

# Bad Apples or Bad Bushel? Ethics, Efficiency and Capital Market Integrity

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## **Introduction**

Popular interpretation of the recent financial scandals describes the individuals and firms charged with wrongdoing as 'bad apples' while retaining a sanguine view of the capital markets overall. The system-wide reach of the revealed malfeasance, however, suggests that the root cause of the scandals resides instead in the capital markets' institutional norms. Specifically, we argue that norms have developed that promulgate the self-enrichment of the intermediaries who facilitate capital transactions at the expense of the principal parties to the transactions. This not only represents an ethical breakdown of the system, but also implies a simultaneous loss of efficiency, since professional integrity is the fundamental value proposition of financial intermediaries.

To set the stage, we establish the holistic and systematic interdependence of the capital markets and clarify the broad roles they require. As increasing numbers of business scandals are brought to light, it becomes ever clearer that the 'problem' facing the capital markets is pervasive throughout financial intermediaries, shifting the relevant questions from ones of how to deal with the few 'bad apples' to questions about the 'bushel' that contains them. The *widespread* and *systematically interconnected* nature of these ethical lapses threatens the markets in a fundamental way.

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Viewed as a single system, the capital markets have an intended purpose of allocating capital in an efficient manner. Much of the recent discussion of reforms has centered on what should be done to restore integrity to the capital markets. Although ‘integrity’ is commonly associated with ethical concerns rather than efficiency ones, we submit that a loss of integrity threatens the ability for the capital markets to achieve their intended purpose, exposing them to the danger of falling apart or becoming obsolete. Setting aside the disruptive impact on society, a complete breakdown of the capital markets is hardly efficient in the long-term for the system or its participants, and as a result, we argue that the same reforms that would restore the system’s integrity will also forestall its demise and enhance its efficiency. Stated differently, without widespread belief that capital market intermediaries are executing their roles in a way that is fair and authentic toward *both* parties to the transaction, they have no value whatsoever to at least one of the parties, and the intermediaries have thus lost their *raison d’etre*. This suggests that the most valuable asset of a financial services institution is neither cash nor the acumen of its professionals, but its integrity.

With a high degree of overlap between the reforms that capital markets should adopt for ethical reasons and those they should adopt for efficiency reasons, it seems plausible to rely on industry self-regulation for enacting reforms. Given the system-wide perspective we advocate, however, we find current approaches to self-regulation to reflect the myopia of an isolationist ‘silo mentality’ within sub-sectors of the financial industry. Sub-sector self-regulation is likely to focus on issues that are isolated in one area rather than issues that spread across multiple sub-sectors. Because of the inherent interconnectedness of the financial services industry overall, such efforts will be wasteful if they address these micro problems rather than macro ones. We argue that this silo mentality is at least partially responsible for some of the perverse incentives that have contributed to the widely reported system abuses.

Finally, proposed and enacted reforms to date—such as the Sarbanes-Oxley Act of 2002—have placed considerable emphasis on increased disclosure and transparency. We find that this approach, though motivated by good intentions, is incapable of producing its desired outcome, from the perspectives of either efficiency or ethics, and may in fact exacerbate the problems it is intended to address. Rather than fixing the underlying ‘cracks in the system,’ the logic of increased disclosure suggests that the system can

automatically fix itself simply because it has more information. Not only is this logic dubious, but also its effectiveness is contradicted by empirical and experimental evidence.

In conducting our analysis, our intent is not to levy unwarranted criticism toward the firms and sectors that play intermediary roles in the capital markets. Rather, it is precisely the opposite. We are motivated by an interest in the restoration of a level of integrity to these intermediaries that is required for them to perform their vital role in a capitalist society. We believe that the perspective we argue for here is necessary in order to bring about the changes that will allow the system to persist.

