Corporate market responsibility: ethical regulation for orderly financial markets

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'What I'm saying to you is, yes, I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact'

Alan Greenspan, Chairman of the US Federal Reserve, 2008

Discovering Corporate Market Responsibility

Since the 1980s, we have frequently heard the message 'greed is good', with the rationale that greed drives efficient markets, which in turn drive economic growth.[1] This particular message has in recent years lost its ironic charm. Since the onset of the financial crisis in 2007-2008, it has become more common to hear that greed is 'irresponsible'. The British prime minister told the United Nations in September 2008 that the world had lived through an 'age of irresponsibility' in financial markets (Brown, 2008), and five months later, the American president heralded a 'new era of responsibility', writing:

'This crisis is neither the result of a normal turn of the business cycle nor an accident of history. We arrived at this point as a result of an era of profound irresponsibility that engulfed both private and public institutions from some of our largest companies' executive suites to the seats of power in Washington, D.C. For decades, too many on Wall Street threw caution to the wind, chased profits with blind optimism

[1] A celebrated quote by the character Gordon Gekko in the film Wall Street (1987), see http://www.youtube.com/watch?v=ONXpaBQnBvE

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Appréciée auparavant, la cupidité est depuis la crise financière de 2007 considérée comme un comportement «irresponsable».

En 2009, Barack Obama a déclaré qu'il était temps d'entrer dans une nouvelle ère de responsabilités, source de nouvelles bases de croissance. Le texte qui suit présente une théorie sur les responsabilités des organismes financiers en matière de stabilité économique et financière.

and little regard for serious risks—and with even less regard for the public good ...

The time has come to usher in a new era — a new era of responsibility in which we act not only to save and create new jobs, but also to lay a new foundation of growth upon which we can renew the promise of America' (Obama, 2009, p. 1).

These messages represent a departure from conventional thinking about the economy and the virtues of self-interest, and this paper engages with them.[2] It outlines a theory about companies' responsibilities for financial and economic stability. Three recent controversies suggest that operating efficiently and within the letter of the law does not suffice to ensure economic progress, or satisfy market actors and regulators. These episodes are focus of this paper: Citigroup's infamous Dr Evil trade, the rise to prominence of sovereign wealth funds, and the post-credit-crunch regulatory debate. In each case, corporate responsibilities towards the wider financial system were invoked.

More corporate responsibilities?

How are companies responsible for orderly financial markets? In economic theory the question is redundant, since markets are self-correcting. Stability is an outcome of normal business activity, with support from regulators. Thus, in Milton Friedman's famous words (1970), 'the social responsibility of business is to maximize profits'. Friedman's statement was a response to the concept of corporate social responsibility (CSR), which holds that firms should ensure they have a positive impact on society. But CSR theorists agree with economists regarding the market. The CSR literature distinguishes between a firm's *social* responsibilities (towards the non-market domain) and their *economic* responsibilities. In CSR theory, 'economic responsibility' is to produce goods efficiently and legally, as economists would put it (Carroll, 1979, 1991; Mitchell, 1998; Schwartz & Carroll, 2003; Wartich & Cochran, 1985; Wood, 1991). If our episodes suggest that financial firms are expected to go beyond legal, competitive profit maximization in conducting their business, this represents a departure from conventional thinking.

As a contribution to the post-credit-crunch rethink, this paper analyses these controversies and proposes the concept of corporate market responsibility (CMR) to explain them. Let us begin with Citigroup.

The 'Dr Evil' trade

At 10.28 a.m. on Monday 2 August 2004, four traders at Citigroup's European government bond trading desk activated a proprietary software

[2] I would like to thank Dr Wendy Chapple and Professor Jeremy Moon of the International Centre for Corporate Social Responsibility at the University of Nottingham Business School for their guidance and support during this research.

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Outre leur responsabilité sociale, les entreprises financières doivent s'assurer qu'elles ont une responsabilité économique, qui consiste non seulement à produire des biens de manière efficace et en toute légalité, mais aussi à contribuer au maintien de la stabilité financière.

Il faut analyser les nombreuses controverses, qui concernent la responsabilité sociale des entreprises financières et leurs responsabilités économiques, pour mieux les comprendre. Nous commençons par Citigroup.

program they called 'Dr Evil' to sell a large number of bonds very quickly. Twenty seconds later, unsure whether the trades had succeeded, they submitted another sell order. By 10.29 a.m. Citigroup had sold €13 billion worth of 119 different European government bonds across 11 platforms of the Rome-based *Mercato dei Titoli di Stato* (MTS) bond exchange. This was roughly the same amount of bonds as the entire market would typically trade over one day, and it happened in one minute. After reconfiguring their program, the traders bought back €4 billion in bonds, realizing a profit of €15 million by 11.25 a.m.

