On Culture, Ethics and the Extending Perimeter of Financial Regulation

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ABSTRACT
The bourgeoning investigation into the manipulation of key financial benchmarks, such as the London Interbank Offered Rate (Libor), has seen the imposition of an escalating range of fines by regulatory and law enforcement agencies. While primarily focused in the United Kingdom and the United States, the misconduct spans the globe. It has also prompted the exit of a number of financial institutions from the setting of benchmark rates. This has posed a range of practical and conceptual problems, which apply at national, regional and global level. At a practical level, the credibility of the benchmarks, which are a public good, has been undermined, prompting an incremental but observable erosion of public confidence in market integrity. At a policy level, the investigation of collusion brings competition regulators into the arcane world of financial regulation. Their focus on breaking up cartels changes the dynamics, prompting a rapid expansion of the regulatory perimeter. It also facilitates a fundamental rethinking of capital market purpose. This chapter evaluates how the combination of regulatory and criminal investigation offers a time-limited opportunity to transcend the incremental and flawed nature of technical reform. It assesses the conceptual coherence of attempts, driven by the United Kingdom, but with significant support from both the Financial Stability Board and the International Monetary Fund, to create ‘fair and effective’ markets by articulating a new vision of ‘inclusive capitalism’ and whether this addresses the observed institutional corruption.

Every June the financial denizens of the City of London gather at the Mansion House to receive a statement of intention from the Chancellor of the Exchequer. For the sixth consecutive time, the Chancellor, George Osborne, returned in 2015. Electorally triumphant, his governing Conservative Party nonetheless faces a multiplicity of tactical and strategic questions on capital market governance. These focus less on technicalities but the more complex, contested and perennial issue of the role and function of finance in society, which has animated the regulation of capital markets since at least the New Deal (O’Brien 2014).

No longer dependent on the Liberal Democrats, which had done so much to instil into the debate a sense of the need to anchor finance more securely to a renewed social contract, the Chancellor, as with his party, wants to use the power of the City of London to drive an innovation agenda. Both he and it remains cognizant, however, that any lessening of regulatory oversight without evidence of meaningful change, risks rendering apart the already fragile bonds of trust. An increasingly shrill debate on the role of city in British society is made manifest, for example, by the machinations over the future domicile of HSBC (Donnellan 2015a). The bank
remains mired in scandal. It is reviewing not only its federated structure, which it accepts is no longer fit for purpose, but also whether to abandon the UK, in part because of increased regulatory costs and in part because of the uncertainty associated with a promised referendum on European Union membership. It is a fear shared by many in the city. A British exit would have profound implications for the dominance of the City in European finance (Donnellan 2015b).

George Osborne (2015) sought to untie the Gordian knot with the release of the Fair and Effective Market Review (2015). As a reformulation of a ‘social contract’, it is designed to reposition the City as a global marketplace that is informed by the institutionalization and internalization of restraint. It is both a laudable and longstanding goal (Kennedy 1934). The unresolved question is whether it will work?

Announced the previous year at the Mansion House (Osborne 2014), the final findings of the Fair and Effective Markets Review offer, if implemented in full and, crucially, if its underpinning normative purpose is accepted by industry, an opportunity to shift a deeply corrosive narrative.

For a country that has had more intensive examination than most of the causes and consequences of malfeasance and misfeasance, the United Kingdom’s decision to constitute the Fair and Effective Markets Review was in itself, on one level, perplexing. United Kingdom had already diagnosed incompetence and hubris in the management of major financial services institutions (FSA 2011); the limitations associated with short-termism (Kay 2012); the problems of regulatory capture (Treasury Select Committee 2012); and how to instil restraint (PCBS 2013). Why was it necessary to convene yet another inquiry? What would its purpose be? The answer to both questions lies in the wave of benchmark scandals that have engulfed the City of London.

These scandals include the corruption of the London Interbank Offered Rate (Libor), a daily calculation of what a panel of banks determines to be the hypothetical cost of borrowing in a range of currencies and timeframes. It is the most important number in finance (Talley and Strimling 2013). To date billions of dollars of fines have been collected, the majority of which have levied by the United States with an increasing component book by United Kingdom regulators (Financial Services Authority 2014a; 2014b; 2013a; 2013b). The malfeasance uncovered also includes systemic manipulation of the multi-trillion dollar Foreign Exchange (Forex) markets. The most important benchmark in this domain is the WM 4PM Fix, a calculation of paired
currency rates administered by a subsidiary of State Street in conjunction with Thomson Reuters.