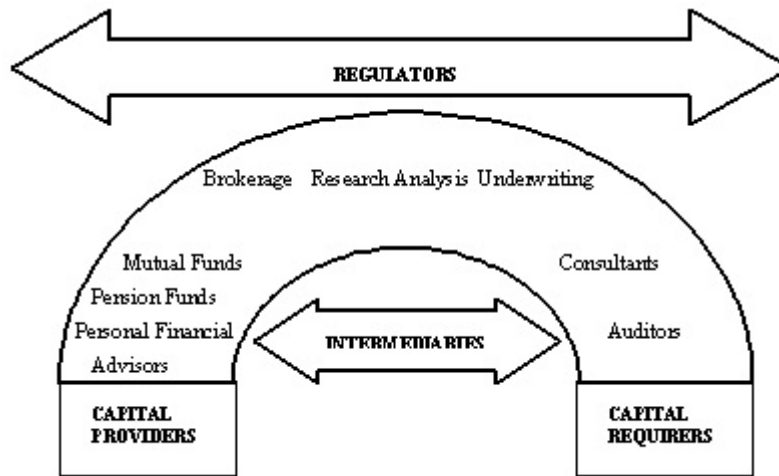
One implication of our analysis is that it is necessary to reconsider the common approach of treating corporate ethics as a separate or ancillary topic from corporate efficiency, typified by the separation of the topics within most business school curricula, and the limited presence of each in the research streams of the other. It might also be illustrated by the targeted nature of legislative action; for example, the Sarbanes-Oxley Act that introduced reforms for the financial services industry in 2002 is an example of legislation designed primarily with ethical considerations in mind.

#### **Capital Markets as a Single System**

Capital markets involve a vast number of participants with various roles that include shareholders, dealmakers, institutional mechanisms, entrepreneurs, financiers, and corporate entities. Despite the many layers of complexity, regulation, and commerce embodied by the financial system, at its core it is simply an enabler of capital transactions. The primary goal of the system is to efficiently connect capital providers with those in need of the capital. In a very broad sense, there are four categories of participants in the financial system. At one end of the spectrum are business ventures that require the provision of outside capital in order to sustain and grow their operations. At the other end are capital providers: individuals and groups who are looking to invest a portion of their assets in business opportunities managed by others. In between, there are a variety of intermediary roles that bring together capital providers with capital requirers and facilitate the capital transactions between them. Actors performing these intermediary roles include mutual funds, investment banks, public accountants, and related professional organizations. Finally, institutions also facilitate capital transactions by establishing appropriate rules and standards of conduct for system participants. Such institutions include government agencies (e.g.,

Securities and Exchange Commission), organized exchanges (e.g., NASDAQ), and professional associations (e.g., American Institute of Certified Public Accountants). A certain type of intermediary generally performs the same type of role for a large number of transactions, contributing some piece to the system that connects providers and requirers of capital. We depict a collection of these different functions in Figure 1. It is interesting to note that the three roles occupying the center of the chain—underwriting, research analysis, and brokerage—are often performed within a single investment banking organization. This is one example of an area where conflict of interest issues have been identified, resulting in both heightened publicity and subsequent reform efforts. As we will show, however, virtually no sector of the financial system remains unspotted from lapses of integrity.

**Figure 1. Schematic of Capital Markets**



It is useful from the outset, however, to conceptualize how the capital markets are *intended* to function, supposing that the system were operating in both a wholly ethical and perfectly efficient way. One of our central arguments is that with respect to the capital markets, these two principles—ethics and efficiency—are aligned, an idea supported by the very purpose (and value proposition) of the market intermediaries themselves. This might

be viewed as an industry-level application of the 'system thinking' view (Werhane, 2002) or an example of the 'market-level' approach (Boatright 1999) to questions of business ethics.

One of the defining features of a system is the interdependence of its components, such that failure in one area will likely lead to failure in another. There may be failsafes and other risk management techniques to detect and control small failures, and keep them from affecting the entire system; however, as illustrated by the massive East Coast blackout in August 2003, large failures—in this case, with electrical power transmission—can have system-wide effects (Behr, 2003).

On a basic level, the purpose of all the capital market intermediaries—and therefore their intended value added—is that they enable a wider range of "buyers" and "sellers" to interact than if requirers and buyers of capital needed to find each other on their own. While the overall importance of this function is self-evident, a naïve glance at Figure 1 might still beg the question, "Why are so many different intermediary roles truly necessary?" The answer stems from the fact that, when reading from left to right on Figure 1, each subsequent intermediary progresses from being more closely aligned with capital providers to being more closely aligned with capital requirers. The different range of roles exists due to the tremendous abstractness of a capital market transaction, in which the capital provider surrenders a highly fungible asset—cash—to a largely anonymous party without receiving anything tangible in return. The capital provider has a professional representative ostensibly protecting the value of the capital she is providing (e.g., a mutual fund) while the capital requirer has a professional representative ostensibly establishing the legitimate capital requirement that justifies the investment (e.g., an auditor). While both of these parties are capital market intermediaries, each remains closely aligned with one of the parties to the transaction, and direct interaction between them is likely to produce the normal tension of negotiations. The additional intermediaries in the system—those more to the center of Figure 1—introduce additional independent financial professionals who can reliably guarantee to both sides that the other party is accurately representing itself.