Although Citigroup was not charged with market abuse, which is illegal, the operation was highly controversial. At the time, it provoked 'bankers' wrath' (*The Daily Telegraph*, 2004a) and 'launched a wave of ill will in the bond markets' (*The Daily Telegraph*, 2004b). The MTS exchange imposed emergency trading limits on the entire market (*Financial Times*, 2004b). Citigroup's rivals, primarily investment banks, 'panicked' during the trade, overwhelmed by its size and speed, and some withdrew from the market for three days. The financial press reported a near-consensus that Citigroup had broken a 'gentlemen's agreement'. Yet no one clearly stated what that agreement had been or what it was for.

When the UK's Financial Services Authority (FSA) ruled on the transaction in June 2005, it levied a fine of £14 million, its biggest to date. The bank had not contravened any laws, but the FSA held that it had 'executed a trading strategy without due regard to the risks and likely consequences of its action for the efficient and orderly operation of the MTS platform' (Financial Services Authority, 2005b). Was Citigroup responsible for the orderliness of its market?

Gentlemen and the market

The notion of a broken gentlemen's agreement emerged two days after the trade, with the *Financial Times*'s Lex column asking 'Has Citigroup, with its audacious selling of €11bn [sic] of Eurozone government bonds within two minutes, been very clever or has it overstepped the boundaries of fair trading?' (*Financial Times*, 2004a). The column sided with Citigroup, saying that 'gentlemen's agreements are not a sensible way to manage risks' (*ibid.*), but failed to explain what a 'gentlemen's agreement' or the 'boundaries of fair trading' are. *The Wall Street Journal* cited traders calling the operation 'savvy, if not slightly untoward', and referred to MTS having introduced measures to stop 'this kind of behaviour' (*The Wall Street Journal*, 2004b), again without explaining the 'kind' of behaviour or why it was 'untoward'. Rival traders had 'felt themselves protected by a "gentlemen's agreement"', but did not elaborate what it was (*The Daily Telegraph*, 2004c). *The Guardian*'s Notebook column said 'Of course,

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Le 2 août 2004, quatre opérateurs de Citigroup ont activé un logiciel afin de vendre très rapidement un très grand nombre d'obligations: plus de 13 milliards de dollars en quelques minutes. L'opération fut très controversée et a provoqué la colère des banquiers qui ont accuse Citigroup d'avoir brisé un "gentlemen agreement".

La Financial Services Authority britannique a estimé que Citigroup avait exécuté une stratégie de négociation sans tenir compte des risques et des conséquences pour l'ensemble du système financier.

Les différents journaux économiques ont eu beaucoup de mal à statuer sur le dépassement ou pas des limites de la légalité des transactions commerciales effectuées.

Citigroup did nothing illegal here. It legitimately filled orders that had been placed by willing counterparties, all of whom were grown-up financial institutions used to dealing in large numbers' (*The Guardian*, 2004a). None of the US or UK newspapers that referred to 'untoward' conduct specified what standard had supposedly been infringed.

One banker's reaction illustrates the problem: 'Really what they did was smart. They didn't do anything wrong, they just cornered the market. I'll tell you this though, $25m doesn't seem like a lot of profit to make when you've got the whole world lining up against you' (*The Daily Telegraph*, 2004c). If Citigroup had been smart and done nothing wrong, then what justified the world lining up against them?

Markets' best interests

Roughly five weeks after the operation, after the MTS lifted the temporary curbs on trading, newspapers picked up a leaked Citigroup memo from Tom Maheras, head of global capital markets, stating that:

Citigroup is committed to holding itself to the highest standards in its business practices. We did not meet our standards in this instance and, as a result, we regret having executed this transaction. ***Unfortunately, we failed to fully consider its impact on our clients, other market participants, and our regulators.***

We need to be sure that in whatever we do, we fully consider the impact of our actions on our clients and the markets. ***We must exercise sound judgement, know our markets and our clients well and act in their best interests*** (compiled from *Financial Times*, 2004d and 2004e, *The Times*, 2004b and 2004c, *The Daily Telegraph*, 2004d, *The New York Times*, 2004; underlining added).

