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The Future of Financial Regulation: Enhancing Integrity through Design

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Abstract

The design of effective and flexible regulatory and corporate governance rules, principles and norms to address the interlinked and intractable problems in both the financial and real economies has become a global policy imperative. Restoring the confidence of investors is critical to the success of the various government initiatives worldwide to address the global financial crisis. This cannot be achieved on a sustainable basis unless the structural changes address the ethical dimensions. The paper is divided into three parts. First, the credit crisis is put in context and the impact on regulatory practice and techniques is investigated. Second, an alternative approach to governance is outlined that addresses how deficiencies in corporate and regulatory practice can be addressed by enhancing integrity through design. Third, the paper suggests that while this approach is likely to be more effective, the dynamics of regulatory reform are foreclosing its introduction.

1. *Introduction*

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

more interventionist approach to corporate governance design.¹ More encouragingly, perhaps, in his inaugural address, President Obama emphasized the need for the inculcation of a new ‘ethics of responsibility.’ This echoed earlier calls by the British Prime Minister, Gordon Brown, for moral restraint within financial centres (if only for instrumental reasons).² Beyond London and New York, however, the extent to which the crisis has metastasised with such ferocity has substantially strengthened calls for an integrated response to nullify what the Australian Prime Minister, Kevin Rudd, has called ‘extreme capitalism.’³ Although many would disagree with the polemical framing, there can be no question that we have reached an inflexion point for both the theory and practice of regulation.

There is recognition that reform requires much greater coordination and integration at the global level, if only for protection of national self-interest.⁴ The G-20 Summit in London in April 2009 has begun to lay the foundations for a new international regulatory architecture covering all systemically important financial institutions and markets (including, significantly, hedge funds which, through judicious structuring, have to date been effectively unregulated) as well as systemically important financial instruments (such as securitisation and credit derivatives). Similarly, the European Union has proposed the establishment of what is described as a European Systemic Risk Council, headed by the president of the European Central Bank. This would be buttressed by a European System of Financial Supervisors. Although detail on the governance structure and enforcement powers remains scant, the European Commission president, Jose Barraso, maintains ‘better supervision of cross-border financial markets is crucial for ethical and economic reasons.’⁵

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¹ See S. Labaton, ‘Overseer to Set Executive Pay at Rescued Companies,’ *New York Times*, 11 June 2009, A1. Note, however, that this decision came after the Treasury Secretary released ten of the largest banks from the governance and remuneration restraints imposed as a consequence of the Trouble Asset Relief Program (TARP). For further detail, see J. O’Brien, *Engineering a Financial Bloodbath* (2009) 89-111.

² G. Brown, ‘The Global Economy’ (Speech delivered at Reuters Building, London, 13 October 2008).

³ K. Rudd, ‘The Global Financial Crisis’, *The Monthly*, February 2009; see also K. Rudd, ‘The Children of Gordon Gekko,’ *The Australian*, 1 October 2008, 12.

⁴ See Statement by Secretary Geithner at the G8 Finance Ministers Meeting (Press Release, US Department of Treasury, 13 June 2009). Geithner argued ‘because markets are increasingly global, the financial rules of the game we are responsible for at the national level need to converge toward higher standards. Risk and leverage will always tend to migrate to where the constraints are weakest. We need a level playing field globally, or the effectiveness of our national safeguards against risk will be undermined.’

⁵ Commission Outlines Plans for Closer Financial Supervision at European Level (Press Release, Brussels, 27 May 2009).

The European Commission president makes a fundamental point. Although there has been criminal activity on the margins, the global financial crisis is the result of ‘perfectly-legal’ if ethically questionable strategies. The unrelenting focus on the punishment of individual malefactors serves to obscure a much more fundamental problem. Corporate malfeasance and misfeasance on the scale witnessed cannot be readily explained by individual turpitude. Moreover, a retreat to rules will not necessarily guarantee better ethical practice or inculcate higher standards of probity. Indeed the passage of rules may itself constitute a serious problem. It creates the illusion of change. Given the fact that much of what occurred was legal, if irresponsible, it is essential to recalibrate the theory and practice of corporate governance, regulation and business ethics. While the policy response to scandal has traditionally been to emphasize personal character, much less attention has been placed on how corporate, professional, regulatory and political cultures inform, enhance or restrain particular character traits. There is a dynamic interplay between the culpability of individual actors and the cultural and ideational factors that not only tacitly condoned but also actively encouraged the elevation of short-term considerations over longer-term interests. This requires that we expand our focus beyond formal rules (which can be transacted around) or principles (that lack the definitional clarity to be enforceable). It is essential to evaluate how these rules and principles are interpreted within specific corporate, professional or regulatory practice.

Notwithstanding the certainty of the former chairman of the Federal Reserve, Alan Greenspan, that it is impossible to have a perfect model of risk,⁶ or in an earlier speech that it is difficult to legislate for ethics,⁷ it has become essential that the integrity deficit in regulatory frameworks be addressed. Sustainable reform requires a thorough excavation of the causes of the crisis as well as the design of new instruments and mechanisms for cross border cooperation.⁸ The policy challenge is to build corporate governance and financial regulation in ways that emphasise

⁶ A. Greenspan, ‘We Will Never Have a Perfect Model of Risk,’ *Financial Times*, 17 March, 2008, 13. A similar dynamic is apparent in the United States, where plans for a consolidation of disparate regulatory agencies have, for now, been jettisoned in favour of greater consultation. For original consolidation plan, see n 29 and accompanying text.

⁷ A. Greenspan, ‘Capitalizing Reputation’ (Speech delivered at Financial Markets Conference, Federal Reserve Board of Georgia, 16 April, 2004).

⁸ ‘IOSCO Finalizes Policy Responses to the Financial Crisis’ (Press Release, Tel Aviv, 11 June 2009). According to Jane Diplock, chair of the New Zealand securities regulator: ‘We need to understand what direction to take in order to reaffirm IOSCO’s pivotal role in the international financial architecture. To do that, we must take account of the lessons every country represented here has learned from the crisis. We need to focus more on identifying risks in financial markets and to addressing stability issues within the purview of securities regulators’: at 3.

duties and responsibilities as well as corporate rights. The appropriate first order question, therefore, is not how we regulate but for what specific purpose? Restoring the confidence of investors is critical to the success of the various government initiatives worldwide to address the global financial crisis. This cannot be achieved on a sustainable basis unless the structural changes address the ethical dimensions that form the core of the research agenda advanced here.

The paper is divided into three parts. First, the credit crisis is put in context and the impact on regulatory practice and techniques is investigated. Second, an alternative approach to governance is outlined that addresses how deficiencies in corporate and regulatory practice can be addressed by enhancing integrity through design. Third, the paper suggests that while this approach is likely to be more effective, the dynamics of regulatory reform are foreclosing its introduction.