An analysis of the efficiency and ethics of this system entails a focus on the 'way things are done' in the financial services sector. These norms can be thought of as the "rules of the game" (North, 1990: 3), organizational schema and resources (Barley, 1986), or guidelines for legitimate behavior (Scott, 2001). Such institutionalized norms powerfully influence the

behavior of firms within industries, and the capital market intermediaries are no exception. In turn, the behavior of organizations and agents has a formative effect on the shaping of institutional norms, resulting in a mutually-dependent evolutionary cycle (Giddens, 1979). We argue that the ubiquitous malfeasance throughout the system as a whole indicates a problem with the 'bushel' of institutionalized norms, rather than the incidence of isolated bad apples. It appears that the capital markets have developed strong norms of self-enrichment for financial sector intermediaries within the system, rather than norms that facilitate efficient, ethical transactions.

### **Integrity as the Key to Efficiency**

The most important implication of this justification for the multiple types of intermediaries is the suggestion that the primary underlying value of the financial services industry arises from its role in authenticating capital market transactions. In other words, the essential "product" (or value proposition) of capital market intermediaries is their integrity. Although we will primarily discuss this integrity in terms of the veracity and completeness of the information provided or authenticated by intermediaries, such integrity would also include other duties, such as the safeguarding of assets or the keeping of implicit contracts. The primary point is this: although technical skill, training, and expertise are important qualities in financial intermediary roles, these things do not represent any real value if the intermediary cannot be trusted to act with integrity.

To illustrate the point, we offer the following example. Consider one of the highest profile capital market transactions, a firm's initial public offering (IPO). As is suggested by the industry term "fairness opinion," the endorsement of the lead underwriter—an investment bank—provides an implicit warranty to potential investors that a team of experts has examined the firm's accounts and operations, and deemed the IPO price to be a "fair value" for them. Actions and events of the future may positively or adversely affect the fair value of the firm, but investors would only contribute capital to the firm in its IPO if they believed that the investment bank has provided a fair and independent valuation.

Although it has attracted relatively little attention, the importance of this implied warranty should not be underestimated. Capital markets would (and should) entirely collapse unless there is widespread acceptance of the idea that fairness opinions of investment banks are accurate and unbiased;

without this, the abstractness of a capital transaction (as described above) would preclude reasonable persons from investing in anything other than firms that they either themselves control, or are controlled by individuals trusted by the investors. The implication is that the efficiency of the entire financial services industry fundamentally relies on the integrity of each intermediary even more than it relies on attributes such as the financial acumen of a firm's professionals or the amount of assets under management.

With respect to the capital markets, then, we argue that the demands of ethics and efficiency are largely aligned. We mean this in the broadest possible sense; rather than exploring fine-grained definitions of ethics and efficiency, we simply define efficiency as 'waste minimizing' and ethics as 'fair dealing.' Given this framework, we contend that professional ethics are so fundamental to the efficiency purpose of the capital markets that they require essentially the same actions and outcomes. Despite this, the start of the twenty-first century has brought with it a wave of increased public scrutiny, which has highlighted concerns about pervasive and system-wide lack of integrity among financial intermediaries.

#### **Failings of Market Intermediaries**

Just how serious and pervasive are the system's ethical problems? To what extent have widespread lapses of integrity infiltrated the entire range of roles within the capital market system? Participants in the full range of capital markets activities have been implicated in ethical abuses. We briefly highlight examples from each sector, first discussing the capital requirers themselves, followed by the intermediaries most closely connected with capital providers, and the more central market intermediaries. We conclude by mentioning the role of the exchange institutions.

##### *Capital Requirers*

The excesses of now-infamous corporate executives and their corresponding shady deals within the executive suites have been well publicized. Business headlines continue to recount the final chapters in the stories of Enron (Bryce, 2002; Cruver, 2002; Toffler, 2003), Tyco (Sorkin, 2003), and WorldCom (Feder, 2003). Beyond these highly publicized cases, there is no shortage of other notable culprits, including HealthSouth (Freudenheim, 2004), Xerox (Morgenson, 2003c), and Gateway (Glater, 2003b), among others. Corporate corruption has bloomed across the Atlantic as well,

evidenced in recent cases like that of Italian firm Parmalat (Delaney, 2004). That a certain amount of such corporate malfeasance exists is beyond doubt; the important question is how widespread such corporate scandals are.