This memo – particularly the reference to acting in markets' best interests – was interpreted as an attempt to placate regulators and clients. Media reports described the memo, which was sent to all of Citigroup's 40,000 banking employees, but not its clients, as 'astonishing' (*Financial Times*, 2004d), 'humiliating' (*The Daily Telegraph*, 2004d) and an 'unprecedented apology' (*The Times*, 2004b). *The New York Times* called it 'an indication that the bank is taking the investigation and the complaints seriously', and drew a parallel between Maheras's language and that used by the FSA: 'When the inquiry was announced, the regulator said that market participants should have "regard to the likely consequences of their trading strategies in the market concerned"' (*The New York Times*, 2004).

A second memo, leaked in late January 2005, revealed that the bank had originally set out to destabilize markets. This significantly damaged Citigroup's standing. The trade's objectives had included imposing costs on competitors, decreasing the attractiveness of German bond futures, spurring 'copycat trades', 'killing off smaller dealers', and 'turning the Eu-

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Pour certains, Citigroup a joué finement sans commettre le moindre délit. Quelques semaines plus tard, une note de Citigroup stipulait que la banque devait désormais considérer pleinement l'impact de ses actions sur ses clients et les marchés, en faisant preuve de jugement.

Cette note a été globalement interprétée comme étant une tentative d'apaiser les régulateurs et les clients impliqués. Une seconde note de la banque, divulguée en janvier 2004, a révélé que la banque s'était, dès le départ, fixé comme objectif de déstabiliser les marchés. Il s'agissait de nuire délibérément aux concurrents européens en diminuant leur attractivité.

La FSA a présenté toute une série de mesures visant à garantir le soin, la compétence et la diligence, que Citigroup aurait dû adopter. La FSA a estimé que l'impact sur le marché au sens large était l'un des principaux problèmes réglementaires.

ropean government bond market into one that more closely resembles the US government bond market' (memo reproduced in *Financial Times*, 2005a). Described as 'hideously embarrassing' by the *Financial Times*'s Lex column (*Financial Times*, 2005b), which had originally supported Citigroup, the memo undid Maheras's earlier PR effort. Various European investigations, led by the FSA (Gans, 2006), culminated in fines from the UK and Portugal. Portugal's regulator used an interesting linguistic flourish to describe Citigroup's operation: 'Repeated violations of the duty to defend the market' (Comissão do Mercado de Valores Mobiliários, 2006). Their inference was clear: markets do not defend themselves.

In detailed analyses of the Dr Evil trade and its aftermath, the FSA outlined a range of measures – related to the exercise of due care, skill and diligence – that Citigroup should have adopted in order 'to consider the impact the trade would be likely to have' (Financial Services Authority, 2005a). The FSA concluded that this wider market impact had been 'the main issue of regulatory concern'. This is an unusual argument: banks were implicitly expected to regulate their own conduct, in pursuit of not only self-interest and transparency, but also market confidence and stability.[3]

I will return to these corporate responsibilities later on, after outlining a broader episode.

[3] See also Beunza *et al.* (2006) on the sociology of bond markets

Codes of conduct for capitalism

Variously labelled 'new global power brokers' (McKinsey, 2007), 'giant locusts' (*The Daily Telegraph*, 2008), and 'a force for stability' (*Financial Times*, 2008), sovereign wealth funds (SWFs) were held up to greater scrutiny in the years before the credit crunch than almost any other kind of financial-market actor. These government-funded investors, primarily from Asia and the Middle East, have existed since the 1950s, but for decades kept a low profile. According to data in the Google News Archive in June 2008, sovereign funds were mentioned in only two news articles in the nine years between 1998 and 2006 – once in 2004 and once in 2006. Then, in 2007 alone, they received over 1,400 mentions, and even more the following year. This was a rapid, though controversial, rise to public prominence, as funds diversified away from low-yield bond markets in the early 2000s and began to invest in high-profile companies and real estate in the West.

The controversy surrounding SWFs is an interesting issue because at first glance there was no clear reason for it – no misconduct by SWFs, or evidence that misconduct was imminent. Some politicians were concerned on protectionist grounds about powerful foreign investors en-

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Les fonds souverains, financés par les gouvernements essentiellement situés en Asie et au Moyen-orient, existent depuis les années 50. Ils ont toujours adopté un profil bas, jusqu'à 2007, où ils furent cités des milliers de fois, leur montée en puissance devenant publique. Alors que rien ne laissait supposer que la faute était imminente, ils avaient pourtant ce pouvoir de déstabilisation des marches financiers de par leur grande taille et leur gouvernance opaque.

