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INSTITUTIONS, INTEGRITY SYSTEMS AND MARKET ACTORS

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The Dynamics of Capital Market Governance:
Evaluating the Conflicting and Conflating Roles of
Compliance, Regulation, Ethics and Accountability

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As is well known, the collapse of the US corporation, Enron, had a devastating effect on shareholders and employees. And in its wake came the revelations of a litany of unethical practices, including conflicts of interests, e.g. CFO Andrew Fastow, auditing failures, corrupt (if not necessarily unlawful) practices, eg. creation of so-called Special Purpose Entities (SPE's) calculated to mislead shareholders in relation to actual performance, and so on.¹ Moreover, the Enron collapse was only one among a number of recent corporate corruption scandals, including Worldcom and the giant accounting firm Arthur Andersen and, in the Australian context, One Tel and HIH. The Royal Commission into HIH found that, as the company lurched towards collapse, it engaged in corporate excesses involving travel, entertainment, charitable donations, and executive gifts. These excesses stripped over AU\$32 million out of its assets. Staff were given gold watches, and a tip of AU\$700 was paid at a dinner attended by the CEO and HIH executives at Port Douglas (Port Douglas is an expensive tropical resort some 1500 miles away from Sydney, where HIH was based). Just weeks before the collapse, AU\$180 000 was paid to a Melbourne football club which was in some financial difficulty.

The HIH collapse has sparked a lively debate into the ethical responsibility of company directors and the role of corporate regulators. The corporate regulators, particularly the Australian Prudential Regulation Authority, claims that it was profoundly misled by HIH, and thus it, in turn, had inadvertently misled the government about the seriousness of the crisis facing the company. The Federal Opposition has questioned how

¹ See Seumas Miller "Corruption" *Stanford Encyclopedia of Philosophy* Winter 2005 for an account of corruption and its divergence (at times) from illegality.

the collapse was not anticipated by the regulatory authorities, given the amount of material showing that HIH was in trouble up to two years before the collapse.

The corporate collapses and corruption scandals of the late 1990s and early 2000s in the US, Australia and elsewhere appears to be part of a recurring cycle. Recall the corporate scandals of the 1980s in the US and elsewhere. That period was notable for a stock market crash, a junk bond collapse, the bankruptcy of numerous highly-leveraged clients, the prevalence of the unlawful practice of insider trading, and the fining and imprisonment of the likes of Michael Milken and Ivan Boesky. Milken paid fines in excess of US\$600 million, Boesky over US\$100 million.²

Self-evidently, these corporate collapses were extraordinarily damaging economically, but apparently they might also be ongoing; perhaps the question is not whether there will be a recurrence, but rather when it will take place. If so, then these corporate collapses and corruption scandals might not be aberrations but rather symptoms of underlying systemic deficiencies in corporate law and regulation, and perhaps of structural deficiencies in the corporate sector itself, notably in the financial services area.

Perhaps, therefore, it is worth trying to take a birds-eye view of the contours of the macro-institutional setting in which particular corporate collapses and corruption scandals have taken place, and doing so from an ethical perspective.

In this paper I focus on the ethical, as opposed to legal, financial or political dimensions of this problem and, in particular, on ethics at the macro-institutional level. In the first section I sketch a normative theoretical account of social institutions, in the

² James B Stewart *Den of Thieves* (NY: Simon and Schuster, 1992) p.20

second section I outline some of the key features of what I will refer to as an integrity system for institutions, and in the third and final section in light of my accounts of social institutions and integrity systems, I offer some speculations concerning some of the ethical problems confronting the corporate sector in general, and the financial services sector in particular.

The term, “social institution” is somewhat unclear both in ordinary language and in the philosophical literature. However, contemporary sociology is rather more consistent in its use of the term. Typically, contemporary sociologists use the term to refer to complex social forms that reproduce themselves, such as governments, universities, hospitals, business corporations, markets and legal systems. A typical definition is that proffered by Jonathan Turner: “a complex of positions, roles, norms and values lodged in particular types of social structures and organising relatively stable patterns of human activity with respect to fundamental problems in producing life-sustaining viable societal structures within a given environment”.³ Again, Anthony Giddens says: “Institutions by definition are the more enduring features of social life”.⁴ He goes on to list as institutional orders, modes of discourse, political institutions, economic institutions and legal institutions.⁵

At this point it might be asked why a theory of social institutions in general, and a theory of market institutions in particular has, or ought to have, any philosophical interest; why not simply leave such theorising to the sociologists and/or the economists?

