design, compliance is dismissed as the key architectural innovation in the building of Potemkin villages that give 'the appearance of effective control and oversight without the reality.'[3] The fact that 'prolonged and blatant misconduct' as evidenced in the Libor and associated scandals occurred without comment, suggest to the Commission a degree of systemic institutional corruption, allied to a 'dismal' and 'striking limitation on the sense

[1] Parliamentary Banking Standards Commission, *Changing Banking for Good* (HM Parliament, Westminster, June 2013), Vol 1, 9.

[2] Parliamentary Banking Standards Commission, *Changing Banking for Good* (HM Parliament, Westminster, June 2013), Vol 2, para 566.

[3] Ibid, para 684.

of personal responsibility and accountability' of banking leaders.[4] The Commission advocates scrapping the Approved Person framework and introducing instead a Senior Persons Regime. This is designed to assign specific roles to specific individuals. It is proposed to combine this with a licensing regime and replace general principles and codes of conduct with 'a single set of rules to be drawn up by the regulators.'[5] Breach of these formal rules would provide grounds for enforcement action. The Commission maintains that while the existing principles are not

> intrinsically wrong...they do not constitute a sufficiently robust foundation for improving banking standards...The rules should explicitly encapsulate expectations about behavior which are currently absent from the statements of principle for individuals, such as treating customers fairly and managing conflicts of interest and a requirement to draw to the attention of senior management and regulators conduct which falls below the standards set out.[6]

This will, argues the Commission, deal with a critical failure of the current regime, the fact that 'regulators have rarely been able to penetrate the accountability firewall of collective responsibility in firms that prevents actions against individuals.'[7] The approach is also designed to simultaneously provide enforcement action against staff senior enough to satisfy public outrage and broad enough to capture those not currently on the Approved Person register. The introduction of a criminal offence for reckless behaviour adds significant teeth to the proposals but only if exercised. Jail or the prospect of it is, as the Commission acknowledges, a critical deterrent. Whether the regulatory authorities have the stomach for such enforcement strategies is however another matter entirely. But for the fact that the United Kingdom has already gone through a radical redesign of its regulatory architecture, the Commission would advocate creating a specific statutory enforcement agency.[8]

Throughout the report there is evidence of continued suspicion of both banks and their regulators. The emphasis on better governance and the lack of confidence in the ability of boards of directors to recognise their responsibilities is manifest in the suggestion that the Companies Act should be amended 'to prioritise financial safety over shareholder interests in the case of banks.'[9] As the Commission makes clear 'it is essential that the risks posed by having a large financial centre do not mean that taxpayers or the wider economy are held to ransom.'[10] Unless the lessons of history are learnt, however, banks will inevitably fail, hence the need for stringent oversight as 'many banks remain too big and too complex to manage effectively.'[11] By extension, it infers, they are too complex to regulate. In a critical passage, the Commission warns against the myth that the problem in British banking is the result of individual failure or that banking has indeed learnt form its mistakes, thus requiring no further action. Specifically, it rejects any suggestion that robust intervention could threaten the future of the industry. 'If the arguments for complacency and inaction are heeded now,

[4] Ibid, para 105.
[5] Parliamentary Banking Standards Commission, above n1, 9.
[6] Parliamentary Banking Standards Commission, *Changing Banking for Good*, above n2, para 634.
[7] Parliamentary Banking Standards Commission, above n1, 10.
[8] Parliamentary Banking Standards Commission, above n2, para 1200.
[9] Parliamentary Banking Standards Commission, above n1, 11.
[10] Parliamentary Banking Standards Commission, above n2, para 8.
[11] Ibid, para 86.

when the crisis in banking standards has been laid bare, they are yet more certain to be heeded when memories have faded. If politicians allow the necessary reforms to fall at one of the first hurdles, then the next crisis in banking standards and culture may come sooner, and be more severe,' it warns.[12] It is this fear that animates the Commission's discussion of professional standards in the industry and whether codes of conduct can have any restraining value.