2. The Credit Crisis in Context

Latest estimates by the International Monetary Fund put the total cost of the multifaceted collapse at \$4 trillion,⁹ the vast majority of which can be attributed to systemic failures of corporate, regulatory and political oversight in the United States. Many of its leading bankers have been forced to resign, castigated for destroying their institutions through a combination of hubris, greed and regulatory gaming (i.e. technical compliance but with derogation from the underpinning principles of corporate disclosure obligations). The crisis was not just a failure of rules-based regulation. In the United Kingdom, the Financial Services Authority has seen its vaunted risk-based approach to regulation fall into as much reputational disrepute as the country's leading banks, whose forced nationalization adds to the humiliation of the City of London. Similar dynamics are apparent in countries as culturally, politically and economically divergent as Iceland and Ireland. Each has seen its banking system collapse with profoundly destabilizing effects on the real economy.¹⁰ Ostensibly, more cautious regulatory frameworks within the European Union have proved equally deficient. The 'passport system' allowing banks to operate across borders with supervision vested in the home jurisdiction was a demonstrable failure, as witnessed by the collapse of regional German banks operating in Dublin.

⁹ International Monetary Fund, *World Economic Outlook* (2009) xv.

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

Regulatory arbitrage over the implementation of directives relating to the finance sector reinforced the problems.¹¹

After taking into account specific national factors, three inter-linked global phenomena are at play: flawed governance mechanisms, including remuneration incentives skewed in favour of short-term profit-taking and leverage; flawed models of financing, including, in particular, the dominant originate-and-distribute model of securitisation, which promoted a moral hazard-culture; and regulatory structures predicated on risk reduction which created incentives for risk capital arbitrage and paid insufficient attention to credit risk. Each combined to create an architectural blueprint for economic growth in which innovation trumped security. Financial engineering, in turn, created fiendishly complex mechanisms that, ultimately, lacked structural and ethical integrity. Take, for example, the collateralised debt obligation and credit default swap market, which generated enormous fee income for the investment bank that structured or distributed the instruments. This raises real doubts as to whether the bank in question acted in an ethical manner, even where there had been formal compliance with legal obligations. Those doubts have also been raised in relation to other participants in these types of transactions, including accountants, lawyers and ratings agencies. Asymmetric information flow, variable capacity—or willingness—to use internal management systems, market mechanisms or regulatory enforcement tools, led to a profound misunderstanding of national and international risks associated with the rapid expansion of structured finance products such as securitisation. Deepening market integration ensured that risk, while diversified geographically, remained undiluted. As the Nobel Laureate Joseph Stiglitz put it in excoriating testimony to Congress, ‘securitisation was based on the premise that a fool was born every minute. Globalisation meant that there was a global landscape on which they could search for these fools—and they found them everywhere’.¹² From northern Norway to rural New South Wales, local councils

¹¹ See D. Murphy, *The Structure of Regulatory Competition, Corporations and Public Policies in a Global Economy* (2004) 107 (highlighting how competition to retain fungible capital can result in a “competition in laxity”). For application to the reinsurance industry, see J. O’Brien, *Redesigning Financial Regulation: The Politics of Enforcement* (2007) 171-200.

¹² Evidence to House Committee on Financial Services, ‘Regulatory Restructuring and the Reform of the Financial System,’ Washington DC, 21 October 2008 (J. Stiglitz). For discussion of “an ideological agenda [which] has pushed excessive reliance” on capital adequacy standards,” see J. Stiglitz, ‘Principles of Financial Regulation: A Dynamic Portfolio Approach’ (2001) 16 *World Bank Research Observer* 1 (arguing that ‘despite its long history, financial market regulation is poorly understood’ and suggesting the need for strong regulation to address “failures in the banking system [which] have strong spillovers, or externalities, that reach well beyond the individuals and firms directly involved’: at 2).

bought products on the basis of misplaced trust in the efficacy of internal controls, the strength of independent directors to hold management to account, the attestation provided by external auditors, legal due diligence, the assurances of those providing corporate advisory services, including inherently conflicted rating agencies and, ultimately, the robustness of the overarching regulatory system at either national or international levels. The progressive visualization of those flaws has led to a massive loss of confidence in the accountability mechanisms designed by or demanded of key actors in the financial markets.¹³

The critical issue facing regulatory authorities across the world is how to deal with a model of capitalism based on technical compliance with narrowly defined legislation and a working assumption that unless a particular action is explicitly proscribed, it is deemed politically and socially acceptable. This degree of ethical failure is neither new, nor unexpected. A striking feature of corporate and regulatory responses to the financial crisis, however, is the paucity of institutional memory. At both Congressional hearings in Washington and testimony provided to the Treasury Select Committee in Westminster, banking executives claimed that the crisis was the result of a ‘perfect storm’ or ‘financial tsunami’; the conflation of factors beyond control.¹⁴ Similar defences were used during the conflicts of interest investigations that accompanied the collapse of Enron, WorldCom and Tyco in the accounting scandals at the turn of the millennium.¹⁵ To a large extent this reflects a continuing

¹³ For trajectory of corporate governance reform, see 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; for global perspective, see J. Hill, ‘Evolving “Rules of the Game” in Corporate Governance Reform’ in J. O’Brien (ed.), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 29.

¹⁴ Evidence to House Committee on Oversight and Government Reform, ‘Hearing on the Causes and Effects of the Lehman Brothers Bankruptcy’, Washington DC, 6 October 2008 (R. Fuld). This choice of metaphor was also deployed by Alan Greenspan to deflect responsibility; see Evidence to House Committee on Oversight and Government Reform, ‘Hearing on the Role of Federal Regulators in the Financial Crisis,’ Washington DC 23 October 2008 (A. Greenspan). Many of the British bankers involved in the crisis, past and present, appeared before the Treasury Select Committee. The former CEO of HBOS, Andy Hornby, accepted that the bonus culture played a part in exacerbating systemic risk; see Evidence to ‘Hearing on Banking Crisis,’ Treasury Select Committee, Westminster, 10 February 2009 (A. Hornby). For specific compliance failure within HBOS, see explosive memo from its former head of compliance, P. Moore, ‘Memo to Treasury Select Committee’, Westminster, 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’).