Ever more stringent settlements related to Libor and FX manipulation have induced institutions that operate offshore subsidiary operations to plead guilty to corporate criminal misconduct (Department of Justice, 2014; 2013). Individuals also have begun to enter guilty pleas (Binham 2014), as have holding companies (Baer 2015). In many cases, reductions in financial penalty reductions are brokered in exchange for ongoing cooperation with regulatory and law enforcement agencies. Increasingly, sophisticated investigatory methods are being deployed. Very deliberately, the Department of Justice in the United States, for example, has signalled the ongoing deployment of undercover operatives inside financial institutions (Holder 2014).

The policy problem is that fine escalation and, as yet, haphazard application of criminal and civil sanctions, have proven insufficient to change conduct in demonstrable, warranted ways. From the implicated banks’ perspective, the financial penalties have been written off as part of the (albeit increasingly expensive) cost of doing business (the arrival of anti-trust regulators into financial markets, may, however, cause a re-evaluation of the cost-benefit analysis, see Baer 2015; O’Brien and Nicholls 2014). Notwithstanding the apparent insouciance of market sentiment, the result has profound practical and theoretical implications. It undermines, if not decisively then certainly damagingly, vaunted theoretical and practical reliance on the restraining power of market forces. This supposed more effective remedy than direct intervention has been largely missing-in-action.

Understandably, the public remains angry. For a trade-off to be acceptable, there needs to be demonstrable change and this was precisely what George Osborne offered at the Mansion House in June 2015. Government, he argued, was ready and willing to exit ownership of the woefully-run Royal Bank of Scotland (RBS), and bank baiting was to end in favour of a dialogue designed to make London the destination of choice for global banking. The ‘ratcheting up ever-larger fines’ was neither sustainable nor, in policy terms, a ‘long-term answer’ (Osborne 2015). In return, he asked for, indeed demanded a sea-change in behaviour, a task fleshed out by the Governor of the Bank of England at the same conference (Carney 2015). For banking, it is an exquisite but dangerous choice. As the banking editor of the Financial Times put it ‘a new era of finance feels within reach (Jenkins 2015)’. The devil, however, will be in the detail.

This chapter explores how the combination of regulatory and criminal investigation
offers a time-limited opportunity to transcend the incremental and flawed nature of technical reform. It assesses the conceptual coherence of attempts, driven by the United Kingdom, but with significant support from both the Financial Stability Board and the International Monetary Fund, to create ‘fair and effective’ markets by articulating a new vision of ‘inclusive capitalism’. It aims to generate ‘fair and effective’ markets by transcending an emphasis on narrow economic efficiency and articulating, and holding repeat players accountable to, a new vision of ‘inclusive capitalism’ (Carney 2014). The chapter evaluates the theoretical mechanisms being deployed and how they could be further enhanced, particularly in conjunction with enhanced contractual terms in the use of the deferred prosecution mechanism.

**BENCHMARKS AND THE CORRUPTION OF INTEGRITY**

The problem of manipulation of financial benchmarks can be unpacked at three distinct levels. Each provides deleterious feedback loops to the others. First, at the level of the firm, the capacity to monitor conduct is low. The extraordinary testimony provided by senior bankers at RBS to the British Parliamentary Commission on Banking Standards (2013) is talismanic in this regard. It demonstrated the weakness of risk management systems. It also left little doubt of the pernicious effects on market integrity of the tacit toleration of moral rule breaking within discrete organizational cultures. Following a standard script, the RBS executives said that they were, in turn, shocked at the crookedness involved in the manipulation of Libor, dismayed at the lack of moral restraint, and keen to differentiate between ethical bankers and amoral traders. If the bankers, ostensibly in control, were guilty of anything it was, according to the then head of investment banking, John Hourican, ‘excessive trust’ (Ebrahimi and Wilson 2013). As the RBS executives conceived the issue, benchmark manipulation was not a core concern, given the fact that ‘we [presumably meaning the board and senior executives] had to deal with an existential threat to the bank’. Instead of dealing with misaligned incentives, the bank (by inference including Hourican) had exhibited ‘blind faith’ in the actions of its traders. It was a message repeated by the then chief executive, Stephen Hester. The scale of the abuse was, Hestor intoned, ‘too readily redolent of a selfish and self-serving culture in banking which I think needs to be addressed and is exactly the reason for this commission’s existence’. Such lofty rhetoric is hard to reconcile with the involvement of RBS traders in FX manipulation after the Libor settlement! Remedial
action to bring activity inside the regulatory perimeter through technical measures alone does little to address such an ethical (and potentially criminally-negligent) deficit.