The Commission is exceptionally cautious about the stated ambition of the banking industry to develop a professional standards body. While seeing potential value, it is exceptionally concerned that this too could become an exercise in regulatory gaming. 'There are also very substantial risks of duplication between the powers and role of a professional standards body and those of regulators as well as risk that the creation of such a body could become a focus of public policy, diverting attention from the changes that are urgently needed within the existing regulatory framework,' it warns.[13] The proposals for a professional body run the additional risk that power is stripped away from regulators at the very point it is most needed. It is a risk that the Commission is not prepared to countenance. 'On the basis of our assessment of the nature of the banking industry, we believe that the creation of an effective professional body is a long way off and may take at least a generation,' it concludes.[14] The reform of British banking remains, therefore a work in progress. The Potemkin facade has been pierced not yet demolished.

Building a sustainable framework necessitates warranted belief in the underpinning rationale. For the process to be effective necessitates commitment in the end itself–that of market integrity–rather than a mechanism to forestall external oversight. Critically, therefore, there is a need to separate 'purpose' from 'ends.'[15] No practice can lead to the sustainable achievements of desired 'ends' if the 'purpose' for holding the beliefs that animates practice differs in substance from the primary goal. The ultimate end of the physician, for example, is to heal. If, however, the purpose of believing in or seeking to achieve that goal is to make money, for example, risks subverting that end. Unnecessary tests or procedures may be prescribed that increase the financial burden on the patient, insurance company or taxpayer. The patient may not necessarily be harmed; she may in fact be healed. The conduct, however, if replicated across a given market, is undesirable. It can impose additional costs, financial and emotional. It also threatens the corruption of the primary end: the protection of life through the application of the do no harm thesis. The imposition of unnecessary costs clearly violates the individual. It also risks bringing the wider institutional system into disrepute. This critical distinction between ultimate 'ends' and 'purpose' has deep resonance for participants involved in the governance of financial markets. The failure to articulate and integrate purpose, values and principles within a functioning ethical framework has created toxic and socially harmful corporate cultures in urgent need of reform, which an emphasis on technical measures alone will be incapable of addressing.

[12] Ibid, para 273.

[13] Ibid, para 598.

[14] Ibid, para 601.

[15] A MacIntyre, 'Ends and Endings' (Speech delivered at the Catholic University of America, Washington, DC, 25 September 2009); see also D Rose, *The Moral Foundations of Economic Behaviour* (Oxford University Press, 2011) 188 ('There is no escaping the fact that why one holds the required moral tastes matters as much as having the right kind of moral tastes.').

The work presented here is the result of a major project conducted by the Centre for Law Markets and Regulation at UNSW Law in conjunction with academic partners at the University of Melbourne Law School and the School of Law at the University of Leeds. The funding provided by the Australian Research Council though Justin O'Brien's Future Fellowship ('Measuring and Evaluating Performance in Securities Market Regulation,' FT120100104) is gratefully acknowledged along with the invaluable assistance provided by the Office of the Legal Services Commissioner, New South Wales through its co-financing of an ARC Linkage Grant. The Centre for Corporate Law and Securities Regulation at Melbourne Law School kindly hosted one of the three workshops that informed this project we are very grateful for the support of its Director, Professor Ian Ramsay. We are also immensely grateful to Professor John Braithwaite at the ANU for his erudite conclusion, which emphasises, correctly in our view, the critical importance of narratives and the need to reframe conceptions of blameworthiness. Effective academic research is predicated on capacity to inform and influence the trajectory of policy and this necessitates the involvement of practitioners and regulators. We would like to acknowledge the engagement of Allens-Linklaters, which hosted the initial workshop in Sydney and Allen & Overy for staging the final workshop in London. In addition, Justin O'Brien would like to acknowledge the support of Harvard Law School in facilitating the excavation of the university archives in relation to James M Landis, in the memory of whom this book is dedicated.