¹⁵ Newspaper profiles were also used to again deflect responsibility, see E. Dash and J. Creswell, ‘Citigroup Saw No Red Flags Even As It Made Bolder Bets,’ *New York Times*, 23 November 2008, A1 (quoting an April 2008 interview in which Rubin argued “In hindsight, there are a lot of things we’d do differently. But in the context of the facts as I knew them and my role, I’m inclined to think probably not.”) This reprised an argument made in his autobiography on the financial reporting scandals at the turn of the millennium; see R. Rubin, *In An Uncertain World* (2003) 337 (‘The great bull market masked many sins, or created powerful incentives not to dwell on problems when all seemed to be going well—a natural

failure to put in place and monitor – on an ongoing basis – ‘the proper mechanisms for the transmission of institutional memory’.¹⁶ This can be traced to the ideational terms of reference and social norms that underpinned the operation of financial capitalism.¹⁷ It is this component, which privileged the individual over the social, the pursuit of profit over obligation that formed the most interesting aspect of Kevin Rudd’s attack on the neo-liberal agenda.¹⁸ These were indeed essential contributing factors to the creation and maintenance of the latest manifestation of irrational exuberance.¹⁹

In the search for responsibility and for solutions it is essential that self-reflection extend to the academy, which failed to internalise (or, more accurately, ignored) insights from classical economics on how markets can be (and often are) corrupted by a lack of restraint. Adam Smith’s disdain of the joint-stock corporation is (almost but not quite) as well known as his fleeting and largely flippant reference to the invisible hand metaphor. Indeed the need for governmental intervention to engineer aspiration over mere duty informs his more philosophical writing, particularly the *Theory of Moral*

human inclination’: 337); for internal conflicts within the Clinton administration over the regulation of financial markets, see J. Stiglitz, *The Roaring Nineties* (2003) 159–62.

¹⁶ A. Montefiore, ‘Integrity: A Philosopher’s Introduction’ in A. Montefiore and David Vines (eds.) *Integrity in the Public and Private Domains* 1999), 10; see also P. Dobel, ‘Public Trusteeship: The Responsibilities of Transparency and Legacy’ in J. O’Brien, *Governing the Corporation* (2005) 317.

¹⁷ Financialization is a distinct model of capitalism. See E. Connors, ‘Future Fund Chief Sees Day Of Reckoning for Banks’, (2008) *Australian Financial Review*, 14 January 2009, 1, 38 (quoting David Murray, head of the Australian Future Fund, ‘Everybody got carried away by the concept of a “millionaires factory” which was not culturally good. Where you don’t want your brightest, or at least too many of them, is in jobs which spend time interpreting or arbitrating rules. This is not really effective work and a lot of investment banking is that type of deal structuring, which is not very constructive. It produces over-engineered stuff that is the first to break when anything goes wrong’.). For broader discussion of the issues raised, see G. Epstein, *Financialization and the World Economy* (2005); for stinging critique, see M Lewis and J. Farnsworth, ‘Financialization and the Ethical Moment: Levinas and the Encounter with Business Practice’ (2007) 2 *Society and Business Review* 179. See more generally, I. Erturk, J. Foud, S. Johal, A. Leaver and K. Williams, *Financialization at Work: Key Texts and Commentaries* (2008).

¹⁸ As the former leader of the Soviet Union, Mikhail Gorbachev has caustically noted, “if all the proposed solutions and action now come down to a mere rebranding of the old system, we are bound to see another, perhaps even greater upheaval down the road. The current model does not need adjusting; it needs replacing,” see M. Gorbachev, ‘It’s Time for a Second American Revolution in the Spirit of Perestroika,’ *Sydney Morning Herald*, 10 June 2009, 15 (‘In the West, the break-up of the Soviet Union was viewed as a total victory that proved that the West did not need to change. Western leaders were convinced that they were at the helm of the right system and of a well-functioning, almost perfect economic model. Scholars opined that history had ended. The dogma of free markets, deregulation and balanced budgets at any cost was force-fed to the rest of the world. But then came the economic crisis of 2008 and 2009, and it became clear that the new Western model was an illusion that benefited chiefly the very rich’: at 15).

¹⁹ For original formulation, see A. Greenspan, ‘The Challenge of Central Banking in a Democratic Society’ (Speech delivered at American Enterprise Institute Dinner, Washington DC, 5 December 1996). Greenspan asked rhetorically, ‘How do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?’ The remarks provided the title for a seminal analysis into the dynamics of speculative bubbles, see Robert Shiller, *Irrational Exuberance* (2000). Shiller, along with a Nobel prize winning economist at University of California at Berkeley have applied similar reasoning to the global financial crisis, see R Shiller and G. Akerloff, *Animal Spirits* (2009). (‘The crisis was caused precisely by our changing confidence, temptations, envy, resentment, and illusions—and especially by changing stories about the nature of the economy’: at 4).

Sentiments (1759).²⁰ The rise of the corporation magnified the need for impartial adjudication. As Edward Mason noted as early as 1958, the corporation had a profound impact on the ‘carefully reasoned’ laissez-faire defence that ‘the economic behaviour promoted and constrained by the institutions of a free market system is, in the main, in the public interest’.²¹ For Mason, as with Smith before him, this rested on foundations that depended largely on the general acceptance of a reasoned justification of the system on moral as well as on political and economic grounds’.²² The emergence of major corporations, immune from meaningful controls, along with its ‘apologetics’ within the management literature ‘appears devastatingly to undermine the intellectual presuppositions of this system’ without offering “an equally satisfying ideology for twentieth century consumption’.²³ As such, ‘the entrepreneur of classical economics has given way to something quite different, and along with him disappears a substantial element in the traditional capitalist apologetic’.²⁴

Despite Mason’s misgivings, the economic conception of the corporation as a ‘nexus of contracts’ extended well beyond the boundaries of the economics tradition.²⁵ Easterbrook and Fischel, for example, maintain that wider social issues are and should remain outside the purview of the market, citing approvingly Adam Smith in defence of the proposition that ‘the extended conflict among selfish people produces prices that allocate resources to their most valuable uses.’²⁶ In this context, the role of corporate law is solely ‘to establish rights among participants in the venture.’²⁷ For Easterbrook and Fischel, the key normative advantage is that it ‘removes from the field of interesting questions one that has plagued many writers: what is the goal of the corporation. Is it profit (and for whom). Social welfare more broadly defined? Is there anything wrong with corporate charity? Should corporations try to maximise profit over the long run or that short run. Our response

²⁰ See L. Fuller, *The Morality of Law* (1964) 5-9.

²¹ E. Mason, ‘The Apologetics of Managerialism’ (1958) 31 *Journal of Business* 1 at 5.

²² *Ibid.*, 5.

²³ Mason, above n 21, 6. 9.

²⁴ *Ibid.*, 10.

²⁵ F Easterbrook and D Fischel, ‘The Corporate Contract’ (1989) 89 *Columbia Law Review* 1416

²⁶ *Ibid.*, 1422.