³ Jonathan Turner *The Institutional Order* (New York: Longman, 1997) p.6.

⁴ Anthony Giddens *Constitution of Society: Outline of the Theory of Structuration* (Cambridge: Polity Press, 1984) p.31.

⁵ Ibid.

One important reason stems from the normative concerns of philosophers; concerns about what ought to be, as opposed to what is or has been. Here I note that what ought to be is not a fanciful notion, but rather a partial extrapolation from what is and, ultimately, a statement of what realistically could be. Philosophers, such as John Rawls⁶, have developed elaborate normative theories concerning the principles of justice that ought to govern social institutions. Famously, he argued that social institutions ought to be structured in such a way as to benefit the least well-off. Advocates of free market economics have argued that this is just what de-regulated markets do, and pointed to the freeing up of the Chinese and Indian economies as evidence of this. Whatever the truth of such claims, my point is that even the most staunch free-marketeers have normative or ethical commitments; they are committed to the ethical value of the social institution of private property, the moral force of contractual obligations and the human right of individual freedom, in particular.

In addition to normative theorizing in relation to principles of distributive justice and the like at the macro-institutional level, philosophers in the area of business ethics have addressed specific ethical failures, such as bribery, conflicts of interest, insider trading, and so on. Remarkably, most of this normative theorizing, including by Rawls, has been done so in the absence of a developed theory of the nature and point of the very entities (social institutions) to which the principles of justice in question are supposed to apply; and, in particular, in the absence of a developed theory of the nature and point of business corporations, and financial and other markets. (I take it that advocates of corporate social responsibility (CSR) are not offering a worked out normative theory, so

⁶ John Rawls *Theory of Justice* (Harvard University Press, 1972)

much as giving expression to (doubtless, reasonable) ethical concerns.) Surely the adequacy of one's normative account of the justice or otherwise, of any given social institution, or system of social institutions, will depend at least in part on the nature and point of that social institution or system.

Moreover, such theorizing is highly germane even to specific ethical questions in business or finance ethics. For example, it is difficult to determine whether or not some alleged conflict or interest is ethically acceptable or not independent of a normative theoretical account of nature and point of the relevant social institutions and/or of their constitutive institutional roles. An auditor auditing a company's accounts has a conflict of interest if the audit firm he or she works for relies heavily on consultancy work provided by the company being audited; but this would not necessarily be so for a plumber contracted to unblock the company's drains and who also happens to hold shares in the company. How so? To answer this question the nature and point of the institutional role of the auditor in the context of the corporate sector needs to be specified.

Social Institutions

Social institutions need to be distinguished from less complex social forms such as conventions, social norms, roles and rituals. The latter are among the constitutive elements of institutions.

Social institutions also need to be distinguished from more complex and more complete social entities, such as societies, polities or cultures, of which any given institution is typically a constitutive element. A society or polity, for example, is more

complete than an institution since a society – at least as traditionally understood - is more or less self-sufficient in terms of human resources, whereas an institution is not. Thus, arguably, for an entity to be a society it must sexually reproduce its membership, have its own language and educational system, provide for itself economically and – at least in principle – be politically independent.

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

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

Roughly speaking, an institution that is an organisation or system of organisations consists of an embodied (occupied by human persons) structure of differentiated roles. These roles are defined in terms of tasks, and rules regulating the performance of those tasks. Moreover, there is a degree of interdependence between these roles, such that the performance of the constitutive tasks of one role cannot be undertaken, or cannot be

undertaken except with great difficulty, unless the tasks constitutive of some other role or roles in the structure have been undertaken or are being undertaken. Further, these roles are often related to one another hierarchically, and hence involve different levels of status and degrees of authority.

Importantly, these roles are related to one another in part in virtue of their contribution to (respectively) the *end(s)* or *function(s)* of the institution; and the realisation of these ends or functions normally involves interaction between the institutional actors in question and external non-institutional actors.