Justin O'Brien and George Gilligan, Sydney, June 2013

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Introduction

Regulating Culture: Problems and Perspectives

Justin O'Brien and George Gilligan

I CULTURE, TRUST AND THE FINANCE SECTOR

Trust in our corporations and in our institutions, both secular and religious, is at an all-time low. Across myriad domains and jurisdictions, from policing to the media, faith-based schooling to banking, governance failures have blighted individual lives, ruined reputations and, in the case of the global financial crisis, social cohesion.[1] Irrespective of domain, corporate culpability for individual ethical failures is invariably and inevitably informed by the relative strength or weakness of organizational culture (ie, the degree to which egregious conduct is informed by a disconnect between stated and lived values).[2] The disjunction can lie along a continuum. It ranges from willful neglect, through reliance on formal but transacted around compliance programs, to misaligned incentives.[3] It is equally dispiriting but nonetheless inescapable that neither commitments to enhanced self-regulation nor strengthened external oversight have proved capable of arresting a decline in the trustworthiness of the financial sector.[4] This is the case irrespective of whether rules or principles-based approaches to regulatory design have been privileged.[5] Indeed, recent legislative

[1] See MD Higgins, 'President's Remarks at the Launch of Up The Republic,' (Speech delivered at the Royal Irish Academy, Dublin, 14 November 2012).

[2] J Sorensen, 'The Strength of Corporate Culture and the Reliability of Firm Performance' (2002) 47 *Administrative Science Quarterly* 70, 72 (defining culture narrowly as a system of shared values (that define what is important)) and norms that define appropriate attitudes and behaviors for organizational members (how to feel and behave); see also L Smircich, 'Concepts of Culture and Organizational Analysis' (1983) 28 *Administrative Science Quarterly* 339 (noting that research into corporate culture is an inquiry into the social order: at 341).

[3] G Rossouw and L van Vuuren, 'Modes of Managing Morality: A Descriptive Model of Strategies for Managing Ethics' (2003) 46 *Journal of Business Ethics* 389 (noting a five-stage process in which corporate activity moves from '(1) immorality; (2) reactivity; (3) compliance; (4) integrity; (5) total alignment: at 391).

[4] J O'Brien, 'Re-Regulating Wall Street: Substantive Change or the Politics of Symbolism Revisited,' in I. MacNeil and J. O'Brien (eds.), *The Future of Financial Regulation* (Oxford, Hart Publishing, 2010).

[5] K Keasey, H Short and M Wright, 'The Development of Corporate Governance Codes in the United Kingdom,' in K Keasey, S Thompson and M Wright (eds), *Corporate Governance: Accountability, Enterprise and International Comparisons* (2005) 21 (noting that reform impulses are driven by scandal).

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innovations have resulted in the design of suboptimal regulatory structures; suboptimal, that is, to society if not the financial sector itself, ostensibly the target but ultimately the beneficiary of flawed implementation.[6] This is particularly apparent in the United States.[7] The *Public Company Accounting Reform and Investor Protection Act* (2002), better known as Sarbanes-Oxley, designed to enhance audit standards in the aftermath of the Enron and associated scandals, for example, transmogrified into an enormous rent-seeking opportunity for the accounting profession.[8] Equally, the *Wall Street Reform and Consumer Protection Act* (2010), or Dodd-Frank, has facilitated ongoing trench warfare between the Securities and Exchange Commission (SEC) and regulated entities over its nature, scope and legislative intent.

These conflicts and tensions are unsurprising consequences of the cultural realities of the financial sector, both past and present. More generally societies, firms, professional associations, specific industries and other groups (including regulatory actors), develop modes of preserving and transmitting through time and generations the mental programming that constitute routines, or *the ways that things are done* in processes that may be difficult to discern specifically, but which nonetheless are well understood, not only by those who may be involved directly but also by those who are not.[9] These mental programs interact with individual and collective value systems, which simultaneously are reflexively interacting with prevailing cultural influences, and thus inevitably shape behaviours. So, the City of London or Wall Street for example, develop patterned modes and mechanisms for evaluating issues and events that are transmitted within their core groups as well as to the broader populations at home, and abroad, as the routine and legitimate ways of doing business – in short, the operational culture of an industry.[10]

Culture can be simultaneously local and general. A universal hermetic definition of what constitutes culture is perhaps impossible. It is, therefore, perhaps more fruitful to accept the conceptual imprecision that permeates debates about culture and understand it as a complex

[6] See, for example, A Haldane, 'The Dog and the Frisbee,' (Speech delivered at Federal Reserve Bank of Kansas Annual Symposium, Jackson's Hole, 31 August 2012), available at www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf.