At the second level, that of the market as a whole, the manipulation of financial benchmarks threatens a narrative that focuses on the problem of ‘bad apples’ rather than a manifestation of a corrupted culture (see Wheeler, this volume). The discovery that capital markets have been rigged, with none of the restraining forces of a Nevada casino, raises profound legitimacy questions. The Nevada Gaming Control Board (2012, 5), for example, can find a casino liable for ‘failure to conduct gaming operations in accordance with proper standards of custom, decorum and decency, or permit any type of conduct in the gaming establishment which reflects or tends to reflect on the repute of the State of Nevada and act as a detriment to the gaming industry’. Such commitment to probity, by both regulators and regulated alike, has been sadly missing in financial regulation.

If the response of banking is restricted to it viewing financial penalties as the price of doing business, then demands for regime change are unlikely to gain traction. Notwithstanding the declamations of senior banking executives that the misconduct could not, and should not be condoned, reform is unsustainable without a reconceptualisation by them (under regulatory guidance) of market or regulatory purpose. Necessarily, this must link duties and responsibilities with the rights associated with the licensing regime. Critically, international coordination is essential to prevent arbitrage and a reduction in regulatory effectiveness at national level, given the reality of global capital and national regulation, ongoing threats of capital flight, and variable capacities of regulatory agencies to influence political outcomes.

This brings us to the third level, the interaction between the regulatory and political domains: the failure of either presents ongoing legitimacy problems. It is particularly telling, for example, that the efficacy of the ‘Approved Person’ regime did not and does not bear scrutiny. The regime was, for example, dismissed by the Parliamentary Commission on Banking Standards (2013, vol 2, para 584) as a Potemkin façade, providing ‘a largely illusory impression of regulatory control over individuals, while meaningful responsibilities were not in practice attributed to anyone’. In an exceptionally critical assessment of prior regulatory design, compliance was dismissed as a key architectural innovation that gives ‘the appearance of effective control and oversight without the reality’ (para 566). The fact that ‘prolonged and
blatant misconduct’ as evidenced in the Libor and associated scandals occurred without comment, suggested to the Commission that systemic institutional corruption was present. It was institutional in that the benchmark serves a public good by providing a reference rate on which to price derivatives. The remarkable thing is that this appears to have not entered the heads of either regulator or regulated, notwithstanding the corruption risk.

The ‘dismal’ and ‘striking limitation on the sense of personal responsibility and accountability’ of banking leaders, the Parliamentary Commission concluded in its final summary report (2013 vol 1, 11), meant that incremental change ‘will no longer suffice’. Changing banking for good, however, requires not only regulatory recalibration. It also necessitates the corporate and political will to transcend a bifurcation between state and market that informs and shapes discourse in profound ways. Changing this will not be easy. It is a deeply ingrained worldview informed by the considerations and interests of haute finance (Polyani 1944, 10). The fact that RBS traders could continue to engage in misconduct in relation to Libor long after being bailed out by the British state is symptomatic of a malaise in which responsibility evaporates in the face of transaction opportunities. Within this rubric, domestic politics risks subservience to the needs and interests of actors with loyalties to neither long-term domestic economic development nor specific societal needs, hence the deeply problematic bargaining over HSBC’s domicile.

The sustainability of haute finance models depends on the strength of the eco-system that underpins it and conditions practice within it. While economic activity is buoyant, it is difficult if not impossible to dislodge ingrained worldviews. Substantive change in the standard of what is considered permissible or acceptable requires an existential crisis, which is what precisely the benchmark manipulation has occasioned. What we have witnessed is the vindication of Susan Strange’s caustic analysis that ‘casino capitalism’ (Strange 1986) had degenerated into psychosis (Strange 1998).

The need for a reconceptualisation of regulatory and political purpose now informs the thinking of the IMF. Characterizing the power of major financial institutions as malign, ‘this kind of capitalism was more extractive than inclusive’, warned Christine Lagarde (2014) the organization’s managing director. ‘The size and complexity of the megabanks meant that, in some ways, they could hold policymakers to ransom’, she added before concluding ‘thankfully, the crisis has prompted a major course
correction—with the understanding that the true role of the financial sector is to serve, not to rule, the economy’. The reason for such international concern is clear. If, through accident or design, the system has become corrupted, then there needs to be a long-term solution.