²⁷ *Ibid.*, 1428 (The authors note, however, circumstances where the corporate contract can be trumped. As they state, ‘the argument that contracts are optimal applies only if the contracting parties bear the full costs of their decisions and reap all of the gains. It applies only if contracts are enforced after they have been reached. The argument also depends on the availability of the full set of possible contracts. If some types of agreements are foreclosed, the ones actually reached may not be optimal’: at 1436).

to such questions is: “Who cares?”²⁸ The contractual promise of a specific corporation is, according to Easterbrook and Fischel a binding one that ensures certainty. As such it maximises welfare more effectively than ‘derogation from some ethereal ideal of corporate governance.’²⁹ To be effective, however, the model requires adherence to the conception of the corporation as a private actor. In many ways, the construct reached its apogee with the publication in 2001 of Hansmann and Kraakman’s landmark essay, ‘The End of History for Corporate Law.’³⁰ The normative claim of ‘the end of history’ thesis was always exceptionally vulnerable to contestation, not least because of its circular reasoning.³¹ Furthermore, the foundational assumption of maximizing individual utility cuts against the plurality approach to governance that is embedded in stakeholder and stewardship conceptions of corporate purpose. The credit crisis has now fundamentally falsified its normative assumptions.

Alan Greenspan’s admission that he was ‘partially’ wrong in his deference to the capacity of the market to exercise necessary restraint marks an important but insufficient step forward. Greenspan cautioned lawmakers not to rely on a command and control approach: ‘Whatever regulatory changes are made, they will pale in comparison to the change already evident in today’s markets. Those markets for an indefinite future will be far more restrained than would any currently contemplated new regulatory regime.’³² Extensive retrenchments across the sector will lengthen the restraining order. This is particularly important in New York, where one study suggests as many as 78,000 jobs could be lost.³³ While the securities industry (5% of total employment and 25% of earnings) has borne the public brunt of announced and planned job losses, the collapse of confidence has a wider spill-

²⁸ Ibid, 1446.

²⁹ Ibid, 1446.

³⁰ H. Hansmann and R. Kraakman, ‘The End of History for Corporate Law’ (2001) 89 *Georgetown Law Review* 439.

³¹ See K Greenfield, ‘September 11th and the End of History for Corporate Law’ (2001) 76 *Tulane Law Review* 1409 at 1426; see also Gorbachev, above n 17.

³² Evidence to House Committee on Oversight and Government Reform, Washington DC, 23 October 2008 (A. Greenspan). For discussion of blame, see J. Reed, ‘Crisis has Resulted from Honest Misjudgments by Finance Sector’ (Letter to Editor), *Financial Times*, 21 October 2008, 14; D. McDonald, ‘Crisis Caused By Negligence and Incredible Stupidity’ (Letter to Editor), *Financial Times*, 24 October 2008, 10.

³³ J. Bram, J. Orr, and R. Rosen, *Employment in the New York-New Jersey Region: 2008 Review and Outlook* (Federal Reserve Bank of New York, 22 October 2008) 5.

over effect on professional and business services, including legal and accounting corporate advisory, as well as advertising.³⁴ A similar reality is dawning in London.³⁵

The remaining challenge for a now weakened financial sector and for society is to build corporate governance and capital market regulation in ways that emphasize duties and responsibilities as well as corporate rights. It necessitates resolving the existential conflict ‘between a public law, regulatory conception of corporate law on the one hand, and a private law, internal perspective on the other’; between ‘a body of law concerned solely with the techniques of shareholder wealth maximization [and] a body of law that embraces and seeks to promote a richer array of social and political values.’³⁶ This conflict has been nicely put by President Obama: ‘There’s always been a tension between those who place their faith in the invisible hand of the marketplace and those who place more trust in the guiding hand of the government — and that tension isn’t a bad thing. It gives rise to healthy debates and creates a dynamism that makes it possible for us to adapt and grow. For we know that markets are not an unalloyed force for either good or for ill. In many ways, our financial system reflects us. In the aggregate of countless independent decisions, we see the potential for creativity — and the potential for abuse. We see the capacity for innovations that make our economy stronger — and for innovations that exploit our economy’s weaknesses. We are called upon to put in place those reforms that allow our best qualities to flourish — while keeping those worst traits in check. We’re called upon to recognize that the free market is the most powerful generative force for our prosperity — but it is not a free license to ignore the consequences of our actions.’³⁷ This leaves unanswered the question of how to design mechanisms that allow for a more precise calibration of ethical content. This redesign requires combining the technical with the normative, both in our investigation of the causes of the crisis and in our evaluation of policy responses. The zeitgeist has moved decisively from governing to governance, from governance to accountability and from accountability to integrity. If the concept is to have meaning beyond rhetoric, it is essential to parse its

³⁴ Ibid, 4 (The report further notes ‘each securities job is estimated to generate 2.3 other jobs by spurring demand for business and professional services...and real estate as well as other services such as hotels and restaurants’: 5). For extension to legal community, see A. Feuer, ‘A Study in Why Major Law Firms Are Shrinking,’ *New York Times*, 7 June 2009, MB1.

³⁵ A. McDonald and C. Bryan-Low, ‘Turmoil Batters London’s Status as Financial Center,’ *Wall Street Journal*, 22 October 2008, A1.

³⁶ D Millon, ‘Theories of the Corporation’ (1990) *Duke Law Journal* 201 at 201-202.

³⁷ Remarks on Financial Regulatory Reform (White House, Washington DC, 17 June 2009).

multifaceted dimensions from an applied ethics perspective. We turn now to how this can be rendered operational.

3. *The Challenge and Opportunity of Integrity*

Policymakers and practitioners across the world have acknowledged that there is a pressing need for the development of a regulatory and corporate architecture based on principles of integrity.³⁸ What remains unclear is what this nebulous concept means in practice and how to rank competing, potentially incommensurable interpretations of what constitutes appropriate behaviour. Can one say, for example, that acting within the confines of the law evidences integrity? This cannot be a satisfactory answer given the ethical void experienced in both fascist and totalitarian societies, each governed by legal (if morally repugnant) frameworks.³⁹ The scale of ethical failure witnessed in the global financial crisis demonstrates the inherent limitations of black-letter law as a sufficient bulwark even within the liberal democratic state. It is equally unsatisfactory to claim that one evidences integrity if one acts consistently. Consistently engaging in deceptive misleading practice may demonstrate ‘wholeness’ or ‘completeness’ but it cannot be a constituent of integrity. Integrity therefore requires of us not only duty (i.e. compliance with the law; consistent and coherent actions) but also principles that contribute to (and do not erode) social welfare (treating people, suppliers and stakeholders with fairness and respect). Seen in this context, enhancing integrity through higher standards of business ethics is a question of organizational design. The aim, in short, is to give substance to what constitutes – or should constitute – appropriate principles of aspiration for the professions.