Dès 2007, les responsables gouvernementaux ont revisé leur politique vis-à-vis des investisseurs étrangers, à l'image d'Angela Merkel et de Nicolas Sarkozy. La position américaine sur les fonds souverains a aussi été précisée.

Mais les fonds souverains pouvaient compter sur de nombreux défenseurs, comme Alastair Darling en Angleterre ou Emma Bonino en Italie. Il y avait un risque d'hostilité politique

tering their economies.[4] Yet the overriding concern was that SWFs might destabilize financial markets due to their large size and opaque corporate governance – even though SWFs, on all the evidence, were profit-maximizing and entirely law-abiding companies. Governments' ultimate response to the funds was to compel them to adopt voluntary codes of conduct which, as I would argue, laid down an ethic for being responsible market actors.

The first signs of controversy emerged when politicians reviewed their policies towards foreign investors. In July 2007 German chancellor Angela Merkel called SWFs 'a completely new conflict situation that one must respond to adequately' (Bloomberg, 2007), and Germany set up a new agency mirroring the US's Committee on Foreign Investment in the United States (CFIUS) to vet foreign investment. France's President Sarkozy stated 'We've decided not to let ourselves be sold down the river by speculative funds, by unscrupulous attitudes which do not meet the transparency criteria one is entitled to expect in a civilized world' (*The Guardian*, 2007a). 'And this,' wrote a Bloomberg columnist in July 2007, 'is happening without anyone [any SWFs] having made any offers [noteworthy investments] recently'.

In turn, the 'US position on sovereign funds was clarified ... in a largely unnoticed speech [by a Treasury official],' in June 2007:

'Identifying the potential "impact on financial market stability", [the official] said that because so little was known about the funds' investment policies, minor comments or rumours could spark volatility. "It is hard to dismiss entirely the possibility of unseen, imprudent risk management with broader consequences," he said...' (*The Times*, 2007).

Controversy begets compromise

SWFs also had their advocates, however. American banks and a range of economists (*The Wall Street Journal*, 2007) pressed the government 'to keep their [policy] reviews narrow enough to encourage foreign investment' (*The Wall Street Journal*, 2008). In Europe, the British chancellor of the exchequer, Alastair Darling, argued that 'calls for the EU to adopt a common approach to vetting corporate acquisitions by foreign state investors' should be resisted (*Financial Times*, 2007). Italy's international trade minister, Emma Bonino, took a similar position, saying in respect of the country's national airline, Alitalia, 'I don't care who buys it, it can be the Chinese, or the Eskimos, so long as they turn it around' (*ibid.*).

Throughout 2007-2008, both sides of the debate recognised there was a risk of political backlash against SWFs, and the debate shifted towards SWFs' discretionary con-

[4] However, there were not many reasons to 'protect' domestic industries from SWFs during the credit crunch. On the contrary, SWF capital helped to save many credit-starved companies, such as investment banks.

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contre ces fonds, en particulier contre leur comportement discrétionnaire.

Les premiers contours de compromis sont apparus en 2008 avec l'élaboration de codes de conduite pour les fonds souverains, à défaut d'accords juridiquement contraignants. Il leur a fallu adopter une éthique de transparence et de prudence.

Un consensus mondial impliquant les USA, l'Union Européenne et le FMI a pu être trouvé. Ces accords ont abouti en 2008 aux principes de Santiago.

duct. EU monetary affairs commissioner Joaquín Almunia described SWFs as offering 'useful investment', adding that they 'must acknowledge that their growing weight in global financial markets brings responsibilities' (British Broadcasting Corporation, 2008).

Contours of compromise emerged in 2008. One might have expected governments to work on reciprocal official policies – for example, establishing quotas on how much money foreign investors could invest in particular industries, or how much influence they could exert over the companies they invested in. Instead, they focused on developing codes of conduct for SWFs. It was in their view more important – perhaps cheaper or more effective – to ensure that sovereign funds learned good market conduct than to achieve binding legal agreements. Thus SWFs were asked to adopt an ethic of openness and prudence as a way to maintain market stability.