The constitutive roles of an institution and their relations to one another can be referred to as the *structure* of the institution.

Moreover, institutions in this sense are dynamic, evolving entities; as such, they have a history, the diachronic structure of a narrative and (usually) a partially open-ended future.

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

culture comprised of attitudes and norms that is aligned to the formal and official complex of tasks and rules might compete with an informal and ‘unofficial’ culture that is adhered to by a substantial sub-element of the organisation’s membership.

In addition to structure, function and culture, social institutions necessarily involve sanctions of various kinds. Social institutions involve *informal* sanctions, such as moral disapproval following on non-conformity to institutional norms. However, formal sanctions, such as punishment, are also a feature of institutions.⁷

Social institutions have a multi-faceted normative dimension. Moral categories that are deeply implicated in social institutions include human rights and duties, contract based rights and obligations, and rights and duties derived from the production and consumption of collective goods. Take police institutions. Police are typically engaged in protecting someone from being deprived of their human right to life or liberty, or their institutional right to property.

Now consider business. Most business organisations do not have the protection of human rights as a purpose; nor should they. On the other hand, moral rights are an important *side constraint* on business activity. Business organisations should not engage in activities that violate the human rights of workers or other members of the community, e.g. clothing manufacturers should not exploit children as underpaid workers in underdeveloped countries.

A further point about markets and business organisations is that, normatively speaking, they have both proximate ends as well as ultimate ends. The proximate end of market actors might be to maximize their financial self-interest or profits or shareholder

⁷ Jon Elster *Cement of Society* (Cambridge University Press, 1989) Chapter XV.

value. However, such proximate goals are not the ultimate ends of markets or of the social institution of the modern corporation. Qua social institution, markets and corporations ought to (and in fact do, albeit imperfectly) serve larger purposes than this, such as to contribute to the material well-being of human societies. Whether this larger purpose is the material betterment of the least well-off (as Rawls suggests) or to maximize the overall benefit (as utilitarians suggest) is a matter for reasoned argument. Moreover, the fact that some prior institution existing outside the market is privatized, indeed legally incorporated, would not undermine this fundamental proposition concerning social institutions. A prison, for example, does not cease to have as an ultimate end the deterrence of criminality and protection of citizens from dangerous persons merely because it becomes privatized. Rather – again, normatively speaking – a proximate end, e.g. maximizing shareholder value or making a profit, has in effect been (rightly or wrongly) ‘designed-in’ to a pre-existing institution as a means to better realize its ultimate purpose.

To claim that the ultimate purpose of the institution of the modern corporation – a product, if ever there was one, of institutional design – is, for example, simply and only to maximize profits or shareholder value is, on this teleological account of social institutions, to confuse proximate with ultimate purposes.

Let us now focus on institutional moral rights. There are at least two species of institutional (moral) rights. There are individual institutional (moral) rights and there are *joint* moral rights. Joint moral rights are moral rights that attach to individual persons, but do so jointly. For example, in the context of the social institution of property rights the joint owners of a piece of land might have a joint right to exclude would-be trespassers,

and one single owner of a piece of land might have a right to exclude would-be trespassers but only on condition that another single owner of a second piece of land likewise had such an exclusion right.

Roughly speaking, two or more agents have a joint moral right to some good, if they each have an individual moral right to that good, if no-one else has such a moral right to that good, and if the individual right of each is dependent on the individual rights of the others.

Such joint rights need to be distinguished from universal individual human rights. Take the right to life as an example of a universal individual human right. Each human being has an individual human right to life. However, since one's possession of the right to life is wholly dependent on properties one possesses as an individual, it is not the case that one's possession of the right to life is dependent on someone else's possession of that right.

Sometimes the end realised in joint action is not merely a collective end, it is also a collective *good*. If so, then a joint right may well be generated. What is the relationship between joint moral rights and collective goods? The good is a realised collective end to which the participants possess a joint right.