Business ethics research tends to calcify around one of four main theoretical approaches: deontological, consequential or utilitarian, virtue-ethics and contextual ethics. The deontological

³⁸ Integrity has also long been recognised as an important intangible asset or liability in strategic management studies, see M Kaptein and J. Wempe, *The Balanced Company: A Theory of Corporate Integrity* (2002) 145-152 (noting that organizational structure and culture generate in a reflexive manner the execution of specific corporate practices).

³⁹ This is the classic focus on a legendary debate in contemporary legal philosophy of what constitutes law. The positivist approach suggest law is merely what is in statute book, a historical record made by properly constituted legislatures, see for example, H.L.A. Hart, *The Concept of Law* (1961). Others have argued that properly constituted law cannot be vouchsafed unless underpinned by an explicit moral component; see Fuller, above n 20. A third approach, suggests that propositions of law are true if they figure in or follow from principles of justice, fairness, and procedural due process that provide the best constructive interpretation of agreed legal practice, see R. Dworkin, *Law's Empire* (1986).

approach derives from Immanuel Kant's categorical imperative, namely 'act only according to that maxim whereby you can at the same time will that it should become a universal law.'⁴⁰ Reliance on short-term profiteering that if universalised (and condoned by regulatory and political authorities) destroys the credibility of the market is ultimately self-defeating. In deontological terms the crisis displays systemic unethical tendencies. Moreover, deceptive or misleading conduct debases moral capacities (indeed it may well also be illegal if the action can be demonstrated to contravene trade practices legislation). The third categorical imperative is to ensure that corporate actions have societal beneficence. In Kantian terms this can only be vouchsafed if the organization acts and is seen to act within defined ethical parameters. Even if one views the global financial crisis from the less demanding utilitarian perspective, the consequential impact - unintended, to be sure - makes both the activity itself and the underpinning regulatory framework equally ethically suspect. Here it is essential to differentiate between the product and the inappropriate uses to which it was put to work. There is nothing unethical about securitisation per se. However, from an ethical perspective it is a deficient defence for chief executive officers to claim ignorance of either how these products were structured or how unstable the expansion of alchemistic engineering had made individual banks or the system as a whole.⁴¹ It is now recognized, for example, that the originate-distribute-relocate model of financial engineering significantly emaciated corporate responsibility precisely because it distanced institutional actors at every stage of the process from the consequences of their actions. Likewise, given the huge social and economic cost, it is deficient for policymakers to profess shock at the irresponsibility of banks, insurance companies and the rating agencies. The failure to calculate the risks and design or recalibrate restraining mechanisms at the corporate, regulatory and political levels grossly exacerbated the externalities now borne by wider society.

The third major approach to evaluate the ethical dimension of corporate activity is, perhaps more demanding. It is also more fruitful in terms of refashioning corporate and regulatory action. The focus of virtue-based analysis is not on formal rules (which can be transacted around) or principles

⁴⁰ I. Kant, *Grounding for the Metaphysics of Morals* (1785), 30.

⁴¹ Indeed, in the United States it is illegal under s.404 of Sarbanes-Oxley. In other jurisdictions, such as Australia, it amounts to misleading, deceptive and unconscionable conduct and can be prosecuted under Trade Practices Act and the Corporations Act.

(that lack the definitional clarity to be enforceable). Rather, it focuses on how these rules and principles are interpreted in specific corporate, professional or regulatory practice. This ultimately, is a question of individual and collective character, or integrity. In a narrowly defined context, it could be argued that the corporate form itself is inimical to virtue. There is prescience to Alasdair MacIntyre's argument that the 'elevation of the values of the market to a central social place' risks creating the circumstances in which 'the concept of the virtues might suffer at first attrition and then perhaps something near total effacement'⁴² This builds on earlier insight that suggested that 'effectiveness in organizations is often both the product and the producer of an intense focus on a narrow range of specialized tasks which has as its counterpart blindness to other aspects of one's activity'.⁴³ 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'.⁴⁴ For MacIntyre, the combination of compartmentalization and focus on external goods, such as profit maximization, corrode capacity for the developments of internal goods, which should be developed irrespective of the consequences.

While the policy response to scandal has traditionally been to emphasize personal character, much less attention has been placed on how corporate, professional, regulatory and political cultures inform, enhance or restrain particular character traits.⁴⁵ It is incumbent upon regulatory authorities (formal and informal) to identify and break down the compartmentalization imperatives at corporate and professional levels and integrate the form and purpose of business ethics into a wider social contract. It is in this context that the fourth key dimension of business ethics theory comes into play:

⁴² A. MacIntyre, *After Virtue* (1984), 254, 196; see also J. Schumpeter, *Capitalism, Socialism and Democracy* (1943), 137 (arguing that the stock market is a poor substitute for the Holy Grail).

⁴³ A. MacIntyre, 'Why Are the Problems of Business Ethics Insoluble', in B. Baumrin & B. Friedman (eds.), *Moral Responsibility and the Professions* (1982), 358.

⁴⁴ A. MacIntyre, 'Social Structures and their Threats to Moral Agency' (1999) 74 *Philosophy*, (74) 311 at 322; see also, however, J. Dobson, 'Alasdair MacIntyre's Aristotelian Business Ethics: A Critique' (2009) 89 *Journal of Business Ethics* 43. For application of the need to avoid compartmentalisation from a practicing law perspective, see Sandra Day O'Connor, Commencement Address, Georgetown Law Center, May 1986 ('[l]awyers must do more than know the law and the art of practicing it. They need as well to develop a consciousness of their moral and social responsibilities... Merely learning and studying the Code of Professional Responsibility is insufficient to satisfy ethical duties as a lawyer.'). See also A. Kronman, *The Lost Lawyer: Failing Ideals of the Legal Profession* (1995) 16 (lamenting a lost-deal in which reputation was defined by who the person was as such as technical mastery).