How might such a thing be measured? On one hand, studies of white-collar crime indicate that financial losses due to corruption are staggering—a domestic economic impact of \$200 billion to \$600 billion annually, with a cost to a typical U. S. company of one percent to six percent of annual sales (Association of Certified Fraud Examiners, 2002; Hogsett and Radig, 1994; Touby, 1994). One third of new business failures have been linked to white-collar crime, irrespective of differences in the firms' asset quality or strategy (Agro, 1978). Given the steady stream of widespread and unforeseen scandals continually being brought to light, these estimates are likely to be understated. Moreover, although research indicates that certain governance mechanisms may either encourage or discourage corporate criminal fraud (Schnatterly, 2003), it is clear that a good portion of all the corporate self-dealing does not necessarily rise to, or result in, criminality.

Alternatively, one might consider the prevalence and frequency of financial statement restatements due to accounting irregularities—characterized by the Securities and Exchange Commission as material misrepresentations of a firm's financial position. A recent General Accounting Office study revealed that such restatements are commonplace, identifying 919 separate restatements of this kind announced between January 1997 and June 2002 (GAO, 2002). The 919 restatements were announced by 845 out of 8,494 public companies, which translates to 9.95 percent of *all* listed companies misrepresenting their numbers at least once during the five-year period. In addition, the data show a significant increase in the number of restatements due to accounting irregularities during those years, growing 145 percent. The crumbling of corporate-level integrity is far from an isolated, infrequent problem.

#### *Intermediaries Closest to Capital Requirers.*

The most well-known example of a financial services intermediary being implicated in business malfeasance is that of Arthur Andersen's involvement with Enron. The conflicts of interest faced by public accountants, typified by the Anderson/Enron example, seemed to be the primary impetus behind the Sarbanes-Oxley Act of 2002. Yet despite the passage of Sarbanes-Oxley, ethical issues in public accounting still remain. While some experts say that Sarbanes-Oxley had little effect on the bad behavior



of public accounting firms (Goff, 2004), others argue that the crackdown on certain unethical practices only opens the door to other abuses (Glater, 2003c). And while it may be premature to fully assess the empirical effects of this legislation on industry behavior, the accounting firms and their partners continue to be the target of criminal investigations and civil lawsuits (Norris, 2003a; Eichenwald, 2003).

*Intermediaries Closest to Capital Providers.*

The most recent business headlines have focused on a similar rash of scandal within the investment community. Mutual fund companies, 401(k) plans, pension funds, and other institutional investors—once held out as the noble representatives of the small investor and the working class—have recently aired their share of dirty laundry, in an account that continues to unfold (Fried and Henriques, 2003; Fuerbringer, 2003; Morgenson, 2003a). Not only does it appear that these investment companies engaged in improper (and in some cases, illegal) self-dealing, they did so at the expense of everyday investors and for the exclusive benefit of their highest net worth clients.

Again, an important question is how pervasive this type of malfeasance is within the investment community on the whole. Although no empirical data on the mutual fund scandal is yet available, there is early indication—via testimony at congressional hearings, etc.—that the improper practices are not isolated to one or two investment companies, but rather they may reflect more general norms of conduct throughout the industry (Atlas and Barboza, 2003; Atlas, 2004; Labaton, 2004). It appears that trading rules were commonly bent and fee structures obscured under a shroud of deception, to the benefit of some and the detriment of others.

Significantly, the conflicts of interest in the mutual fund scandals are inextricably connected to the problems previously discussed; the high net worth clients benefiting from the investment company trickery are—perhaps not surprisingly—found facing scandals of their own, be they company executives or agents of other market intermediaries. One economic agent from one corner of the system scratches the back of another agent from another corner, and ultimately the true cost ends up being borne by rank-and-file employees or household stockholders (Norris, 2003a; Eichenwald, 2003).