It is easy to see why these agents, and not some other agents, would have a right to such a good; they are the ones responsible for its existence, or continued existence. In this connection consider the shareholders, managers and workers (officers and employees) in a factory that produces cars that are sold for profit. Managers, shareholders and workers in the factory have a joint right to be remunerated from the sales of the cars that they jointly produced. It is also clear that if one participating agent

has a right to the good, then - other things being equal - so do the others. That is, there is interdependence of rights with respect to the good.

Now notice that the managers, shareholders and workers – and indeed the car company itself – depends for their skills, knowledge, security, transport and so on, on other social institutions, including educational and policing institutions, legal and political institutions, transport and communication infrastructure etc. Accordingly, the moral rights to the collective goods produced by the car company include rights that attach to members of the wider society; this moral fact is reflected in tax regimes, including corporate tax, albeit often inadequately. Evidently, many corporations often pay less tax than is fair or reasonable by virtue of ‘creative accounting’ and/or their ability to exploit offshore tax havens, e.g. in poor countries desperate to attract investment.

Notice further that these joint moral rights are not equivalent to, or reducible to, moral rights based on legal contracts. A contract might or might not reflect a person’s contribution to the production of a collective good, depending on a host of contingencies (notably relationships of power). Consider in this connection the extraordinarily generous executive compensation packages on offer in some corporations.

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

Let us now give more give more detailed attention to the sources of deontic properties that attach to institutional roles. Such deontic properties comprise both rights and duties. The sources of deontic properties, such as rights and duties, include the following ones.

Firstly, as we have just seen, collective ends - that are also collective goods - generate joint moral rights under certain conditions. So the normative dimension of institutions involves more than deontic properties, and some deontic properties are presupposed by this normative dimension. Specifically, it involves the ethical or moral worth of the ends or purposes of institutions, i.e. the kinds of human goods that institutions produce or fail to produce. Accordingly, the definition of an institution will typically include a description of the human good that it purports to produce. For example, universities purport to produce knowledge and understanding, economic systems ought to produce material well-being, and so on.

Secondly, explicitly formulated directives issued by properly constituted authorities can give rise to duties to perform certain kind of actions under certain circumstances, e.g. a CEO instructs a subordinate to undertake a financial task.

Thirdly, promises generate obligations to perform the promised actions. This is relevant to institutional actors in so far as they enter into contracts, undertake oaths of office and the like. Moreover, part of the moral and/or legal basis of some institutions, such as corporations and governments, might consist in part in contracts or quasi-contracts, e.g. the so-called social contract between an elected government and its citizens or between regulators and those they regulate.

Fourth, various natural properties that persons have, e.g. human needs, generate moral rights, namely, human rights and correlative duties. Typically, human rights act as side constraints on the actions of institutional actors.

This multiplicity of sources of deontic properties suggests a pluralist explanatory account of the deontic properties of institutional actors, including market actors. Moreover, on a teleological account of social institutions, participants in an institution pursue a collective good and this gives rise to deontic properties. However, this (normative) teleological explanation of deontic properties needs to be supplemented by recourse to the other above-mentioned sources of deontic properties, e.g. promises (including contracts), human rights.

The two points to be stressed here are as follows, Firstly, normatively speaking, social institutions including business corporations and markets exist for ultimate – and not merely proximate - purposes or ends, namely, to provide collective goods, e.g. material goods for consumption. Here Adam Smith's invisible hand mechanism is salient. The outcome of the workings of the invisible hand is the ultimate purpose of this institutional mechanism; the pursuit of financial gain, the proximate end. Secondly, again normatively speaking, the rights and duties of institutional actors, including CEO's, directors, managers, shareholders, employees, derive in part from the collective ends, i.e. collective goods, that it is the *raison d'être* for the existence of that social institution.

So the fundamental normative question that needs to be asked of a business corporation, or financial market, is precisely the same as for any other social institution, namely, What collective good(s) is it providing? Once an acceptable answer to this

question is provided then a host of subsidiary normative questions arise including, Who is possessed of a jointly held right to this good and on what moral basis?

Integrity Systems

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

In practice integrity ‘systems’ are a messy assemblage of formal and informal devices, processes and roles, and they operate in often indeterminate, unpredictable and sometimes even conflicting ways.