From spring 2008, one year after the controversy erupted, the US, the EU and the IMF acted more or less in concert. The US Treasury agreed the first, trilateral code of conduct for SWFs with the governments of Singapore and Abu Dhabi (US Treasury, 2008). This was framed as an input to the multilateral initiatives under way at the IMF. The EU Council of Ministers, which represents national governments at EU level, agreed on a Europe-wide stance toward SWFs and to channel their input to the IMF (European Commission 2008a and 2008b). These efforts culminated in a private-public initiative hosted by the IMF, establishing the Santiago Principles:

'Participants agreed that SWFs invest on the basis of economic and financial risk and return related considerations … [and established] a common set of **voluntary principles for SWFs**, drawing on the existing body of principles and practices, **to help maintain the free flow of cross-border investment and open and stable financial systems**' (IMF, 2008a; emphasis added).

An editorial in *The Guardian* referred to the codes as 'users' manuals' (*The Guardian*, 2007b) to help SWFs participate constructively in markets. Sceptics such as the Kuwait Investment Authority (initially) and US Senator Evan Bayh derisively referred to them as 'best practice' (*The Guardian*, 2008, *The Wall Street Journal*, 2008a). The adoption of these codes signalled a step change. As SWFs 'learned' good market conduct, adopting responsible management protocols, so public perception matured.

Resolution through responsibility

By November 2009 the IMF, a driver of global liberalization for 50 years, was encouraging the Angolan government to establish its own fund in order to manage its foreign reserves (IMF, 2009). Today, the idea that SWFs pose a threat to the global economy is so outdated as to seem almost quaint.

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Les fonds souverains doivent investir en considérant les risques économiques et financiers, avec une participation devant être constructive. L'adoption de ces codes a marqué un changement d'étape, caractérisé par un comportement plus responsable. Aujourd'hui, l'idée que les fonds souverains puissent être une menace pour l'économie mondiale est dépassée. Ils doivent toutefois adopter d'autres comportements éthiques de bonne gouvernance, de gestion des risques et de probité commerciale.

Selon une anecdote qui fait référence à une conversation entre le président de JP Morgan Jamie Dimon et sa fille, les crises financières ayant lieu tous les 5 à 7 ans, il n'y avait finalement aucune raison d'être surpris.

A key feature of the Santiago Principles is the notion that SWFs have to do more than pursue commercial objectives and comply with regulations. If an effective financial system is to be preserved, SWFs must adopt other ethics of sound governance, risk management and commercial propriety. Before elaborating on this, I will discuss the regulatory rethink that has followed the credit crunch.

'Daddy, what's a financial crisis?'

In testimony to the US Financial Crisis Inquiry Commission (FCIC) on 13 January 2010, Jamie Dimon, chairman of JP Morgan, told two anecdotes that offer a curious juxtaposition.[5] The first was this:

'My daughter called me up from school and said "Daddy, what's a financial crisis?" And without trying to be funny, I said, "It's something that happens every five to seven years". And she says "So why is everyone so surprised...?" So we weren't – we shouldn't be surprised.'

Here is the other, an hour earlier:

'The biggest mistake we made [at JP Morgan], somehow, in mortgage underwriting, we just missed that home prices don't go up forever.'

Brian Moynihan, head of Bank of America, told the FCIC that his bank had made the same mistake, and Lloyd Blankfein agreed that stress-testing had been highly deficient at Goldman Sachs (FCIC, 2010, video minute 01:56:00). These banks had ostensibly missed the scenario of falling house prices, even though the Bank for International Settlements (BIS), which oversees international banking policy coordination, warned in its 2003, 2004, 2005, 2006 and 2007 Annual Reports that a downturn in housing prices was a significant risk (see Chapter VII of each report). Yet, according to Dimon, JP Morgan had prepared for 'almost everything else' (FCIC, 2010, video minute 01:53:00).

If a bank's chairman can amiably quip that crises happen every five to seven years, then how does his bank 'just miss that home prices don't go up forever'? The answer is that it may fail to exercise due skill, care and diligence in risk analysis (in contravention of the FSA's Principles of Market Conduct). It may also perceive an implicit guarantee that the state will fund it in case of crisis, to prevent a system-wide meltdown. This is known in economics as moral hazard – over-willingness to take on risk when the consequences will be largely borne by others.[6]

Whether lacking in due care, or influenced by moral hazard, banks engaged in a wide range of legal, yet controversial, activities. Their corporate governance failed to include critical voices on company boards (see UK Treasury, 2009, pp. 91-92) and relied unduly on misunderstood

[5] FCIC, 2010, video minutes 02:34:00 and 01:53:00.

[6] Curiously, moral hazard is rarely discussed as a moral issue; see, for example, Pauly (1968, p. 531), cf. Dembe & Boden (2000).