*Central Intermediaries.*

Almost equally familiar is the controversy besetting the investment banking community. In addition to now-familiar anecdotal accounts from media coverage of several high-profile trials and settlements, several scholarly studies have verified the existence and influence of the damning conflict of interest faced by investment bank stock analysts. One study found that analysts at banks rate the stocks of the bank's clients more favorably than independent analysts rating the same companies. Specifically, the study found that over eighty percent of focal analysts' ratings were "at least as favorable" as the average of independent ratings. Therefore, according to the authors, "anecdotal and empirical claims that bank relationships compromise analysts' objectivity and independence seem well founded" (Hayward and Boeker, 1998, p. 17). Another study (Michaely and Womack, 1999) supports this idea, showing that stocks recommended by underwriter analysts perform more poorly than stocks recommended by unaffiliated brokers—both prior to and after the recommendation date. As a follow up to this research, the authors surveyed investment bankers, 88 percent of which identified conflict of interest as the most plausible explanation for the study's results. It is striking that the very parties involved in the conflict of interest recognize its existence and influence.

This issue ultimately culminated in the high-profile settlement between the government and Wall Street's ten largest firms (Labaton, 2003). But the scandal hardly stops there; the Securities and Exchange Commission continues to pursue and implicate brokerages for their role in 'spinning shares' during initial public offerings (Bloomberg News, 2003), as well as general complicity in the unethical or illegal behavior of their corporate clients (Norris, 2003b). Many experts argue that—in a manner similar to the accounting firms after Sarbanes-Oxley—the Wall Street settlement has generally had little effect upon the behavior of the investment banks (Morgenson, 2003b).

*Exchange Institutions.*

There is a long list of other organizational agents that occupy an assortment of important institutional and transactional roles. These actual marketplace and/or transactional organizations themselves—institutions to which we might ascribe the utmost levels of objectivity and efficiency—have also come under fire, ranging from the New York Stock Exchange itself

(Thomas, 2003) to seemingly innocuous or peripheral institutions like the international currency exchanges (Fuerbringer and Rashbaum, 2003). Law firms have even been warned that their sacrosanct attorney-client privilege may bring culpability when it equates to knowledge of client wrongdoing (Glater, 2003a).

The list goes on; the roster of market intermediaries and other economic institutions that are tainted by ethical lapses is astounding in its length and breadth. Far from being infrequent or isolated, the examples of compromised integrity encompass a very wide range of economic actors, transaction enablers, and market mechanisms. Yet the most startling and serious implication arising from the scandalous body of evidence is the revelation of precisely how interconnected the various scandals are. The applicability of this holistic, systematic view becomes clear from the connections between the different breakdowns of integrity among the various sectors of market intermediaries.

### **Implications for the Financial System**

What is most interesting about the examples above is that the failures of integrity occurred not only in one sector, but across the entire system—among the supposedly independent matchmaking intermediaries, as well as intermediaries linked to both capital providers (e.g., mutual funds) and capital requirers (e.g., accountants). Moreover, the wide range of our non-exhaustive list of examples suggests that the failures of integrity are not trivial, but rather reflective of widespread practices among all three types of intermediaries. The logical conclusion to follow from our premises is that a widespread lack of integrity should lead to a collapse of the capital markets.

It may therefore seem contradictory to observe that capital markets appear to be alive and well. There have been bankruptcies of individual firms, a loss of prestige among intermediaries, and billions of dollars paid in fines, but despite all this, the intermediaries that enable capital markets to exist have generally maintained the presumption of integrity in the eyes of their constituents. It may be viewed as a testament to the prior strength and integrity of the system that it continues to remain largely intact.

However, it would be shortsighted to conclude that the system is not vulnerable. As an analogy, it is likewise a testament to the strength of a well-built house that it can withstand an occasional crack in its structure.

Upon seeing a crack in the wall, the homeowner has two very different choices. On the one hand, she can paint over the crack, making the wall appear to be as good as new. On the other hand, she can further investigate the underlying cause for the crack, and fix it before painting over the crack. Determining the cause may prove to be difficult, and fixing it will invariably cost more than painting over the crack. At the same time, if the crack turns out to be an early warning sign of a much greater problem—say, a leaky pipe—the homeowner’s early action may prevent a more disruptive and costly crumbling of the entire wall at some point in the future.

In evaluating reforms prompted by the recent business scandals, the challenge is to distinguish those that ‘paint over the cracks’ from those that address the underlying sources of the ethical lapses. We tackle this challenge by first considering the merits of industry self-regulation, and then by analyzing the popular emphasis on increased disclosure.