The term ‘integrity’, as used in the expression ‘integrity system’, is also problematic in that it appropriates a moral notion normally used to describe individual human agents, and applies it to organisations and other large groups of individuals. Roughly speaking, individual human persons have integrity if: (1) they possess the full array of central moral virtues, such as honesty, loyalty, and trustworthiness, and (2) they

exercise rational and morally informed judgment in their adherence to any given virtue, including when the requirements of different virtues might seem to come into conflict.

For example, persons with integrity would not allow themselves to act dishonestly out of a misplaced sense of loyalty, notwithstanding the importance of loyalty as one of the virtues possessed by a person with integrity.

By contrast with the notion of an individual person's integrity, integrity used in the context we are employing it here of an "integrity system" for institutions applies to the members of organisations and occupations, and also to the structure, function and culture of organisations.

The integrity of an organization or occupational group is in large part dependent on the individual integrity of its members, and therefore an integrity system is in large part focused on developing and maintaining the individual integrity of these members. Nevertheless, these organisations and groups are not simply the sum of their members, and so determining the integrity levels for an organization or group is not simply a matter of summing the levels of integrity of the individuals who happen to be its members at a particular time.

In the first place, the individuals who comprise institutions, including the so-called professions, are role occupants, and the responsibilities and virtues required of them are somewhat different from, and in some respects greater than, those required of ordinary individual persons not occupying such roles. So, for instance, scrupulous attention to numerical detail might be a constitutive virtue of the role of an accountant but not of the role of a husband.

Moreover, what counts as a professional responsibility or virtue, both in terms of technical and ethical competencies, varies greatly across different professional and occupational groups. While, arguably, the “zealous advocacy of one’s clients interests” might be a critical virtue to the role of a lawyer or barrister in an adversarial legal system, it is clearly not a critical virtue for the engineer. One important task then, for specific professional areas is to determine what precisely the constitutive virtues of the individual role-occupant are, and devise strategies to ensure that these virtues are developed and maintained in the members of that occupational area.

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

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

Moreover, in the case of markets and business corporations more generally, realizing the ultimate, as opposed to proximate, institutional purposes is a fundamental

ethical concern. Here there is a need to address an array of questions including the contribution of the business, market or industry to human material well-being, e.g. the ‘contribution’ to human health of the tobacco industry is self-evident, but so is the international pharmaceutical industry if, as appears to be the case, it is neglecting the development of drugs for poverty related diseases afflicting millions in favour of drugs for the minor ailments of much smaller numbers of the relatively rich. Again, the real costs, e.g. environmental costs, of specific industries need to be factored in institutional cost/benefit analyses of the extent of the realization of proximate and ultimate ends.

In the case of the financial services sector in particular, there appears to be a prior fundamental ethical question in need of an answer, namely, what are, i.e. what ought to be, the ultimate institutional ends of this sector? Is it to provide capital to any person or organization that will maximize shareholder value? Perhaps this is (again) to confuse proximate with ultimate ends. At any rate, without an answer to this question, an integrity system – and a regulatory system in so far as it is concerned with institutional (ethical) integrity, as it surely must be – is quite literally without a basic purpose; it does not know what ethical ends it is seeking to embed in the target institution(s). I return to this theme in the next section.

Finally, consider culture. In an institution possessed of integrity, the pervasive ethos or spirit, i.e., the culture, would be one that was, for example, conducive to high performance, both technically and ethically, and supportive in times of need, but intolerant of serious incompetence or misconduct.

In looking at options to promote integrity and combat ethico-professional failures it is very easy to leap to a particular single ‘magic bullet’ solution, like increasing

penalties or giving more intrusive powers to investigative agencies, and doing so without considering the full array of implications, including the demonstrable (as opposed to hoped for) benefits (Which of these measures has been tested and, as a consequence, is *known* to work?), and the costs in terms of resources, damage to ethico-professional ethos, and so on.