Ongoing contestation over what caused the crisis, degree of responsibility – and over what constitutes or should constitute the balance between rights and duties in the creation and maintenance of market integrity – reflects changing power relations within the bounded community of practice or ‘structured action field’ constituting financial regulation (Fligstein and Dauter 2007). This field delineates the range of ‘rational’ and, therefore, acceptable responses. It is informed by embedded norms. In summary, to understand the dynamics of global finance, one has to look at the underlying basis of belief. This is informed by what the influential French sociologist Pierre Bourdieu (1990, 28) has termed the ‘logic of practice’, practice that accepted ethical myopia. At the same time, it is also clear that the benchmark scandals offer the most contingent opportunity faced by regulators in a generation to challenge this. Precisely because the misconduct has been endemic and systemic, occurred after state intervention to protect misguided executives, and destroyed corporate, political and regulatory reputations alike, it has profoundly destabilizing implications. The unresolved question is whether each or all have the ambition, drive and skill to use the contingent moment to deliver truly transformative outcomes. The critical move, and one explicitly mentioned by the FEMR final report (HM Treasury et al 2015), is the entry of anti-trust regulators, with capacity to impose financial penalties that dwarf those inflated sums that worry George Osborne.

**CARTELS: THE CHANGED RATIONALE FOR INTERVENTION**

The core innovation is to use competition priorities to reconnect financial institutions to the societies in which they function. Unanchored since the rise of haute finance, the strategy represents a potentially fundamental shift in power within financial regulation at both national and international level. It is indicative, for example, that the final report of the Fair and Effective Markets Review (HM Treasury et al 2015) explicitly draws the attention of financial institutions, as well as their traders, to the need to be more than aware of anti-competitive penalties.

Three immediate paradoxes come to mind. The agenda for change focuses on the City of London itself. The driving force is the Bank of England, which is led by Mark
Carney, a former Goldman Sachs banker. His agenda has the active support of the FSB, which he chairs, and the IMF, the managing director of which is a former Baker & MacKenzie partner, Christine Lagarde. Thirdly, in the United Kingdom, the fulcrum of misconduct and an important site for the framing of an alternative conception of purpose, a Conservative Party government is sanctioning what can only be described as a more invasive (if delayed) corporate governance agenda. In his Mansion House speech in June 2014, for example, Osborne gave approval to the Bank of England, Treasury and the Financial Conduct Authority (FCA) to scope out an agenda for change. Although designed to be consistent with international reform imperatives, the symbiosis is obvious. Given the critical role played by both Carney and the head of the FCA, Martin Wheatley, in facilitating, and through leadership positions shaping, international discourse, imperatives fuse seamlessly. A year later, in conceptual terms at least, the job is complete.
The terms of reference, as envisaged by both Carney and Wheatley and allies within the IMF and FSB, combine three elements. Structural reform is accompanied by a broadening of the regulatory perimeter. This is achieved through legislative reform, including substantially increased civil and criminal penalties. Critically, the purposive dimension of structural and legislative change is rendered explicit, with a normative repositioning of the purpose of capital markets and their role in society, issues which had been comprehensively signalled in the consultation phase (Shafik 2014; Carney 2015). Finally, the stated ambition of the G20 to use capital markets as a force for driving growth in the real economy potentially has locked in political support. Admittedly, all this could result, yet again, in the elevation of the symbolic over the substantive, a dismal reality all too familiar to students of regulatory politics (Edelman 1960; O’Brien 2003; 2007; 2009; 2014). The cost of inaction, or of the privileging of the symbolic over the substantive, has, however, never been higher, as politicians and regulators alike have acknowledged.
The simplicity of the financial benchmark scandals, and the pivotal role that the institutional doyens of the City of London played in facilitating them by not addressing conduct risk, have created a litigation tsunami on both sides of the Atlantic and beyond. It has spawned multiple investigations and brought competition regulators, with their focus on breaking up cartels, into an increasingly crowded litigation marketplace. The deeper the investigation goes into questionable practices, the more problematic the situation becomes, not least because the Competition
Directorate of the European Commission, the bugbear of the Conservative right in Britain, has extracted an admission from implicated banks in a Euro 1.7 billion settlement that they permitted a cartel to operate, through their failures of risk management. The outgoing European Competition Commissioner, Joaquin Almunia (2014) highlighted that proceedings continue against those banks that had refused to settle. The European Commission probe has been augmented by one in New Zealand, where the Trade Commission has formally launched an investigation into financial benchmark manipulation following receipt of a leniency application. The belief that Libor and associated benchmark corruption derives from the existence of a cartel, albeit through default, also informs the IOSCO agenda.

The drip feed of revelations over the course of the past year that traders in the multi-trillion dollar Forex markets were routinely exchanging information in chat rooms given monikers such as ‘the pirates’ and ‘the cartel’ is exceptionally problematic in this regard (Baer 2015). It calls into question the efficacy of the entire reform agenda, a point underscored by the FSB, of which IOSCO is a core component. In a report released in 2014 on identified problems in the Forex market, the FSB noted:

> at a minimum, this market structure creates optics of dealers ‘trading ahead’ of the fix even where the activity is essentially under instruction from clients. Worse, it can create an opportunity and an incentive for dealers to try to influence the exchange rate – allegedly including by collusion or otherwise inappropriate sharing of information – to try to ensure that the market price at the fix generates a rate which ensures a profit from the fix trading. That is, it is the incentive and opportunity for improper trading behaviour of market participants around the fix, more than the methodology for computing the fix (although the two interact), which could lead to potential adverse outcomes for clients (FSB 2014, 2).