[7] D Mitchell, 'The End of Corporate Law' (2009) 44 *Wake Forest Law Review* 703 ('In the course of the past century corporate law has been used first to legitimate corporate power and then to exempt those exercising it from liability': at 703); see more generally H Collins, *Regulating Contracts* (Oxford, Oxford University Press, 1999) 59 (describing private law as 'the index finger of the invisible hand that guides the markets'); for the importance of political framing, see E Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 *Washington & Lee Law Review* 1565 (noting 'corporate law involves the simultaneous pursuit and coexistence of a number of ends or purposes, with the mix a preponderance of different values depending on particular legal context': at 1565).

[8] J O'Brien, *Redesigning Financial Regulation: The Politics of Enforcement* (Chichester, John Wiley & Sons, 2007); for discussion of the role of politicians as active rent extractors, see F McChesney, *Money for Nothing* (New York, Oxford University Press, 1987) 157 (characterizing politicians 'not as mere brokers redistributing wealth in response to competing private demands but as independent actors making their own demands to which private actors respond.').

[9] The residual, seemingly perennial relative regulatory autonomy (especially in the Anglo-American context), of the financial sector to shape its own regulatory discourse and infrastructures over many centuries is testimony to this power. For a detailed analysis of these forces at work in the UK context, see: G Gilligan, *Regulating the Financial Services Sector* (London, Kluwer Law International, 1999).

[10] G Hofstede, *Culture's Consequences: International Differences in Work-Related Values*, (Beverley Hills, CA, Sage, 1980) 25 (Culture could be defined as 'the interactive aggregate of common characteristics that influence a human group's response to its environment. Culture determines the identity of a human group in the same way as personality determines the identity of an individual.').

interaction between networks of specific epistemic communities that aggregate interweaving dimensions. For example, Becker views culture as a set of shared understandings that permit a group of people to act in concert with each other.[11] Cotterrell sees culture as having four general components: beliefs/values; traditions; instrumental (economic/technological) matters; and matters of effect (emotion).[12] These elements can be especially mutually reinforcing amongst professional communities that have a history of shared customs and business practices. So, when one analyses how a regulatory culture evolves within any given industry, numerous sources of regulatory culture are apparent. Significant amongst these are: general culture (especially in a national context); social structures; law (particularly statutes and court decisions); regulatory traditions; and the practice of regulatory work itself.[13] It is important to remember that as these regulatory sources emerge and grow, the groups that comprise *the regulated* are almost invariably much larger than the regulatory agencies charged with regulating them. Moreover, the former may well have far greater resources available to shape the discourses and evolutionary pathways of ostensibly more powerful regulatory sources.

The financial sector is one of the areas in which these regulatory source imbalances have been most pronounced over the years. Professional, structural and cultural embeddedness condition the interplay of regulatory authority and regulatory responses. These coalitions of embeddedness allow those players or firms with the requisite resources and inter-organisational alliances to build up and legitimate their image of regulatory authority.[14] If their regulatory authority is strong, then they can subsequently challenge and/or negotiate the rules of regulation. Contemporary regulatory conditions shape future regulatory structures. It is clearly in the self-interest of powerful actors within an industry like financial services to be as reflexively influential as possible on current regulatory practice, so as to maintain or increase future levels of influence.