Moreover, ‘magic bullet’ solutions are often offered in relative ignorance of both the actual nature and causes of the problems they are supposed to address. The truth is sometimes in the detail. For example, in attempting to determine the causes of unethical practices in a given profession there are a number of preliminary questions that need to be addressed. One set of questions pertains to the precise nature of the unethical practice at issue, and the context in which it occurs. Consider legal practitioners operating in the context of incorporated, multi-disciplinary legal practices. Are there, for example, some compelling practical facts that explain the unethical practice of conflicts of interest or breaches of confidentiality? What pressures and opportunities might there be for the unethical practice in question? Another set of questions concerns the extent of the corruption or unethical practice: Is it sporadic or continuing, restricted to a few ‘rotten apples’ or widespread within the area? Here, as elsewhere, rhetoric is no substitute for evidence-based conclusions.

Other times one cannot see the wood for the trees. In the case of the global financial sector integrity assurance is in the hands of national governments. However, national governments – and their regulatory agencies – are not simply umpires, they are also players in the financial ‘game’.

Even when the answers to these questions have been provided there will arise further questions in relation to any remedies proposed. For example, any contemplation of mechanisms to redress ethico-professional misconduct that will require the expenditure of energy and resources needs to be justified in terms of the seriousness and extent of the misconduct to be successfully combated. Consider here the claims that Sarbanes-Oxley has had costs that are greater than the benefits it has provided – and, of course, the counter-claims. More importantly, such remedies need to be efficacious. Pious rhetoric accompanied by tough regulation does not necessarily deliver the required results. Understanding the causes of ethico-professional misconduct and failures and the tailoring of remedies to address them will involve considering and distinguishing between three sorts of motivation for compliance with moral principles and ethical ends.

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

There are also important connections to be highlighted and promoted between ‘self-interest’ and ‘moral belief and sentiment’ so that these conceptions are more in

balance and integrated and less at odds. First, of course, the appeal to moral sentiment must be balanced by the appeal to self-interest. If, e.g., it is at great cost to self to be, say honest or fair, then one may have sufficient reason to not be honest or fair. Indeed, the reason need not be purely self-interested but also count as moral. So, e.g., if it means my livelihood and that of my family, then I may have significant reasons from both prudence and morality to, say, commit fraud.

It is evident that widespread and ongoing compliance typically requires appeals to self-interest (sticks and carrots) but also appeals to moral beliefs. Ideally, integrity systems should have penalties for those who do not comply, should enable benefits to flow to those who do comply, and should resonate with the moral beliefs of the people thus regulated, e.g., laws and regulations should be widely thought to be fair and reasonable.

Thus, institutional design which proceeds on the assumption that self-interest is the only human motivation worth considering fails. It fails because it overlooks the centrality of moral beliefs in human life, and therefore does not mobilise moral sentiment. On the other hand, institutional design that proceeds on the assumption that self-interest can be ignored, and that a sense of moral duty on its own will suffice, also fails; it fails because self-interest is an ineradicable and pervasive feature of all human groups.

Moreover, deserved reputation has a pivotal role to play in the convergence of self interest and ethical concerns. Let me explain what might be referred to as a virtuous triangle.

High reputation is much sought after by occupational groups and firms alike, and a low one to be avoided at all costs. Accordingly, there is an opportunity to mobilize this

reputational desire in the service of promoting ethical standards. Here the aim is to ensure that organizational and professional reputation aligns with actual ethical practice, i.e. that an organization, group or individual's high or low reputation is deserved. The way to achieve this is by designing appropriate integrity systems. Key elements of an integrity system track compliance with rules, e.g., accountability. The additional thought here is that key elements of an integrity system should track features of organization and occupational groups that determine or should determine reputation. Most explicitly, reputational indexes could be constructed whereby an ethics audit awards scores in relation to specific ethical standards.

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

First, reputation is linked to self-interest; this is obviously already the case – individuals, groups and organizations desire high reputation and benefit materially and in other ways from it. Second, reputation needs to be linked to ethics in that reputation ought to be deserved; as already mentioned, the integrity systems are the means to achieve this. Third, and as a consequence of the two already mentioned links, self-interest is linked to ethics; given robust integrity systems that mobilize reputational concerns, it is in the self-interest of individuals, groups and firms to comply with ethico-institutional

standards. We should also reassert that we do not believe that self-interest is the only or ultimate motivation for human action; the desire to do the right thing is also a powerful motivator for many, if not all people. Accordingly, the triangle is further strengthened by the motivation to do right.