⁴⁵ For exceptions, see R. Sennett, *The Culture of the New Capitalism* (2006) and R. Sennett, *The Corrosion of Character* (1998).

the contextual framework. What is required, therefore, is a synthesis between an appreciation of context, the need for virtuous behaviour, the importance of deontological rules and consequential principles of best practice within an overarching framework that that is not subverted by compartmentalized responsibilities.⁴⁶ The problem, therefore, is not the relative importance of virtue but whether it can be rendered operational in a systematic, dynamic and responsive way, with specific benefits to business.⁴⁷ Accountability is, therefore, as noted above, a design question at both corporate and regulatory levels, which to be effective needs to be mutually reinforcing and address dynamically the calculative, social and normative reasons for behaving in a more (or less) ethically responsible manner.⁴⁸

It is axiomatic that when a complex trading model disintegrates, the clarion calls for action inevitably target the regulator. The scale of the credit crisis requires us to transcend an increasingly sterile debate over whether it is preferable to privilege rules over principles. Rules need to work ‘hand in glove’ with principles within an interlocking system of incentives and disincentives. In some areas, compliance with rules might be more important than alignment with principles. On the other hand, for some problems in other areas, for example potential conflicts of interest, the emphasis might need to be on principles in the context of verifiable procedural requirements, such as an internal but independent mechanism for determination of any conflict of interest. In still other areas, such as disclosure requirements, principles and rules might both need to be met. More generally, principles may require ongoing testing to ensure consistency and coherence in terms of application. How to ensure that rules and principles mutually reinforce one another – rather than compete with one another – is central to regulatory effectiveness. It has long been recognised that strong moral and ethical codes

⁴⁶ One suggested approach derives from an integrative social contracts theory approach, which set out corporate and reciprocal arrangements and expectations. Micro social contract norms must be compatible with hyper norms (i.e. norms sufficiently fundamental that they can serve as a guide for evaluating authentic but less fundamental norms), see T Donaldson and T. Dunfee, *Ties that Bind: a Social Contracts Approach to Business Ethics* (1999).

⁴⁷ For application to business as an intangible asset, see J. Petrick and J. Quinn, ‘The Challenge of Leadership Accountability for Integrity Capacity as a Strategic Asset’ (2001) 34 *Journal of Business Ethics* 331; for original formulation of the model, see J. Petrick and J. Quinn, ‘The Integrity Capacity Construct and Moral Progress in Business’ (2000) 23 *Journal of Business Ethics* 3.

⁴⁸ S. Winter and P. May, ‘Motivation for Compliance with Environmental Regulations’ (2001) 20 *Journal of Policy Analysis and Management* 675; see more generally I. Ayres and J. Braithwaite, *Responsive Regulation* (1992); for study suggesting the power of outsiders to frame the emphasis on effective internal controls only if there is a perception within the company that performance is being monitored, see C. Parker and V. Nielsen, ‘To What Extent Do Third Parties Influence business Behaviour’ (2008) 35 *Journal of Law and Society* 309 (reporting survey evidence from 999 large Australian companies).

are required to ensure economic viability.⁴⁹ Moreover, the falsification of the efficient market hypothesis has been accompanied by a belated acceptance that pursuit of (deluded) self-interest is not only corrosive but when taken to its logical conclusion diminishes accountability.⁵⁰ The search for sustainable reform necessitates examining what factors contribute to the reinforcement or degradation of social norms.⁵¹ Unless this dimension is addressed it is highly unlikely that sustainable behavioural change can be expected. The unresolved question is what form those national standards should take and how to enforce compliance with rules and – more importantly – enhance the ambition of aspiration. Here evidence from Australia provides room for cautious hope.

Its business conduct regulator, the Australian Securities and Investments Commission, has completed a strategic review of its operations. Five key priorities have been identified: (1) a focus on outcomes; (2) the development of initiatives to help retail investors manage and protect wealth; (3) the introduction of new investigative techniques to reduce systemic problems; (4) the reduction of red-tape in administration; and (5) an emphasis on facilitating inward and outward investment by differentiating the Australian marketplace from its competitors by an emphasis on business integrity. The objective is to provide clarity over regulatory objectives and the mechanisms used to achieve them. The strategic review may well reconstitute the form and substance of capital market regulation in Australia. Its success, however, will depend on ASIC's ability to cause market participants to embrace the reform agenda including, crucially, its conception of business integrity. What is clear, however, is that ASIC's strategic shift taps into the intellectual shift identified by the US Treasury blueprint.

⁴⁹ D. North, *Structure and Change in Economic History* (1981), 47 (suggesting that they are the 'cement of social stability').

⁵⁰ Behavioural economics must play a critical role in adjudicating how incentives and preferences are arrived at. Psychological factors such as confidence, perception of fairness, toleration of or condemnation of corrupt and anti-social behaviour, money illusion tempered by narratives influence market actors in profound, if imperfectly understood manners, see Shiller and Akerloff, above n 19, 5-6. Other disciplines too have significant roles to play: law, through its primary but not exclusive focus on rules; political science for its emphasis on the dynamics of power; ethnography for its detailed examination of cultural rituals; philosophy for its focus on ethics and management for its focus on organizational design and accounting research for its focus on transparency and disclosure. This list is far from exhaustive. It demonstrates, however, that the search for more effective and more accountable governance necessitates parsing the dynamic interaction of what constitutes rational behaviour within and between each dimension.

⁵¹ See L. Stout, 'Social Norms and Other-Regarding Preferences' in J. Drobak (ed.), *Norms and the Law* (2006) 13 (reviewing results from social dilemma, ultimatum games and dictator games and postulating 'taken as a whole, the evidence strongly supports the following proposition: *whether or not people behave in an other-regarding fashion is determined largely by social context tempered-but only tempered by considerations of personal cost* [emphasis in original]': at 22).

ASIC has been particularly vulnerable following three high profile property collapses – Fincorp, Westpoint and Australian Capital Reserve. In each case, investors were provided with a debenture (or promissory note), periodic but higher interest repayments than offered by the mainstream banking sector and a return on initial capital at the end of the term. ASIC has attempted to introduce an integrity dimension with a discussion paper on the market for unrated unlisted investment vehicles. The market in unrated, unlisted bonds accounts for AUS\$8 billion and involves 92 vehicles. ASIC has been careful to note that risk-levels vary considerably within this grouping. Its decision to publish the full list of providers in a consultation paper adds significantly to the demonstration power of reputation.⁵² Inevitably, benchmarking performance requires the sector to begin differentiating according to risk profile. As the investment vehicles seek to retain or grow market share, they are much more likely to provide the enhanced disclosure – benchmarked articulation of risk-benefit across credit rating, equity capital, liquidity, lending principles, portfolio diversification, valuation of stock, related party transactions and rollovers and early redemption possibilities and penalties; disclosure of relative ranking, which if not complied with should be justified; external gatekeepers such as trustees, advisors and auditors should explicitly take disclosure into account when issuing valuations.