Historically, more aggressive enforcement has proved problematic in changing corporate culture, with the imposition of ever increasing fines written off as part of the cost of doing business.[15] Paradoxically, in the contemporary crisis accusations of 'overreach'[16] frequently accompany judicial complaints that a façade of enforcement is being privileged.[17] In cases in which insiders have been brought to trial, juries have been reluctant to

[11] H S Becker, 'Culture: A Sociological View' (1982) 71 *The Yale Review* 513.

[12] R Cotterrell, 'Law and Culture–Inside and Beyond the Nation State' (2008) 31 *Retfærd: Nordisk Juridisk Tidsskrift* 23.

[13] E Meidinger, 'Regulatory Culture: A Theoretical Outline' (1989) 9 *Law & Society* 355.

[14] The term regulatory authority is being used advisedly. It refers to those situations in which it is deemed legitimate for the regulated to have power and this legitimacy is recognised by regulators. The larger and more influential a firm is within the financial services sector, the more likely it is that it can legitimately build up its image of regulatory authority.

[15] H Rockness and J Rockness, 'Legislated Ethics: From Enron to Sarbanes-Oxley, the Impact on Corporate America' (2005) 57 *Journal of Business Ethics* 21 (noting the need for meaningful sanctions, increased investigatory capacity and external fines that exceed expected gains).

[16] JB Stewart, 'Another Fumble By the SEC on Fraud,' *New York Times*, 16 November 2012, available at www.nytimes.com/2012/11/17/business/another-fumble-by-the-sec.html?_r=0.

[17] T Hemphill and F Cullari, 'Corporate Governance Practices: A Proposed Policy Incentive Regime to Facilitate Internal Investigations and Self-Reporting of Criminal Activities' (2009) 87 *Journal of Business Ethics* 333, 335–342 (noting the increased prosecutorial arsenal); for critiques of its application, see J Hasnas, 'Ethics and the Problem of White Collar Crime' (2005) 54 *American University Law Review* 579; M Koehler, 'Revisiting a Foreign Corrupt Practices Act Compliance Defense' (2012) *Wisconsin Law Review* 609; M Koehler, 'The Façade of FCPA Enforcement' (2010) 41 *Georgetown Journal of International Law* 907.

convict.[18] At a broader strategic level, judicial skepticism over the agency's use (or misuse) of cost-benefit analysis has significantly curtailed the efficacy of its discretionary ability to introduce enhanced standards.[19] Despite the long-standing antagonism between the DC circuit in particular and the SEC, deference to agency discretion remains intact. The unresolved question is how that discretion is applied, a question to be explored more fully below. The point to underscore at this stage, however, is the abject failure of moral exhortation alone as a regulatory strategy. For example, huge bonuses in the banking industry, even when firms are reporting massive losses or are being rescued by taxpayers, is an issue that highlights the seemingly willful blindness and deafness of finance industry professionals towards strident criticism from the media, community, governments and regulators alike.[20] In far too many instances, boards remain impervious to exhortations from the SEC that 'those who act on behalf of a company give life to the corporate conscience.'[21] There is, of course, an inherent tension between monitoring and the provision of strategic advice.[22] The failure of the 'conscience' metaphor calls into question the extent to which self-regulation is possible, a fact acknowledged by the SEC.[23] If exhortations from regulatory agencies are viewed with derision, so too are common law precedents. Guidance to corporations and their advisors as to what should constitute minimal compliance standards has served little better.[24] Transactions have been carried out around codes of conduct through a combination of hubris, myopia and the decoupling of ethical considerations from core business.[25] Taken together, the failure to articulate and integrate purpose, values and principles within a functioning ethical framework has created toxic and socially harmful corporate cultures.

It is equally dispiriting that policymakers have conflated the essential function provided by banking with the security of individual banks, a compromise that because of the

[18] See P Henning, 'Mixed Results for SEC in Financial Crisis Cases,' *New York Times*, 19 November 2012, available at dealbook.nytimes.com/2012/11/19/mixed-results-for-s-e-c-in-financial-crisis-cases.

[19] See J Fisch, 'The Long Road Back: Business Roundtable and the Future of SEC Rulemaking' (2012) *Seattle University Law Review*, forthcoming.