Integrity systems can be thought of as being either predominantly reactive or predominantly preventive.⁸ Naturally, the distinction is somewhat artificial, since there is a need for both reactive elements, e.g., a complaints and discipline system, as well as preventive elements, e.g., codes of practice, ethics training and transparency of processes, in any adequate integrity system.

Integrity-building strategies involve reactive systems as well as preventive systems, and within preventive systems there are mechanisms that promote ethical behaviour, there are corporate governance mechanisms with, e.g., anti-fraud or corruption functions, and there are various transparency mechanisms.

Moreover, it seems clear that an adequate integrity system cannot afford to do without reactive as well as preventive systems; and that preventive systems need to have all the elements detailed above. This suggests that there are two important issues. The first is the adequacy of each of the elements of the above systems, e.g., how adequate is the complaints and discipline processes including the investigative capacity? or how effective are the mechanisms of transparency? The second issue pertains to the level of integration and complementarity between the reactive and the preventive systems; to what extent do they act together to mutually reinforce one another?

⁸ Derived in part from Seumas Miller, Peter Roberts and Ed Spence *Corruption and Anti-corruption* Chapter 7 (Prentice Hall, 2005).

We should think of (better) integrity systems therefore, as holistic in character, and conceive of specific integrity building mechanisms as elements of a unified, integrated, holistic integrity system the elements of which reinforce, rather than conflict with, one another.

Corporations, Financial Markets and Market Actors

Notwithstanding the general features of integrity systems for institutions adumbrated above, any given integrity system for an institution must be tailored to the needs of that particular institution.

Arguably, market actors, including financial service providers, present a number of relatively distinct problems when it comes to devising integrity systems to ensure ethical practice; or, at any rate, this is a source of the following speculations concerning the integrity system or systems for these groups.

In the first place, and as noted above, market actors do not have an ethical purpose as their proximate end; rather they have some commercial end, such as profit maximisation. The ultimate end is one provided for by the invisible hand. Market actors pursue (individual and collective) self-interest and – by virtue of the workings of the invisible hand – the material well-being of the society is provided for. In this respect market actors are unlike, say, doctors or hospitals. The latter can reasonably be required to have the promotion of life and health at the forefront of their concerns, i.e. as their proximate as well as ultimate ends.

Economic self-interest, especially when linked to social status and power, is a powerful driver, and establishing markets in previously non-market economies, and de-

regulating previously heavily regulated market economies, has unleashed a great deal of hitherto dormant human energy. Moreover, the modern corporation as an institution, and the development of global financial markets, has enabled the mobilization of vast capital sums in the service of this human energy. One only has to visit Shanghai today and remember what it was like twenty years ago to appreciate the power of market forces (perhaps especially government assisted market forces).

However, from an ethical point of view, the *institutionally structured* self-interested orientation of market actors – including corporations – may well give rise to an immediate problem. How is this institutionally structured impetus and habit of pursuing economic self-interest to be contained within reasonable limits and channeled in appropriate directions? Presumably, this is to be in part achieved by means of some mix of self-regulation and external regulation. However, this brings us to a second set of problems.

It is one of the principal tasks of those who design and oversee the market system, including governments and regulators, to ensure that the ultimate purposes of markets (and, therefore, market actors) are in fact achieved, i.e. to contain and channel the pursuit of economic self-interest. Perhaps there is a lack of clarity in the collective minds of governments and regulators in relation to their role in this regard. Politicians sometimes talk as if the market was an intrinsic good, i.e. good in itself and independently of its outcomes in terms of human material well-being. But on the view elaborated above, markets need to be conceived in purely instrumentalist terms; they are simply a means to an end (even if not for the market actors themselves). Moreover, if one looks, for example, at the objectives of many regulators one finds only limited aims, e.g. to reduce

crime and protect consumers, and procedural concerns, e.g. to promote competition and efficiency. There is little or no reference to what I have been referring to as the ultimate ends of markets, i.e. the outcome the invisible hand is supposed to bring about.