There is a risk that enhanced levels of disclosure can obfuscate as well as illuminate, making the sector potentially more resistant to transparency. To counter this possibility, ASIC has suggested that attention must also be placed on and accountability demanded from those providing corporate advisory services and the creation and dissemination of technically legal but misleading advertising. These include not just trustees and auditors but also copywriters, production teams, publishers and broadcasters who sell the print, audio-visual and online space. On one reading this could be construed as a further example of regulatory creep. On the other, it is recognition that the regulator lacks the resources to resolve the problem on its own. Rather, it requires professional groups to acknowledge their own responsibility and be accountable for their actions, meaning in this narrow sense

⁵² ASIC, 'Unlisted Unrated Debentures – Improving Disclosure for Retail Investors' (CP89, Sydney 23 August 2007); see also ASIC, 'Debenture Advertising' (CP94, Sydney, 31 October 2007). The result was the introduction of two new regulatory guides (RG 69 on disclosure requirements and RG 156 on advertising standards), both of which are available on ASIC's website.

acquiescing to external scrutiny of what codes of conduct mean in practice. None of this is going to be of any use to those bewitched by the potential returns. While investment guides can and should be simplified by their very nature these products are exceptionally complex. Investor education programs are to be encouraged, particularly when couched in terms that highlight the investors' own personal responsibility. Behavioral change, however, needs to be inculcated at a higher level within the product market and it is for this reason alone that the processes advanced by ASIC should be warmly welcomed and endorsed. Although the unlisted debenture market is relatively insignificant in monetary terms, the reputational damage associated with public perception of sharp-practice is enormous. Harnessing this power has enormous benefits, particularly as one seeks to address broader questions of market integrity.

Regulators and those providing intermediating services are repeat players, whose interests are substantially harmed by those who defect from market convention. While the introduction of advanced training and investigative techniques are to be welcomed, in the absence of a catastrophic failure, it is unrealistic to expect a regulator to understand the dynamics and, therefore, design the optimal form of compliance for any given organization. Even in such a case, it is arguable that the measures introduced may fail to deal with the substantive underlying problem. This partly accounts for the controversy over the role and function of enforceable undertakings and other innovative mechanisms to embed compliance, such as pre-trial diversion in the United States. This is not to suggest that the corporate probation that the enforceable undertaking permits is indefensible on legal, ethical or public policy grounds. Rather, it is to argue that efficacy is likely to be improved as a result of an agonistic dialogue and that this is unlikely to occur in circumstances in which the regulator imposes solutions. It is, therefore, necessary that the design and implementation of enforceable undertakings is the product of cross-cutting agency taskforces, which are, in turn, advised by high-level working groups. This requires a much more sustained dialogue than has been evidenced to date in Australia. This does not mean ceding regulatory authority. Rather it means that the agency establishes mechanisms that build informal trust networks. This not only enhances the quality of market intelligence, it also reinforces the restraining power of articulated norms. By adopting a less intrusive approach to the construction of organizational frameworks – in return for access to the

organizational blueprints, as required for wider demonstration effect – the regulator also fulfills a statutory objective to reduce regulatory burden without necessarily sacrificing effectiveness.

Identifying and repositioning the precise intersection between law and ethics requires, therefore, the design and implementation of an integrated set of nuanced strategies. To be effective, the set must align the interests of institutional actors to overarching regulatory ‘mission’ or ‘purpose’. In this regard, the motivational rationale of specific actors is irrelevant. By building on a foundation of common *stated* values, an agonistic understanding of what constitutes the problematic core is generated, from which deviation lowers reputational standing and access. This framework can only be sustained through an interlocking dissemination network comprising and reinforcing formal and informal nodes. The resulting synthesis has three key practical and normative advantages. First, it reduces real and artificial incommensurability problems between participants in the regulatory conversation (irrespective of whether or not they have been accorded formal surveillance authority). Second, it reduces the retreat to legal formalism, deescalates confrontation and contributes to behavioral modification across the regulatory matrix. Third, by clarifying accountability responsibilities it offers greater certainty for corporations and the market in which they are nested, thus facilitating investment flows. It provides a more meaningful baseline from which to measure and evaluate subsequent regulatory performance. As with the social and political systems in which they are nested, financial centers depend on integrity. Disclosure, transparency and accountability mean little if the polity understands these in formal mechanistic fashion.

4. The Trajectory of Reform

The United States had already begun the process of overhauling its dysfunctional regulatory system before the inauguration of President Obama promised change we can believe in. The process is likely to generate turf wars in Washington for some time to come (and, in the process, be much more evolutionary than revolutionary, characterized by piecemeal advances and setbacks rather than linear

progression). The need for reform was highlighted well before the crisis reached such catastrophic levels, most notably in a blueprint for reform offered by the then Treasury Secretary, Hank Paulson.⁵³ The Treasury Blueprint suggested a conceptual redesign, replacing a diffuse functional with an objectives-based regulatory approach, covering what were termed Federal Financial Services Providers. The redesign addresses the designated goals of regulation – market stability; prudential financial regulation; and business conduct. It thereby endorses replicating the model of oversight currently used in Australia and the Netherlands. According to the Treasury Blueprint, the business conduct dimension would focus on ‘providing appropriate standards for firms to be able to enter the financial services industry and sell their products and services to customers... The establishment of a FFSP charter would result in the creation of appropriate national standards, in terms of financial capacity, expertise, and other requirements, that must be satisfied to enter the business of providing financial services.’⁵⁴ In the event, the Obama administration did not grasp the nettle of simplifying the regulatory structure, preferring to encourage coordination between functionally disparate regulatory agencies.⁵⁵ As with the original Treasury blueprint it has significantly enhanced the authority of the Federal Reserve to supervise all firms that could pose a threat to financial stability. Mirroring European proposals, the Treasury has recommended the establishment of a Financial Services Oversight Council, which is charged with identifying emerging systemic risks and improving interagency cooperation. It has recommended the creation of a new Consumer Financial Protection Agency with a wide-ranging remit to remit to ‘reduce gaps in federal supervision and enforcement; improve coordination with the state; set higher standards for financial intermediaries; and promote consistent regulation of similar products.’⁵⁶ Investor protection is to be enhanced by providing the Securities and Exchange Commission with authority to impose on broker-dealers an explicit fiduciary duty to their clients when dispensing investment advice and to ban compensation models that are tied

⁵³ H. Paulson, R. Steel and D. Nason, *The Department of Treasury Blueprint for a Modernized Financial Regulatory Structure* (2008). The document derives from a conference convened in March 2007 and builds on an agenda shaped by the work of the Committee on Capital Markets, a self-appointed commission co-chaired by John Thornton, a former Goldman Sachs executive and Glenn Hubbard, a former chairman of the Council of Economic Advisors and Dean of Columbia University Business School.

⁵⁴ Paulson, Steel and Mason, above n 33, 19.

⁵⁵ See Department of Treasury, *Financial Regulatory Reform: A New Foundation* (2009).