The Federal Reserve Bank of New York, led by former Goldman Sachs partner William Dudley, expressed considerable unease at the failure of industry to shift cultural norms. In a speech at New York University, Dudley (2014) bemoaned what was uncovered in the initial Libor investigations (and which could equally apply to the broader Forex probe).

The questionable behavioral norms in the industry—along with the weak control environments and compliance processes—that were uncovered during the investigations, exacerbated and facilitated the misalignment of incentives that are specific to LIBOR. It is a sad state of affairs if unethical behavior is socialized among new traders with the explanation that this is business as usual, and, if compliance and risk management are inadequate as a counterweight to prevent or identify wrongdoing. It is untenable if
people working in compliance and risk are treated as second-class citizens relative to the firms’ revenue generators.

In describing these practices as untenable, the New York Fed president consciously, if obliquely, references the concerns expressed by Christine Lagarde, who noted that the scandals ‘violate the most basic ethical norms…To restore trust, we need a shift toward greater integrity and accountability. We need a stronger and systematic ethical dimension’. It would be easy, but erroneous, to dismiss these concerns as mere handwringing or window-dressing.

While the United States can provide the enforcement muscle, and the IMF gravitas, it is in the United Kingdom where the most concentrated work has been conducted, in part because of its reputational damage. In his address to the Mansion House, George Osborne (2014) noted the alignment of corporate, regulatory and political interests:

Britain was the undisputed centre of the global financial system. But all this can so easily be put at risk. By badly conceived EU rules that only reinforce the case for reform in Europe. By populist proposals for self-defeating bonus taxes and punitive income tax rates…We should be candid tonight about another risk. The risk that scandals on our trading floors calls into question the integrity of our financial markets. People should know that when they trade in London, whether in commodities or currencies or fixed income instruments, that they are trading in markets that are fair and effective.

The emphasis on ‘fair and effective’ markets, which draws heavily from Carney’s speech at the same venue the previous month, represents a potential sea change in how the UK Government sees the rationale for regulatory intervention. The reasons for resolute action (and the curtailment of options) were spelled out even before the extent of the malaise became apparent. In a cutting warning the Parliamentary Commission on Banking Standards (2013, para. 273) noted

if the arguments for complacency and inaction are heeded now, when the crisis in banking standards has been laid bare, they are yet more certain to be heeded when memories have faded. If politicians allow the necessary reforms to fall at one of the first hurdles, then the next crisis in banking standards and culture may come sooner, and be more severe.

The unresolved question is to what extent the underpinning regulatory philosophy proposed is both coherent and cohesive. The following section outlines the rationale, coherence and implications of this repositioning in a domestic and international context and evaluates whether it can in fact facilitate the restraining of haute finance.
THE CONCEPTUAL FOUNDATIONS OF INCLUSIVE CAPITALISM

Even before Carney’s elevation to the Governorship of the Bank of England, he had set out the need for the finance sector to determine value beyond narrow definitions of economic efficiency. A realist, Carney (2013) accepted that ‘virtue cannot be regulated. Even the strongest supervision cannot guarantee good conduct. Essential will be the re-discovery of core values, and ultimately this is a question of individual responsibility’. It was an exhortation that has long informed regulatory policy in the capital markets. In fact it goes back to the very first public address by the first chairman of the Securities and Exchange Commission in the United States, Joseph Kennedy (1934):

[The SEC’s aim is to] recreate, rebuild, restore confidence. Confidence is an outgrowth of character. We believe that character exists strongly in the financial world, so we do not have to compel virtue; we seek to prevent vice. Our whole formula is to bar wrongdoers from operating under the aegis of those who feel a sense of ethical responsibility. We are eager to see finance as self-contained as it deserves to be when ruled by Honor and Responsibility... But you best can help yourselves. You can make the investing of money honest. Then you will truly become your brother’s keeper. And to me that is to acquire merit.

The problem faced by Kennedy in the 1930s is similar to that facing his successors. Industry has consistently engaged in bad faith. Stated intention has not been matched by warranted action. An egregious example of this mis-match can be found at the Mansion House in 2010 when, just prior to a major conference on values and trust, leaders of British-domiciled financial institutions made a remarkable pledge. Organized by the then chairman of Barclays, Marcus Agius, the pledge was designed to demonstrate commitment to change. Given the wave of scandals that subsequently crashed ashore, including most notably Barclays’ own ensnarement in the Libor manipulation, that pledge and the commitments given by Marcus Agius and his counterparts are worth recalling in detail.