Further, there is the problem mentioned above of the ambiguous role of national governments and regulators when it comes to global markets, including global financial markets. National governments and their regulators are to some extent partisan, and seek to look after the economic interests of their own industries and businesses, including their financial service providers. Moreover, in the absence of a uniform set of global regulations and a single global regulator with real authority, regulators operating at a national level can be played off against one another by multi-national corporations.

In the case of the global financial sector, regulation and integrity assurance are ultimately in the hands of national governments. However, national governments – and their regulatory authorities – are not simply umpires, they are also players in the financial – and, more generally, corporate – ‘game’. For example, the UK government – and its financial regulator (the Financial Services Authority) - cannot be expected to regulate entirely impartially in the interests of ethical ends and principles, given the substantial interest the UK government has in ensuring that the UK corporate and financial sector retains and increases the benefits accruing to it from global financial markets.

A third set of problems confronting the establishment of an integrity system or systems for some market actors, perhaps especially corporations and financial service providers, pertains to the professions. Lawyers and accountants have roles to play in the integrity systems of corporations, including financial service providers. For, example, auditors conduct audits in order to determine financial propriety and performance, and

enable disclosure thereof to regulators and shareholders. However, in many cases auditors and auditing firms appear to have become themselves predominantly market actors. Their status as independent professional adjudicators of, for example, financial health, has been compromised. To this extent an important element in the integrity system for corporations has been weakened.

Perhaps there is a fourth problem pertaining to various specific unethical practices, such as insider trading and conflicts of interest; one that derives in part from the detachment of ultimate ethical purposes from the self-understanding of market actors, and from the regulation of market actors by governments and their regulatory agencies. The unethical practices in question are not mala in se; they are not bad in themselves.

Consider insider trading. Insider trading is not bad in itself as, for example, murder is bad in itself. Rather insider trading is only morally problematic in a particular institutional context. Now assume that one holds the view, putting it crudely, that markets exist only to further the self-interest of market actors, e.g. to maximize profit or return to shareholders. Why not, then, engage in some insider trading, given that it is in one's self-interest, i.e. it is not easily detected and, therefore, one can get away with it. It might be replied that one should not do so because one is breaking the rules, indeed the law. But unlike murder, insider trading is not morally wrong in itself. Compliance with the law is reinforced by strong moral sentiment, but equally compliance is reduced in the absence of strong moral sentiment. And so, if the practice is not bad in itself, the attitude may take hold; if one can get away with it, why not do it?

Perhaps fair competition is the ethical issue here? But competition in the corporate sector is inevitably unfair; appeals to fairness may (reasonably enough) carry little moral weight. Rather the substantive moral objection to insider trading is presumably that in the long run if enough people practice it, then it undercuts the ultimate, not simply the proximate, ends of the corporate sector. Without compliance with a set of rules or laws that promote competition, the market will not deliver the outcomes promised by the invisible hand. However, this ultimate purpose of markets is not in the forefront of market actors, preoccupied as they are, and need to be, with the proximate ends of generating profit or maximizing shareholder value. This is perhaps especially the case in the financial services sector. For this sector is arguably at two removes from the ultimate purposes of the market as a whole; in accordance with the invisible hand it seeks to provide finance to firms that in turn – and again in accordance with the invisible hand - generate the products actually required for the material well-being of the wider society. But if this ultimate purpose is lost sight of – in the self-understanding of market actors and in the policymaking of/regulation by governments and regulators – then perhaps insider trading is bound to be seen as much less weighty an ethical problem than in reality it is.

A fifth and final cluster of problems derives in part from the foregoing ones, and pertains to education, ethos and ideology. If the prevailing ethos or culture of an organization, and perhaps even ideology of central elements of a sector, downplays ethical considerations in favour of self-interest then it should hardly surprise when self-interest overrides compliance with ethical principles, even ones enshrined in the law. The point here is not that the majority of individuals themselves engage in corrupt or

unethical practices, but rather that in certain cultural or ideological contexts they may well refrain from reporting or otherwise preventing a minority from doing so. Many key elements of integrity systems such as ethics codes, codes of practice, education programs and the like, do not exist for the most part to directly prevent the minority of wrongdoers from doing wrong, but rather to ensure that the majority are intolerant of wrongdoing.