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Comment une telle banque peut-elle négliger la compétence, le soin et la diligence dans l'analyse des risques ? Probablement parce qu'elle sait que l'Etat va intervenir et financer en cas de crise. Ce comportement se nomme le «risque moral». La gouvernance interne des banques est remise en cause tout comme les pratiques comptables qui contournent les exigences réglementaires à défaut d'y répondre.

mathematical models that failed to diversify risk (Financial Services Authority, 2009d). Innovative accounting practices were often predicated on circumventing rather than meeting regulatory requirements (Securities and Exchange Commission, 2009b, 2009c and 2009e). Poorly structured remuneration encouraged excessive risk-taking (Turner & Financial Services Authority, 2009). In capital markets, the practice of short selling (betting that the value of a financial product will fall) created severe instability, leading to temporary bans in Europe (see International Organization of Securities Commissions, 2008, Securities and Exchange Commission, 2009e, UK Treasury, 2009a). In retail banking, so-called 'exploding mortgages' were sold to over-ambitious house buyers, often aggressively or under false pretences (UK Treasury, 2009a). [7]

Responsible compliance

Les entreprises financières sont dorénavant confrontées à une refonte réglementaire durable. Cette réglementation bancaire ainsi que la supervision doivent être enracinées dans une approche systémique, selon la FSA.

Financial companies are now facing a lasting regulatory rethink. Before the crisis, regulators assumed that regulating individual institutions would mitigate generalized risks. Interdependency did not figure highly on their agendas. In the FSA's view, this is the main reason why regulators did not suitably address the issues that led to the crisis: 'The reality of excessive risk can sometimes only be spotted at systemic level' (Financial Services Authority, 2009d, p. 80).[8] Now, wrote the British regulator, 'the future of banking regulation and supervision needs to be rooted' in a systemic approach (Financial Services Authority, 2009d, p. 52). One dimension of this new approach concerns how companies can protect financial markets.

I would highlight two prominent corporate responsibilities in the post-credit-crunch debate: responsible compliance and ethical competence. However specific or prescriptive it may be, all regulation requires discretionary, and responsible, interpretation.[9]

The UK authorities, which favour principles-based regulation, have emphasized this point: 'The Prudential Regulation Authority will expect firms not merely to meet the letter of these requirements, but also to consider the overriding principle of safety and soundness', the Bank of England wrote about the FSA's successor in 2012. Perhaps surprisingly, the Securities and Exchange Commission, a rules-based regulator, also concluded one of its testimonies on 'Securities Law Enforcement' in the following words:

[7] This account is not intended to put the whole blame for the crisis on banks. I am, however, interested in the idea that banks are expected to control certain legal activities when these threaten market stability. I outline these as illustrations (N.B. an 'exploding mortgage' is one with very low but mandatory interest rate repayments that subsequently increase disproportionately).

[8] A systemic risk is one that threatens the entire financial system, or a core part of it (Financial Services Authority, 2009d), for example when one institution's failure leads to large losses for others (International Monetary Fund, 2010).

[9] In some cases, the more specific a regulation, the more interpretation it requires for idiosyncratic applications.

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Dans le débat post-crise, il faut mettre en avant deux responsabilités essentielles: le respect de la réglementation, qui est la base de départ et la compétence éthique. Les directions des banques doivent encourager le personnel à développer des techniques innovantes de surveillance et de contrôle.

La compétence éthique des individus est bien sûr primordiale: le jugement humain et responsable doit prévaloir. C'est souvent un impératif éthique que de reconnaître que l'on est capable ou pas d'effectuer une mission. L'honnêteté et la compétence sont donc étroitement liées.

'...we need to encourage a tone and culture … that mere compliance with the law, narrowly viewed, is not the highest goal to which we aspire, but the base from which we start. The securities industry as whole needs to embrace this compliance culture, and [become] responsible stewards of the assets entrusted to them' (Securities and Exchange Commission, 2009d, pp. 14-15).

Complying responsibly with regulation will entail pursuing some shared objectives with regulators. This should not mean complying uncritically; on the contrary, its focus is the spirit, not the letter, of the law. Under the European principle of 'comply or explain' (UK Treasury, 2009, p. 38, European Commission, 2006), banks may identify innovative ways to implement controls, and these may indeed improve – and cost less than – the official guidelines. Ultimately, senior management must encourage staff to develop innovative supervisory techniques and, often, share them with the industry.