In the run-up to the recent crisis it must have seemed to the public at large that for many financial institutions the only arbiters of economic action were law and profit. If these were indeed the only arbiters of action, then there can be no lasting or effective response to what went before without the development and inculcation of a different and more enlightened culture; regulatory and fiscal actions alone will not suffice….There is, of course, a necessary distinction between the duties owed by traders to their counterparties and the duties owed by investment advisers to their clients. But in the end both should not be bound only by the requirements of law to engage in profitable business in the
service of their shareholders, but also be motivated by, and subject to, a larger social and moral purpose which governs and limits how they behave…Law and regulation are there to protect people. But of themselves they cannot create or sustain the imperatives that motivate financial institutions and those who work in them. That can only come from the culture of organizations, and what they see themselves as existing to do, and how they ensure this culture is promoted and strengthened. In all this, it is essential to restate and affirm the social purpose of financial institutions as well as affirming the personal vocation of those who work in the industry… Ultimately, it is the responsibility of the leaders of financial institutions – not their regulators, shareholders or other stakeholders – to create, oversee and imbue their organizations with an enlightened culture based on professionalism and integrity. As leaders of financial institutions we recognize and accept this personal responsibility.

The public commitment to change advanced in the Mansion House in 2010 was broadly welcomed, not least by the then regulator, the Financial Services Authority. Its then chief executive, Hector Sants (2010), argued ‘it is crucial that we improve behaviors and judgments. To do this we must address the role that culture and ethics play in shaping these. I believe that until this issue is addressed we will not be able to prevent another crisis of this magnitude from occurring again, and will never fully restore the trust of society in the financial system’. Sants then made clear, however, that unless this was done voluntarily, regulators had a duty to intervene. What is equally apparent in recent history is that stated improvements by industry, while laudable, are in themselves insufficient drivers for change. They run the risk of privileging cliché over substance, not least because of a failure to warrant change across potentially incommensurate risk management programs.

The contours of the changed approach were sketched out in a pivotal speech in 2014 on ‘inclusive capitalism’, given again, not surprisingly, at the Mansion House. Mark Carney set out an ambitious, if still vague agenda for renegotiation of the social contract linking the finance industry to broader society. Using ‘fair and effective’ as an organizing framework, he argued the industry faced an existential choice. What gave particular theoretical strength to the speech was its emphasis on how the economically rational was itself a political construct, a throwback to a canon of political economy jettisoned in favour of ideological posturing.

All ideologies are prone to extremes. Capitalism loses its sense of moderation when the belief in the power of the market enters the realm of faith. In the decades prior to the crisis, such radicalism came to dominate economic ideas and became a pattern of social behaviour…. Market fundamentalism – in the form of light-touch regulation, the belief
that bubbles cannot be identified and that markets always clear – contributed directly to the financial crisis and the associated erosion of social capital (Carney 2014).

Critically, Carney suggested that the inculcation and the living through practice of broader sets of values must accompany. These, he argued, must subjugate individual rights to the needs of the collective, if only to ensure that societal needs are protected. (A belief system that, it will be recalled, informed the unsubstantiated commitments given in 2010 by industry itself.) For Carney, as an institution, the Bank of England has a pivotal role to play in this reordering. As the primary regulator, it could no longer stand aside, wedded to falsified theoretical assumptions that were informed by ideational rather than rational belief. In a clear throwback to the exhortation by Kennedy (1934) to the business community in Boston, he declared that the function of the market is to develop the economy through the internalisation of professional obligation. Similar philosophical reasoning informed Christine Lagarde’s new-found prioritisation of normative issues. ‘By making capitalism more inclusive, we make capitalism more effective, and possibly more sustainable. But if inclusive capitalism is not an oxymoron, it is not intuitive either, and it is more of a constant quest than a definitive destination’ (Lagarde 2014).

The agenda, as articulated in the Mansion House in June 2015, is the re-negotiation of the social contract (Carney 2015). Implementation requires some delegation of authority. The navigational pilot for this journey is Martin Wheatley, the combative chief of the Financial Conduct Authority. From the initial investigation into the corruption of Libor, to the management of a still burgeoning review of problems within the FX markets, Wheatley has become one of the most influential market conduct regulators globally. For Wheatley, the malaise reflects both a lack of regulatory jurisdictional power and a failure of the banks to self-regulate. In recent speeches and interviews (eg Wheatley 2014), he has reflected growing frustration with an industry that appears not to see that its own self-interest lies in demonstrating commitment to its stated intention. For Wheatley, progress demands more activist strategies, not mere nudging. There has, therefore, been a discernible hardening of position. In a speech just before the announcement of his elevation to the Fair and Effective Markets Review Panel, for example, he set out his stall. Both industry and regulators, he argued, were ‘navigating make or break debates around the social utility of some of our biggest firms, as well as witnessing sweeping changes in technology, demographics, public attitudes, and so on and so forth. So, in a very real
sense, the decisions and directions we take today are likely to reverberate for many years to come’ (Wheatley 2014).