### **The Silo Mentality of Self-Regulation**

One of our earlier points was that there is a high degree of overlap between the reforms that capital markets should adopt for ethical reasons and those they should adopt for efficiency reasons, and therefore the most holistic approach to reform will consider both sets of reasons simultaneously. At first glance, this seems to suggest the appropriateness of industry self-regulation as a means for enacting ethical reforms. After all, who knows better than industry leaders the ways to be most efficient? Moreover, self-regulating bodies already exist for most sectors of the financial services industry, so this would seem like an easily implemented and effective approach to reform.

However, another of our main points emphasizes the importance of treating the capital markets with a system-wide perspective. Existing self-regulating bodies in the financial services industry are almost exclusively organized at the sector or sub-sector level. For example, the Public Company Accounting Oversight Board has been created to partially govern the ethics of public accountants, but it has no standing with investment bankers, while the National Association of Securities Dealers establishes standards of conduct for brokers, but has no authority over research analysts. The silo mentality inherent in this piecemeal approach to the financial services industry runs completely counter to our emphasis on system-wide understanding and analysis. Our view is that from either an ethical or an

efficiency standpoint, the specific intermediary roles depicted in Figure 1 only have value within the larger context of the financial system. Without capital markets, the commercial need for all of the types of intermediaries shown largely falls away. When we talk of the convergence of the ethical and efficiency perspectives, it is at the level of the entire system, not its supporting sectors. For this reason, we find it unlikely that a silo approach to self-regulation could produce anything other than 'painting over the cracks' versions of institutional reform.

Shapiro suggests that such self-regulation is a form of "institutionalized conflict of interest" (1987: 646), which can cause problems even if the intent to defraud is assumed away. She presciently points out that, for example, CPA firms can be fooled by deceitful managers, or may be compromised by business arrangements with client firms that provide significant revenue.

To explore this argument, we refer to the recent history of the existing self-governing bodies in the financial services industry. In our view, the already prevailing silo mentality is at least partially responsible for some of the perverse incentives that have contributed to the widely reported ethical abuses among intermediaries, in that the self-regulating bodies tend to be concerned with increasing the domain of their own sector—relative to other intermediaries—in addition to maintaining standards of professional conduct. Perhaps the most famous example of this comes from certified public accountants, fulfilling Shapiro's (1987) prediction. Over the 1980s and 1990s, it became apparent that corporate clients were willing to pay more for management consulting services than for the traditional work of auditors (Osterland, 2002). Given that individuals with similar education and training are capable of performing both of these intermediary roles, large auditing firms placed an increasing emphasis on specifically cultivating consulting relationships with their clients. Because the revenue for consulting projects was higher per hour than for audits, partners who focused more on consulting were able to earn larger incentive payments than those who focused on audits. Eventually, as is now known, some individuals began to 'sell' consulting projects by allowing liberal internal accounting policies to go unchallenged during audits. Given the paramount importance of an accurate audit function overall in the capital markets, this represents a perverse incentive, at least from a systemwide perspective. As detailed by Greenwood, Suddaby, and Hinings (2002), Canada's professional association for accountants actively participated in the migration to increase

the emphasis on consulting; our qualitative assessment of the equivalent organizations in the U.S. suggests that they were at least as active in promoting the development of consulting business among accounting firms.

The general point is that it makes little sense to take a piecemeal approach to self-regulation for a system that is as interdependent as the capital markets. When this occurs, it raises the possibility that individuals will be rewarded for activities that may be profitable in the short-term for their organization or sector, but are inconsistent with the perpetuation of the financial system as a whole. When revealed to the public, these perverse incentives discredit the integrity of the individuals or sectors that participated in them, which has the secondary effect of undermining the value of the entire system. Moreover, reputation effects—the supposed economic costs that should dissuade unethical behavior by legitimate business organizations—are insufficient to counter these incentives; after all, reputation effects lose all impact if virtually all firms in a sector engage in the same abuse, since no honest firms remain to which customers can transfer their business.

### **The Pitfalls of Transparency**

In the ensuing public discussion about corporate reform, the notion of transparency has received a great deal of attention, the idea being that organizational sins and conflicts of interest should be brought to light. The result of this focus on transparency has been formalized into enacted legislation—such as Sarbanes-Oxley—in which significant portions are aimed at increasing or requiring certain levels of disclosure. This disclosure orientation continues to be a major emphasis in reform and enforcement (e.g., Henry, 2003; White, 2003). General acceptance of the idea that transparency is in fact a desirable economic mechanism raises an interesting question: are disclosure mechanisms enough to ‘cure’ the system’s ills? Is increased transparency the answer?