Ethical competence

Individuals' ethical competence is of course paramount. The regulatory debate has frequently mentioned what the FSA termed a 'misplaced reliance on sophisticated maths' (Financial Services Authority, 2009d, 16), where the issue is not only technical content (such as the relative merit of value-at-risk modelling versus stress-testing) but also human judgement. Senior executives have been criticized for failing to understand their risk models, and less senior managers for 'confusing the model with the world' (*The New York Times*, 2008b). As MIT's Andrew Lo put it, 'technology got ahead of our ability to use it responsibly' (*ibid.*).

It stands to reason that the 'job market' does not always replace those who fail to do their jobs effectively with more competent individuals. It is often an individual's ethical prerogative to acknowledge his or her own incompetence for a role. Honesty and competence are closely related. They comprise the twin categories for the UK's 'Fit and Proper Test for Approved Persons', which individuals must pass in order to obtain certain jobs in the financial industry or to purchase major companies. The test's categories are 'Honesty, integrity and reputation' and 'Competence and capability'. Explaining one decision to fail an individual on this test, the FSA cited indications of a banker's incompetence, which as a result 'prejudiced the interest of consumers' (Financial Services Authority, 2009e, p. 2).

Roszaini Haniffa calls for 'training in how to apply codes of conduct in everyday [accounting] situations' (*Financial Times*, 2009). 'Students must be exposed to alternative business models and thinking,' she continues, 'not just trained to resolve complicated financial problems through mathematical modelling. These tend to be detached from the real world and consideration of human elements' (*ibid.*). Ethical competence introduces human, qualitative dimensions to formalist risk mana-

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Roszana Haniffa plaide en faveur d'une formation sur la façon d'appliquer des codes de conduite dans la vie financière quotidienne. La compétence éthique introduit des dimensions humaines et qualitatives visant à optimiser la gestion des risques et la conformité réglementaire.

Une démarche non proactive peut mettre en danger l'ensemble du système.

Les établissements bancaires doivent contribuer à assurer un système financier stable et équitable incluant l'adoption d'une nouvelle éthique pour la conduite des affaires.
Parmi les comportements attendus chez les financiers figurent l'adoption de pratiques de gestion des risques pour anticiper les impacts. Repérer les limites des modèles de risques est tout aussi crucial, tout comme la préparation aux scénarios de crise prévisibles.

gement and compliance; it looks for weaknesses in the models, and in individuals (see also *The New York Times*, 2008a, and *The Wall Street Journal*, 2009).

Economic theory holds that those who do not demonstrate the necessary skill will succumb to competitors. But it has become clear that those who do not better their ways proactively may put not only themselves at risk, but the entire system. More is at stake than just the firm's and the individual's freedom to compete legally. The market commons relies on responsible compliance and ethical competence.

Corporate Market Responsibility

The controversies involving Citigroup, sovereign funds and many banks during the credit crunch suggest that financial firms must help to ensure a fair and stable financial system, adopting new ethics for business conduct, above and beyond legal regulation and profit maximization.[10] In the course of researching these episodes, I have analysed a data sample of over 540 documents, comprising regulatory papers (as indicators of regulatory risk) and media articles (as indicators of reputational risk). The data point to three central types of ethic expected of financial companies.

The first of these is *adopting risk management practices that anticipate the firm's impact on its market environment*. Incentives for bank personnel should encourage ethical competence at all levels, and accountability at senior level, for the bank's key risk models. Day-to-day management controls, such as risk-taking limits, should be aligned with the company's overall risk appetite, set at board level and informed by broader market conditions. Pinpointing the limitations of risk models and the role of subjective judgement is also crucial. Appropriate risk foresight was important for Citigroup (which failed to consider its trade's impact on the MTS market), for SWFs (to reassure host countries that they would not destabilize their economies) and for the many banks that failed to prepare adequately for foreseeable crisis scenarios.

The second is *implementing a transparent investment policy with parameters for acceptable financial transactions*. This may take various forms. Investment products should be aligned with customers' risk profiles; for example, complex derivatives are generally not appropriate products for pensioners. Financial strategies such as short selling should be suspended when they threaten market liquidity, lest they become self-

[10] In this paper I have used the Oxford Dictionary definition of ethic ('a set of moral principles, especially ones relating to or affirming a specified group, field, or form of conduct') and moral ('concerned with the principles of right and wrong behaviour'). See oxforddictionaries.com.