Together these transatlantic regulatory leaders have signalled a rapid and significant expansion of the form and purpose of oversight powers first introduced to deal with the Libor scandal. This is now, as a consequence of George Osborne’s Mansion House address in June 2015, settled government policy. As such, the opportunity for change has been linked directly to the political cycle. As with the articulation of the securities model of oversight first championed in the New Deal, there is a thorough grounding in ethical reasoning; namely it cannot reasonably be objected to; it is both optimum, and, universally willable. In essence, the policy is fusing the philosophical and practical imperatives identified by Derek Parfit (2007) – Kant’s categorical imperative and Bentham’s utilitarian ethics – in the context of an audacious experiment to transform haute finance. There is, of course, a degree of narrow British national self-interest in this regard but, as that most astute of political advisors once noted, the end justifies the means only in pursuit of a noble objective (Machiavelli 2003). Self-interest can, after all, deliver optimum outcomes if tied to societal commitment.

THE EXPANDING REGULATORY PERIMETER
The United Kingdom is wary of an expansion of European regulation, an issue directly referred to the Chancellor of the Exchequer at the Mansion House in June 2014 and again the following year. The European Commission has already announced planned legislation to formally regulate all benchmarks. Putting in place a formal mechanism to regulate a narrower range of systemically important benchmarks, can demonstrate first-mover advantage. It may also have the effect of minimizing the disruption to the market caused by the competition regulation agenda, which is focused on breaking up rather than managing cartels, and has resulted in a number of cases in the financial services sector.

Wheatley and his colleagues have positioned themselves carefully, referencing back to domestic political commitments. The consultation documents, for example (FEMR 2014, 6) noted that ‘credibility…can be undermined if the benchmark can be distorted, either by accidental errors in its compilation or calculation, through the exposure of participants to conflicts of interest or incentives to manipulate the benchmark, or through abuse of a dominant competitive position in the compilation of
a benchmark’. Those conclusions base the case for intervention on three main criteria: scale, jurisdictional power, and transactions not covered comprehensively by existing market abuse regulation. They reflect a changed worldview in which trust in reputational capital is unquestionably, and, understandably, operating at a steep discount. It has the added advantage of changing the cost-benefit calculus, precisely because fairness and effectiveness now displace an emphasis on economic efficiency. It is equally clever to link progress on implementation to international oversight. While the framework is sound, operational questions remain on the efficacy of external oversight of managerial imperatives, not least because of a lack of research capability in IOSCO itself. The IOSCO review into the WM 4PM Fix for forex, for example, was at best cursory. The veracity of WM’s responses was not checked other than against the policy and working documents that WM itself supplied voluntarily and at the Review Team’s request. The Review Team did not observe directly the practices that WM asserted that it followed. Moreover, IOSCO acknowledges ‘a key part of this report is the description of the status of any plans for WM to fully implement (or to ensure a greater degree of implementation of) the Principles. The report does not assess these plans; it simply describes them’ (IOSCO 2014, 7). This, in turn, suggests that reform will require much more granulated conception of what constitutes responsibility for upholding the public good of benchmarks.

In summary, three distinct agendas are being followed in relation to enforcement in both the United Kingdom and the United States, by far the most important actors in this space. The first focuses on ex post enforcement. The second on ex ante structural change to the nature of specific benchmarks, with particular emphasis on governance, data quality and benchmark construction methodology, and internal controls and accountability. Thirdly, there is a renewed focus on the broader question of culture and normative change. These three agendas are integrative rather than distinct. Critically, they reflect a growing sophistication in both litigation and settlement negotiations. This framing suggests that it is insufficient to rely on stated commitments to change, such as those outlined in the failed industry pledge articulated at the Mansion House in 2010. It appears that mandating corporate governance reform and ensuring evaluation through verifiable performance indicators, as part of settlement negotiations, offers the most sustainable approach to benchmark integrity. It does so because industry has failed to demonstrate its good faith.
Faced with existential questions, it is futile to remain wedded to falsified assumptions. The efficacy of the deferred prosecution mechanism depends crucially on the strength of the contractual terms. If drawn too weakly, they risk privileging what has been termed the ‘façade of enforcement’. The ongoing nature of the investigations offers a contingent moment to lever public outrage in order to achieve the overdue falsification of a deeply embedded worldview. Nowhere has this changed state of affairs been more comprehensively signalled than in London and New York. As William Dudley (2014) has acidly pointed out, ‘it is time to get on with it’.