We argue that this over-focus on transparency, though motivated by good intentions, is incapable of achieving any lasting success in restoring integrity to the wide range of capital market intermediaries, from the perspectives of either efficiency or ethics. Instead, disclosure can serve merely to provide an illusion of propriety rather than attending to the underlying problems in a meaningful way. Such efforts also tend to fall into

the silo mentality discussed above, which in a grand sense serve to distract reform efforts away from more substantive, system-wide solutions. Moreover, since the revealing of information about an unethical activity is not something that directly addresses the activity itself, any substantive effect arising from the transparency is presumed to result from the deterrent effect of shame—an outcome that is not as self-evident as often assumed. Finally, disclosure on the part of market intermediaries may also simply serve as a ‘stamp of approval’, exacerbating the problems it is intended to address.

As objectionable conflicts of interest are revealed, it is natural to create applicable disclosure requirements in an attempt to prevent future conflicts from remaining hidden. But if regulatory response only goes that far, the foundational problem remains unaddressed; disclosure merely serves as window dressing. As a prescription, disclosure seems inadequate. An equivalent medical analogy is that of a physician only giving a decongestant for the symptoms of an illness, but neglecting to prescribe an antibiotic to neutralize the source of the malady.

Prescriptions that only address the disclosure of information also tend to be narrow in scope, reinforcing the compartmentalized ‘silo’ view of the financial system. As argued above, such an approach is unlikely to be successful in addressing system-wide problems. In addition, the focus on change at the sector level in itself displaces focus from more system-wide, holistic views of the capital markets. In this way, efforts to restore integrity at the sector level may serve as red herrings.

The logic of increased disclosure also suggests that the system can automatically fix itself simply because it has more information. Built on an assumption that capital market participants will be able to accurately value the new information, the idea is that if a conflict of interest is disclosed, capital providers can determine the extent to which they believe it introduces bias, and adjust their behavior accordingly. This represents a very strong assumption about the ability of participants to interpret new information; it essentially assumes that capital providers, many of whom are not finance professionals, will understand and correctly assess the impact of this information. Consider the potential conflicts of interest that are disclosed in the ‘fine print’ of lengthy required corporate filings; are typical investors likely to be able to correctly interpret all this information, given that such documents are crafted to reveal as little information as possible while complying with the law? Such an assumption is unlikely to be true,

given the bounded rationality of decision-makers (March and Simon, 1958; Simon, 1997).

Even if we accept this assumption, however, there are two reasons for skepticism that increased disclosure alone can produce meaningful reform in the financial services industry. First, considering the widespread prevalence of the ethically questionable practices that have been publicly revealed, small investors who must rely on intermediaries to conduct any capital market transactions have limited ability to exert economic pressure based on disclosure alone. That is, if the disclosure of a firm's conflicts of interests is troubling to a small investor, but she discovers that other firms in the same sector are engaged in similar conflicts, she cannot credibly use the threat of transferring her business to another firm to pressure the focal firm into altering its practices. Her only real alternative may be to withdraw from the capital markets entirely, an outcome as unappealing to her as it is to the firm she is pressuring to reform. This provides yet another reason to suggest that increased disclosure embodies the characteristics analogous to 'painting over the cracks.'

Second, events of the recent past suggest that organizations may interpret increased disclosure requirements as giving *carte blanche* for any activities that are not actively opposed by capital providers. Recall that when concerns were first raised about abuses of executive compensation levels in the 1980s, firms were required to increase disclosure by publishing in proxy statements data on individual compensation levels for their senior executives. After further concerns were raised about the clarity of the disclosure provided, the Securities and Exchange Commission re-issued its guidelines with stricter rules and a more prescribed format, which went into effect in 1993. Both times, the underlying rationale for requiring additional disclosure of compensation data was that it should constrain future growth in executive pay levels. As is well known, precisely the opposite actually occurred. Compensation for CEOs and other senior executives increased at a far higher rate throughout the rest of the 1990s than it had during the periods that prompted the increased disclosure. The annual issuance of proxy statements now receives only passing interest; while a select few individual CEO pay packages might receive attention and criticism, executives are rarely removed for this reason, and Boards of Directors seem to keep approving increasingly lucrative executive compensation programs.