[20] See A Cuomo, *No Rhyme or Reason: The Heads I Win, Tails You Lose, Bank Bonus Culture*, (New York, State Attorney General Office, 2009).

[21] C Glassman, 'Sarbanes-Oxley and the Idea of "Good" Governance' (Speech delivered at the American Society of Corporate Secretaries, 27 September 2002). The belief in common purpose animates SEC policy formulation; see M Shapiro, 'Address to the Practising Law Institute' (Speech delivered at PLI Securities Regulation Seminar, New York, 4 November 2009): '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.'

[22] J Fisch, 'The New Federal Regulation of Corporate Governance' (2004) 28 *Harvard Journal of Law and Public Policy* 39.

[23] See 'Securities and Exchange Commission's Chairman Cox Announces End of Consolidated Supervised Entities Program' (Press Release, Washington, DC, 26 September 2008), noting that 'self-regulation does not work,' available at www.sec.gov/news/press/2008/2008-230.htm.

[24] *In Re Caremark International Inc Derivative Litigation*, 698 A.2d 959 (Delaware Chancery Court) at 970 (holding that directors can be held liable and this can be easier to prove in the absence of an effective compliance program).

[25] J O'Brien, 'Managing Conflicts: The Sisyphean Tragedy (and Absurdity) of Corporate Governance and Financial Regulation Reform' (2007) 20 *Australian Journal of Corporate Law* 317.

maintenance of an explicit 'too big to fail' subsidy facilitates risk-taking.[26] Ingrained cultural forces can distort perceptions within organisations about risk and incentives, especially in the hyper-competitive environment of international finance which may adapt ever-increasing matrices of risk as the norm.[27] Moreover, the complexity of modern finance and globalized, fragmented chains of command governing the production and dissemination of specialized knowledge increases the information asymmetry risk. As a consequence, the risk that the unscrupulous will take advantage of what the economist David C. Rose has termed the 'golden opportunities' of deception is increasing.[28] Recent survey evidence from the corruption and anti-money-laundering domain confirms this insight. The annual Ernst & Young global fraud survey, for example, is one of the most detailed snapshots of the bribery and corruption challenges facing multinational corporations.[29] One of its most 'troubling' findings is what Ernst & Young terms a growing widespread acceptance of unethical business practices (eg, 64 per cent of respondents believe that the incidence of compliance failure has increased because of the downturn).[30] The trend is particularly apparent in East Asia (eg, 60 per cent of respondents in Indonesia deemed it acceptable to make cash payments to secure new contracts; 36 per cent of respondents in Vietnam suggested it was permissible to misstate financial accounts).[31] The decline in ethical commitment is traced to a lack of training, and, more significantly, to mixed messages from senior management as to the importance of compliance with Anti-Bribery and Corruption Policies (ABACP). As Ernst & Young concludes, if action is not taken to hold offenders to account, stated commitment to high standards remains an exercise in symbolism. While many reported the existence of sophisticated compliance systems, these were not subject to ongoing external testing. Only 33 per cent reported using external law firms or consultants to provide assurance.[32] In a significant finding, 54 per cent of CFOs surveyed had not taken ABACP training,[33] while 52 per cent of all respondents reported that the board was not sufficiently aware of operating risk.[34] The report concludes, somewhat bleakly, that hard times stretch ethical boundaries.[35]

[26] See R Whelan, 'Misunderstanding the Banking Industry,' Rethinking Financial Markets Online Conference, World Economics Association, 1–30 November 2012, available at rfconference2012.worldeconomicsassociation.org/wp-content/uploads/WEA-RFMConference2012-Whelan.pdf.

[27] DC Langevoort, 'Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk Taking' (2011) 96 *Cornell Law Review*, 1209.