⁵⁶ *Ibid.*, 6-7. The blueprint recommendation is explicit that rules set by the agency should be ‘a floor not a ceiling’ and gives states the authority to impose stricter standards: at 13.

to putting ‘investors into products that are profitable to the intermediary, but are not in the investors’ best interest.’⁵⁷ More controversially, the SEC is authorized to establish a fund to ‘pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards.’⁵⁸

Innovation, renewal and stagnation conflict and conflate. This is most apparent in the thorny issue of how to wean the banking sector off its addiction to irresponsible and unsustainable lending and trading practices. Treatment options were clarified with the release on 7 May 2009 of stress tests conducted by the Federal Reserve in conjunction with the Department of Treasury into 19 of the most important banks. Not surprisingly, given the extensive media management that preceded publication, prognosis was favorable. As widely reported, the Charlotte-based Bank of America is the most exposed. The bank is required to enhance capital reserves by \$34 billion. Citigroup, by contrast, one of the weakest major banks, requires only \$5.5 billion. The former investment banks, Morgan Stanley and Goldman Sachs, have fared much better. Morgan Stanley has been cautioned to raise just \$1.5 billion. Goldman is regarded as adequately capitalized as is JP Morgan Chase, which has managed the integration of Bear Stearns much more successfully than the hapless management at Bank of America, where empire building led to the disastrous acquisition of Merrill Lynch and Countrywide at the peak of the crisis. Remarkably, this exercise in regulatory oversight did not identify the need to change senior management. Indeed, the overall picture presented was of relative strength not weakness. In total only \$75 billion was deemed necessary to insulate the banking sector. For Timothy Geithner, the US Treasury Secretary, investors should now be reassured that all losses were accounted for and that entrenched management was credible. ‘With the clarity today’s announcement will bring, we hope banks are going to get back to the business of lending,’ he said in a news conference. The suggestion overstates the case.

The content and conduct of the tests and the way in which the results were disseminated leave huge questions about the ultimate purpose and who will stand to gain most of all from this exercise in managing expectations. There are a number of profound methodological flaws. The tests used worst-case scenario baselines that have already been proved optimistic. More problematically, the banks

⁵⁷ Ibid, 69-70.

⁵⁸ Ibid, 70.

were able to negotiate privately with the Government over how the latter interpreted the results. None of this gives confidence in the veracity of claims that the banking sector, as a whole, is adequately capitalized or would remain so if explicit and implicit guarantees were removed. What is clear, however, is that a process of differentiation has begun, which is likely to intensify in coming months. The perceived stronger banks are extricating themselves from congressionally imposed remuneration caps and trading restrictions. JP Morgan Chase and Goldman Sachs have already sought to repay mandatory loans advanced under the Troubled Asset Relief Program (TARP). Weaker banks will now have to raise new sources of capital from markets in which the true state of individual bank counterparty risk remains hideously opaque. The total recapitalization of \$75 billion may persuade some investors to plunge back into the financial sector. Already there is evidence that this is working with successful capital raising conducted by some of the leading banks. Moreover, the vote of confidence spurred a short-term rally in financial stocks around the world that was particularly pronounced in the United States. There are a number of reasons for caution. Weaker entities face unpalatable options. They can off-load prize assets at bargain-basement prices or convert government stakes, which take the form of preferred stock, into common equity. This raises a profoundly difficult policy option that the Treasury is, for now, evading.

Preferred stock provides the Government with the privileges of repayment over holders of common equity. It also attracts a guaranteed interest premium and a lower risk profile. Common equity, on the other hand, forces the Government to articulate a vision of how it will exercise its ownership rights and for what purpose. For the moment, economic policymakers appear to favor creative ambiguity. This involves the creation of the Mandatory Convertible Preferred Share. The MCPS is designed for conversion into common equity only when required. Crucially, it does not dilute further existing shareholders. It also delay the need for an articulation of what kind of banking sector the federal government would like to see established. This has clear short-term benefits. First, it staves off the immediate need for partial or total nationalization, a policy option that is anathema to leading economic advisors, including Timothy Geithner himself. Second, it quells, partially, investor fear of expropriation just as the Government suggested a pragmatic revoking of decades of precedent in bankruptcy law. Its controversial support for the Chrysler re-organization sees the UAW trades

union retirement fund privileged over bondholders, who were pressured to accept a payment of just 30 cents in the dollar. Crucially the plan gained the support of major banks. Many had a vested interest in not being seen to contradict the government. It was not a good idea to alienate the body that is to decide your viability just days before adjudication. Bondholders outside this US version of a tarnished golden circle rejected the deal on the grounds that liquidation would generate a fairer outcome. President Obama dismissed their understandable concerns as the greed of speculators who failed to put America first. The Obama administration is playing a very dangerous game here. Any suggestion that the banks acted under duress or colluded in the Chrysler deal for political not corporate motives raises the potential for class actions. Creative ambiguity may well be an effective short-term strategy. Unless a practical, ethical framework underpins the entire enterprise the opportunity to transform in a fundamental manner the operation of the capital markets will be lost. While much has been made of plans to regulate the over the counter derivatives market and impose more stringent caps on executive pay, neither initiative offers fundamental change. The first will provide more transparency but does not necessarily deliver on more effective risk management. The value of the second is undermined by the fact that major banks are outside the purview of governance reform, making for a piecemeal approach that does not deliver meaningful change. Moreover, the focus on executive remuneration, while laudable, derives from imperatives imposed by Congress rather than the White House, which had initially argued that such policies were too invasive.

5. Conclusion

Securitization was and remains perfectly legal. Used in moderation and as part of an integrated investment strategy geared toward the long-term, the mechanism does have value. The problem is not the products but the way in which they were deployed. A marketplace in which ideological considerations trump security may be acceptable to private actors, but when such views are promoted with abandon by the political establishment, on both the left and the right, the social risks are magnified. We are all paying the price for that miscalculation. Suggesting that the marketplace is somehow cleansed and chastened by the experience is naive. There is simply no evidence of the

Pauline conversion that the Obama administration is suggesting has occurred. What makes matters even more problematic is the laxity of the conditions to allow banks to exit Congressional oversight. Securing partial Wall Street approval for industrial policy, which may yet be deemed unacceptable by the bankruptcy courts, could allow the banks to get away with what, in financial and moral terms amounts to the crime of the century. The stage is now set for one of the largest transfers of wealth in US banking history. Those with the highest rating, including Goldman Sachs, Morgan Stanley and JPMorgan Chase are best placed to take advantage. This occurs precisely because differentiation flatters disproportionately. Far from controlling Wall Street, the Government's policy is likely to increase its capacity at precisely the same time as the economic crisis hits Main Street with increasing force. It is therefore essential to return to the drawing board. This paper provides the reasons why.