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Il faut aussi mettre en place une politique d'investissement transparente avec des paramètres fixant les transactions financières acceptables, afin de renforcer la confiance dans les marchés et éviter toute controverse.
La troisième mesure éthique attendue concerne le respect de l'esprit des lois et la proactivité nécessaire pour en corriger les lacunes. Il faut coopérer avec les organismes de réglementation dans la compréhension et codification des responsabilités, et dans l'élaboration de techniques de pointe pour surveiller les transactions et détecter celles suspectes.

Le respect de l'éthique est devenu indispensable, son absence générant des risques réglementaires et une atteinte à la réputation. Le modèle d'éthique CMR (*Corporate Market Responsibility*) est la meilleure incarnation de la méta-régulation.
Le CMR a également une qualité normative: il s'agit de l'intérêt public et l'interdépendance économique.

fulfilling or abusive.[11] Investments should be driven by financial returns on invested assets, and should not aim for unfair advantages in particular markets. In general, parameters that define acceptable financial transactions help to build confidence in markets. In each of the aforementioned episodes, the lack of such parameters (e.g. for the Dr Evil strategy, SWF investments, or 'exploding mortgages') fuelled the controversy.

The third type of ethic is *responsible compliance: abiding by the spirit of the law and correcting shortcomings proactively, even when regulations are not actually breached.* There are many grey areas when implementing both the spirit and the letter of regulations. This type of ethic promotes cooperation with regulators in understanding and codifying responsibilities; developing and adopting leading industry practices; emphasizing the organization's values and reflecting them in procedures; and strengthening compliance departments (for example, improving communication between compliance and client-facing business units). This general expectation was evident in each of our episodes. Citigroup's fine was decreased in response to improvements it made during the FSA investigation (Financial Services Authority, 2005a). SWFs avoided restrictions on foreign investment by helping to design reflexive codes of conduct. Following regulatory calls for proactive improvement, major investment banks have been investing heavily in trade surveillance technology to enable them to detect suspicious activities and report them to regulators.

Enforcing ethics

Together, these ethics represent a new corporate market responsibility (CMR). Our episodes suggest that the absence of these types of ethic increases regulatory and reputational risk, while their adoption decreases those risks. Thus CMR ethics are voluntary, but nevertheless enforced. I would argue the concept of CMR is part of a model known as meta-regulation, also referred to as 'the regulation of self-regulation' (Black, 2006; Braithwaite, 2003; Gray & Hamilton, 2006; Grabosky, 1995; Parker, 2007). In meta-regulation, 'the quality of firms' internal controls is the paramount focus of attention', writes Black (2006), usually with the aim of managing 'the extent to which, and ways in which, those firms will comply with regulatory requirements' (p. 3).

However, CMR also has a normative quality (it is content, not just method): it concerns the public interest and economic interdependency. In this sense, CMR is similar to 'ethical self-regulation'.[12] Chiu (2009) summarizes it thus: 'In a narrow sense ethics may relate to the

[11] Short selling becomes self-fulfilling when the target company finds it increasingly difficult to raise funds, and ultimately becomes insolvent, as more and more traders become involved in the bet. Shorting can constitute market abuse (which is illegal) if traders conspire to create a self-fulfilling bet.

[12] See also 'enforced self-regulation': Ayres & Braithwaite (1992).

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En considérant que les crises financières se reproduisent tout les cinq à sept ans, c'est peut-être le bon moment pour se pencher sur la responsabilité du marché des entreprises.

prevention of … detrimental behaviour that may inflict organizational and social costs. Seen in that light, ethical self-regulation would include risk management, social responsibility in the sense of prevention or mitigation of externalities, and corporate governance. Ethics may also relate to "proactively" adding to social good ... ' (p. 32).

Illustrating some of the parallels between these various models, Parker (2007) writes of 'legally accountable corporate social responsibility', and Shamir (2008) of 'responsibilization' for moral conduct. CMR is an invitation to implement and develop better market conduct.

Conclusion

It has often been taken as given that, if an economic incentive exists, morality will be subsumed in it; but this way of thinking is rapidly losing credibility. In 2008 one of its most renowned proponents, Alan Greenspan, told the US Congress 'Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shock and disbelief ... I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms ...' (pp. 35-37).

The old economic morality is being challenged by the emerging ethics of corporate market responsibility. Western financial markets appear to be recovering from the credit crunch. Several investment banks have recovered to pre-crisis levels of profitability. If JP Morgan's Jamie Dimon was right when he said that financial crises occur every five to seven years, now may be a propitious time to attend to corporate market responsibility. •

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