[28] DC Rose, *The Moral Foundations of Economic Behavior* (New York, Oxford University Press, 2011) 16; see also P Pettit, 'Republican Reflections on the Occupy Movements,' in F O'Toole (ed), *Up the Republic* (Dublin, Faber & Faber, 2012) 169–81 (noting 'it is a sad fact of human nature that while not many of us might be corrupt, not many are incorruptible; when opportunity offers not many are capable of resisting the temptation to make a quick buck. The timber may not be rotten but it is crooked:' at 177).

[29] Ernst & Young, *Growing Beyond, A Place for Integrity* (New York, EYGM Limited, 2012), hereinafter *Ernst & Young Survey*. The survey is drawn from a sample of 1700 senior executives. It includes respondents drawn from incumbent Chief Financial Officers (CFO) and senior executives charged with running the legal, compliance and internal audit functions of major corporations across 43 different countries

[30] ibid, Figure 1, 4.

[31] ibid, Figure 2, 5.

[32] ibid, Figure 4, 7.

[33] ibid, 3.

[34] ibid, 3.

[35] ibid, 5.

The critical importance of trust in lowering agency and transaction costs, building cooperation and innovation and creating more efficient exchanges has, of course, long been recognized.[36] Absent ongoing substantial institutionalized commitment to ethical behavior, however, credible *ex ante* detection of unthinking, blinkered or compartmentalized ethical consideration remains implausible.[37] The critical question, therefore, is how to strengthen the restraining forces and whether this effectiveness can be monitored and evaluated. As Weaver, Revino and Cochran have nicely phrased it, 'how does one ensure integrated rather than decoupled corporate social performance?'[38] Resolution of this conundrum cannot take place without critical reflection on the corporation and its place in society.[39]

Corporate cultures do not exist in a vacuum; nor are they mere reactive responses to externally mandated rules. Instead they reflect the values of the organization. The emphasis on culture underpins an influential definition of corporate governance provided by the Australian jurist Justice Neville Owen. In his investigation into the collapse of HIH Insurance, Justice Owen maintained that he was "not so much concerned with the content of a corporate governance model as with the culture of the organization to which it attaches." For Justice Owen, "the key to good corporate governance lies in substance, not form. It is about the way the directors of a company create and develop a model to fit the circumstances of the company and then test it periodically for its practical effectiveness. It is about the directors taking control of a regime they have established and for which they

[36] S Banerjee, N Bowie and C Pavone, 'An Ethical Analysis of the Trust Relationship,' in R Bachman and A Zaheer (eds), *Handbook of Trust Research* (Cheltenham, Edward Elgar, 2006) 303; more broadly see D North, 'Economic Performance Through Time' (1994) 84 *American Economic Review* 359 (noting 'societies that get "stuck" embody belief systems and institutions that fail to confront and solve new problems of societal complexity': at 364. For origins of the administrative process and its legitimation, see JM Landis, *The Administrative Process* (New Haven, Yale University Press, 1938) 4 (noting that increased complexity calls 'for greater surveillance by government of the appropriate use of these resources to further the admittedly dim but recognizable aims of our society.'). See more generally, R Frank, *Passions Within Reason: The Strategic Role of the Emotions* (New York, Norton, 1988) 19 (noting that indoctrination and practice are essential building blocks of character formation).

[37] D Murphy, 'The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics' (2002) 87 *Iowa Law Review* 697 (noting that compliance programs without an explicit framework for assessing ethical dilemmas are unlikely to work: at 716–17); for the danger of compartmentalization, see A MacIntyre, 'Social Structures and their Threats to Moral Agency' (1999) 74 *Philosophy* 311 (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:' at 322); for discussion of the application of virtue ethics to the problem of sustainable financial reform, see J O'Brien, 'The Future of Financial Regulation, Enhancing Integrity Through Design' (2010) 32 *Sydney Law Review* 39.

[38] G Weaver, LK Trevino and P Cochran, 'Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures and Corporate Ethics Practices' (1999) 42 *Academy of Management Journal* 539; see also LS Paine, 'Managing for Organizational Integrity' (1994) 3 *Harvard Business Review* 106 (noting that ethics has everything to do with management: at 106).