In line with its consultation document, the final report of the UK’s Fair and Effective Markets Review (FEMR) seeks to develop a global code (or codes) of conduct for Fixed Income Commodity and Currency Markets (FICC), which are ‘written by the market in terms that market participants understand’ (HM Treasury 2015, X). The headlines are: ‘bringing trading in certain FICC markets more fully into the scope of regulation; further steps to strengthen the translation of firm-level standards into more effective control and incentive structures; stronger tools for ensuring that firms’ hiring and promotion decisions take due account of conduct; greater use of electronic surveillance tools by firms; and stronger penalties for staff breaching internal guidelines’ (ibid). Taken together, these moves could add up to the biggest change in financial regulation since the emergence of the disclosure paradigm in the United States in the 1930s. This time, industry’s stated commitment to upholding market integrity is not taken at face value.

None of this is to suggest that the most appropriate response is coercion. Self-regulation is the most effective restraint as long as it is internalized and warranted. Indeed, the FEMR is explicit on this point, offering to provide guidance in the event that it feels that industry commitments have sufficient granularity to be effective and to be deserving of public trust. The collective action problem is minimized if there are sufficient moves by industry itself to police itself, precisely because it has the capacity to have global application. Moreover, the establishment of registers, the creation of early-warning systems within the industry, and effective communication channels to regulators, could stave off problems and disseminate best-practice models, thus generating the dynamic for an upward trajectory in risk management and corporate governance rather than a race to the bottom. At the same time, given the failure of deferred prosecutions to effect the kind of behavioural change expected, it is incumbent on prosecutors and regulatory authorities to significantly strengthen the
contractual terms. Failure to do so would result in an incremental but decisive loss of authority, precisely because it would privilege the erection of a symbolic façade. In such circumstances the triumphant return of Osborne to the Mansion House will be a pyrrhic one.

CONCLUSION
Any successful proposal to extend responsibility and accountability – rather than clarifying the enabling conditions governing – constitutes a major shift in the structure of the financial services industry. The integration of more interventionist normative objectives with enabling ones may also significantly change the ethical boundaries of global finance. It is this possibility that animates the reconceptualisation of regulatory purpose that informs the ‘inclusive capitalism’ agenda.

Rebuilding and restoring trust animates the Fair and Efficient Markets thesis. The emphasis on ‘fair and effective’ markets represents a significant advance precisely because it implies the dynamic integration of rules, principles and social norms within an interlocking responsive framework. As John Kay (2012, 9) has persuasively argued, sustainable reform must be predicated on capability to ‘restore relationships of trust and confidence in the investment chain, underpinned by the application of fiduciary standards of care by all those who manage or advise on the investments of others’. This is particularly the case in the Libor and FX domains, precisely because price setting on verifiable and uncorrupted benchmarks is an undoubted public good, which, to be protected, requires honest cultures. As we have seen, within the capital markets context, efficiency is predominantly privileged. Ostensible improvements, measured largely through short-term financial performance, provided a proxy for societal progress and, as a consequence, political legitimacy.

Ineffective or inefficient markets do not necessarily result in a crisis of legitimacy. Past inefficiencies can be – and often are – redressed by the passage of further ostensibly more stringent rules, expansion of regulatory perimeters or more granular articulation of overarching principles. This dynamic is particularly apparent in corporate governance and financial regulation reform, where these initiatives are often presented as evidence of increased accountability. More often that not, however, these same initiatives tend to privilege the politics of symbolism. This is no longer sustainable, as Mark Carney and Martin Wheatley, Christine Lagarde and William
Dudley have ably demonstrated. Whether they have the capacity to translate theory into practice is another matter entirely.

Change requires industry to commit to solving its own collective action problem by creating verifiable enforcement protocols. It also necessitates much more invasive oversight, time-limited through the application of deferred prosecutions mechanism which, if violated, trigger at least partial license revocation. Unless this occurs, the problem of too big to fail, too big to jail and too big to regulate once more moves centre stage.

The coming year offers an unprecedented opportunity to reshape discourse and practice, rather than remaining wedded to outmoded assumptions that have been falsified. The critical innovation associated with the ‘inclusive capitalism’ agenda is the invitation by regulators to industry to verify its stated commitment. It is not designed to be coercive but failure will, necessarily and justifiably, have coercive implications.

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