We suggest that the disclosure of pay levels—if such disclosure prompts no specific objection—gives tacit endorsement to the idea that the executives' compensation levels are consistent with market levels for similar executive talent. Far from 'shaming' executives into accepting lower pay packages, as was once expected, increased disclosure may have actually allowed them to justify (at least to themselves and their boards) a progressively greater disparity between modest wage increases for workers and lavish compensation increases for executives. Furthermore, research has shown that such increased executive pay may not be desirable in any event; increased executive compensation may increase the likelihood of financial misrepresentation by the firm (Harris and Bromiley, 2003; O'Connor et al., 2003).

Abstracting back to a more general level, it is therefore possible that other types of official disclosure by institutional market intermediaries can serve as a signal of appropriateness, serving to give a 'stamp of approval' to the actions being disclosed, irrespective of the level of integrity actually represented by the actions. Ironically, this can actually serve to exacerbate whatever problem the transparency is attempting to address—which becomes particularly important with respect to people's dealings with financial intermediaries. The institutionalization of these ancillary certifications or guarantees of trustworthiness becomes essential to principals who have "abdicated their distrust to these new guardians," providing increased opportunity for exploitation on the part of intermediaries (Shapiro, 1987: 651). Because decision makers operate under conditions of bounded rationality, they often tend to conserve belief about institutions in which they have placed significant trust (March, 1994).

Yet even setting the reputation effects of market intermediaries aside, it can be shown that disclosure can have a perverse effect upon decision making. Through the use of agency theoretic models, Povel et al. (2004) show that increased disclosure requirements have the potential to exacerbate fraud. But how? In a recent experiment, Cain et al. (2005) asked one group of people (estimators) to look at several jars of coins from a distance and estimate the value of the coins in each jar. The more accurate their estimates, the more the estimators were paid for participating in the experiment. Another group of people (advisers) were allowed to get closer to the jars and give the estimators advice. The advisers, in contrast to the estimators, were paid according to how high the estimators' guesses were.

The experimenters found that the advisers' counsel positively impacted the estimators' guesses, *even when the estimators knew of the conflict of interest*. In addition, the researchers discovered that once the conflict of interest was disclosed, the advisers' advice actually got worse—suggesting that disclosure can actually have the perverse effect of increasing the bias of intermediaries, rather than reducing it (Surowiecki, 2002).

The point of these arguments, of course, is not to discourage transparency or suggest that specific types of disclosure be curtailed. Rather, we contend that disclosure is inadequate to cure the ills of the financial system on its own. Although efforts to increase transparency may be well-intentioned, and should ultimately be part of any approach to system-wide improvement, we have shown how an over-focus on disclosure can serve to displace more comprehensive reform efforts and potentially lead to counterproductive results. It may well be that, similar to the notion of an 'optimal' level of trust (Wicks et al., 1999), there is an ideal level of transparency at which the benefits can be realized and the harms avoided.

### **Conclusion and Implications for Future Research**

With respect to the task of restoring integrity to the capital markets, we have argued that the demands of ethics and efficiency are not in opposition, but fundamentally aligned. Having developed the premise that the primary value proposition—or foundation—of the entire spectrum of capital market intermediaries is based on the intermediaries' professional integrity, we conclude that restoring and safeguarding this integrity is the primary consideration for reform initiatives in financial services, from the perspective of either efficiency or ethics.

Based on our argument that capital markets represent a single, interdependent system, not a partitioned collection of intermediary sectors, we argue that the object of reform should be the integrity of the system as a whole. This suggests that the 'silo mentality' of current efforts at self-regulation is inadequate, due to its orientation toward specific intermediary sectors. Such an approach attends to only small portions of the capital transaction cycle, resulting in potentially short-sighted or contradictory incentives for certain intermediaries or financial sectors. We extend this observation to the emphasis in recent reforms on transparency and increased disclosure, arguing that a similarly segmented approach is unlikely to

produce the benefits desired, while simultaneously serving as a potential distraction from system-wide changes, or—at worst—working *against* the very objectives for which the disclosure was required in the first place.

We call for future research to approach questions about the capital markets from this holistic, systemic point of view. Ethics scholars, management academics, and public policy researchers should focus their research on ways to view the capital markets as an integrated system. We propose that this paradigm is the critical means to discovering the system-wide approaches that will enable the most efficient—and ethical—restoration of integrity to the capital markets.

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