[39] E Mason, 'Introduction,' in E Mason (ed), *The Corporation in Modern Society* (Cambridge, Harvard University Press, 1960) 19. ('[T]he fact seems to be that the rise of the large corporation and attending circumstances have confronted us with a long series of questions concerning rights and duties, privileges and immunities, responsibility and authority, that political and legal philosophy have not yet assimilated').

are responsible.'[40] Warranted commitment to moral restraint necessitates ongoing critical reflection on what constitutes obligation—to whom and for what purpose.[41] It is in this context that corporate culture plays an essential disseminating role. It informs employees of what the company stands for.[42] To be effective, it must be informed by belief not prudence (ie, the fear of detection) precisely because the risk of detection can be quite low and fines written off as part of the price of doing business.[43] As Rose puts it, 'there is no escaping the fact that why one holds the required moral tastes matters as much as having the right kind of moral tastes.'[44] This, in turn, suggests it is essential to build the governance of the financial sector on an explicit normative foundation, a fact recognized, for example, but not implemented by senior regulators.[45] Notwithstanding plausible demands for a return to

[40] Report of the HIH Royal Commission, *The Failure of HIH Insurance* (Canberra, Commonwealth of Australia, 2003) xxxii, available at www.hihroyalcom.gov.au/finalreport/index.htm. For rare recognition of failure to internalize responsibility from former head of compliance at British Bank HBOS, see Paul Moore, 'Memo to Treasury Select Committee,' Westminster, London, 10 February 2009 ('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.')

[41] See J Kay, *The Kay Review of Equity Markets* (London, HM Government, July 2012) 9. (According to Professor Kay, sustainable reform must be predicated on capability to 'restore relationships of trust and confidence in the investment chain, underpinned by the application of fiduciary standards of care by all those who manage or advise on the investments of others.' This necessitates a move away from short-termism, as 'trust and confidence are the product of long-term commercial and personal relationships: trust and confidence are not generally created by trading between anonymous agents attempting to make short term gains at each other's expense': at 5), available at bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf.

[42] See also Paine, above n38 (noting that the task of ethics management is to define and give life to an organization's guiding values, to create an environment that supports ethically sound behavior, and to instill a sense of shared accountability among employees.' As such, 'organizational ethics helps define what a company is and what it stands for: a 111).

[43] See O'Brien above, n4. The rise of class actions, however, may change this dynamic, see J Harris and M Legg, 'What Price Investor Protection: Class Actions vs Corporate Rescue' (2009) 17 *Insolvency Law Journal* 185. Recent litigation success (through settlements) in Australia has underscored the monetary pain; see for example, the $200m settlement reached by Centro and its auditors PwC to end a class action, N Lenaghan and B Wilmont, 'Centro, PwC to Take Record $200m Hit,' *Australian Financial Review*, 9 May 2012, available at afr.com/p/national/centro_pwc_take_record_legal_hit_6CaSTKu6K1w7nJFFIZOxWL.

[44] Rose, above n28, 188.

[45] See H Sants, '*Annual Lubbock Lecture in Management Studies*' (Speech delivered at Said Business School, University of Oxford, March 12, 2010) ('We need to answer the question of whether a regulator has a legitimate focus to intervene on the question of culture. This arguably requires both a view on the right culture and a mechanism for intervention. Answering yes to this question would undoubtedly significantly extend the FSA's engagement with industry. My personal view is that if we really do wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of both society as a whole, and the management of major financial firms. This will not be easy. A cultural trend can be very widespread and resilient—as has been seen by a return to a 'business as usual' mentality. Nevertheless, no culture is inevitable'); see more generally D North, *Structure and Change in Economic History* (New York, Norton, 1981) 47 (suggesting that ethical standards are the 'cement of social stability'); see also O Williamson, 'The New Institutional Economics: Taking Stock, Looking Ahead' (2000) 38 *Journal of Economic Literature* 595. (Williamson notes that analysis of the 'non-calculative social contract' or 'level one' component of social theory is conspicuous by its absence within regulatory studies: at 597). 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.

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