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Submission to the Financial System Inquiry

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We hope that this submission assists the Committee in its deliberations. If you require further information please do not hesitate to contact us.

Yours sincerely

Professor Justin O'Brien and Dr. George Gilligan

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Introduction

1. We welcome the establishment of the Financial System Inquiry (the Inquiry), which is timely given the significant changes that have occurred in global financial markets since the last major review of Australia's financial system, the Wallis Inquiry of 1997. The current Inquiry is appropriately wide-ranging regarding its Terms of Reference (TORs), given the strategic importance of the financial sector to the Australian economy and Australian society more generally. Our submission below does not seek to cover all of the TORs. Instead it focuses on the competition implications of a still metastasizing scandal involving financial benchmark manipulation and presents nine specific recommendations.
2. As the Inquiry will be aware, on 19 March the Australian Securities and Investments Commission (ASIC) announced a domestic review of currency rate-setting.¹ The decision is in line with similar investigations in Hong Kong, Singapore, the European Union (EU), the United Kingdom (UK) and the United States (US). These investigations build on the initial probe into the London Inter-Bank Offered Rate (Libor) and its facsimiles, which has been determined by the European Union Competition Directorate as having the features of a cartel.

Recommendation One: The Inquiry should explicitly evaluate the implications to the integrity of the financial services system if evidence of a cartel is uncovered.

3. This finding, accepted by securities market regulators in Australia and overseas, has profound implications for capital market governance. If critical benchmarks on which trillions of dollars of Over The Counter (OTC) derivatives have been corrupted, the entire edifice underpinning capital markets and their governance is weakened. It is, perhaps, even more problematic when currency rates are manipulated, precisely because they are based on observed transactions rather than the exercise of subjective judgment, as in the case of Libor. Observable rates, it will be recalled, has underpinned the stance of the Commodities Futures Trading Commission (CFTC) in the US in relation to Libor reform. As we have seen from two recent settlements in relation to attempted

¹ J. Smyth, P. Davis and D. Schafer, 'Australia regulators to probe forex market', *Financial Times*, 19 March 2014, <http://www.ft.com/intl/cms/s/0/51e79260-af26-11e3-bea5-00144feab7de.html?siteedition=intl#axzz2xTfLDsrc>.

manipulation of the Bank Bill Swap Rate here in Australia involving UBS and BNP Paribas, there is reason to be cautious about cultural mores precisely because the Australian rate is based on observed transactions.

4. The inter-linked scandals tell us much about how banking practice has changed in the aftermath of the Global Financial Crisis (GFC). Even before the most recent revelations, the UK Parliamentary Commission on Banking Standards noted in its final report, *Changing Banking for Good*, that 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.’²

Recommendation Two: The Inquiry should conduct a comprehensive evaluation of the use of Enforceable Undertakings by the ASIC, the Australian Prudential Regulatory Authority (APRA) and the Australian Competition and Consumer Commission (ACCC) to ascertain their effectiveness in changing conduct.

5. In relative terms, Australia weathered the GFC better than most. This can be attributed to structural design and regulatory effectiveness, the particular circumstances of the Australian market, the tyranny of distance, and, let us be frank, luck. Any substantive domestic review that does not give sufficient cognizance to the signals emanating from international investigations of market manipulation and demonstrable evidence of cartel behavior raises profound questions for the regulatory agencies that are charged with overseeing the market.
6. It is, therefore, appropriate, in our view, that ASIC has signaled a review. This review should, in our opinion, inform the deliberations of the Inquiry. Unless the normative foundations of capital market governance are shored up there is no credible basis on which to trust. The Inquiry offers an opportunity to demonstrate that trust is warranted and if not already in place provide a route-map to achieve it.
7. We respectfully submit that failing to pay significant attention to how to mitigate the risks posed by some prevailing cultural norms and behaviours within national and international actors operating in the Australian finance sector could be problematic. These risks may pose a profound threat to Australia’s reputation for integrity at a time

² Parliamentary Banking Standards Commission, *Changing Banking for Good* (HM Parliament, Westminster, June 2013), Vol 2, Para. 273.

when Australia itself exercises a global leadership position, in particular as President of the G20, Member of the United Nations (UN) Security Council and Chair of the International Organisation of Securities Commissions (IOSCO).

8. The Centre for Law, Regulation and Markets (CLMR) at the University of New South Wales (UNSW) has invested significantly in mapping and tracking the global financial reform agenda since the onset of the GFC, primarily through an interactive online portal³ and the staging of multiple workshops, most recently in Sydney on 26 March 2014. Although these workshops extend beyond the question of benchmark manipulation, the question of how to regulate culture has been a defining feature of the research agenda pioneered by the CLMR. A further workshop on divergent enforcement agendas in relation to financial benchmarks is to be staged in conjunction with the Edmond J Center for Ethics at Harvard University in Cambridge, MA in May, with others planned for London and Sydney later in the year assessing the efficacy of the regulatory design. These workshops, which have been filmed and are, therefore, available, to the Inquiry, integrate insights from regulators, practitioners and academics, including the primary authors of this submission.
9. In the recent Sydney workshop, the ASIC chairman, Mr. Greg Medcraft, confirmed that the ASIC review will be far-reaching and, in response to a question from the floor, suggested that individual institutions involved in the FX market should ‘kick the tyres’ by conducting an internal review in advance of ASIC requesting information. This makes sense from a regulatory perspective. It also raises the question of what might be uncovered and whether if evidence of ‘cartel’ like behavior by individual traders and/or individual institutions emerges, how that should be handled. To date cartel investigations have been the sole preserve of the ACCC. This may be more appropriate given the limited range of sanctions available to ASIC.
10. As ASIC has made clear in its most recent report on penalties, Report 387 *Penalties for corporate wrongdoing* (Report),⁴ the agency lacks the legislative provisions to extract meaningful financial settlements. It is telling, for example, that the enforceable undertakings into the manipulation of the Bank Bill Swap Rate (BBSW) in Australia by

³ Centre for Law, Regulation and Markets, University of New South Wales <http://www.clmr.unsw.edu.au/>

⁴ Australian Securities and Investments Commission, Report 387, *Penalties for corporate wrongdoing*, 20 March 2014, <http://www.asic.gov.au/asic/asic.nsf/byHeadline/14-055MR%20ASIC%20reports%20on%20penalties%20for%20corporate%20wrongdoing?opendocument>

UBS⁵ and BNP Paribas⁶ were each accompanied by a ‘voluntary’ donation of \$1m to a fund established to improve financial literacy. This is in sharp contrast to steep fines available to regulators in other countries, particularly the US.

Recommendation Three: The Inquiry should evaluate the extent to which the penalty regime in Australia is fit for purpose and recommend a significant strengthening to ensure a rebalancing of incentives in line with the enforcement tools available to US and UK regulators and prosecutorial authorities.

Regulating Culture

11. The GFC illustrated dramatically that poor operational culture in business organizations, especially banks, can have devastating impacts beyond business bottom lines and across social and political structures. Indeed, this concern informs the UK Parliamentary Commission on Banking Standards, arguably the most extensive investigation of the interaction between technical and normative standards yet undertaken. The combination of prior investigation and evaluative judgment make it questionable just how robust the global economy would be if faced with another GFC and that possibility is by no means a far-fetched scenario. So, a key challenge for all associated with, and affected by, the financial sector, which in this day and age is just about everybody, is what potential is there to re-cast operational cultures in business especially in the financial sector? This has particular relevance to Australia for internal market and external positioning purposes. From an internal perspective the dramatic increase in superannuation and its reliance on the Australian equities market, mean that we are all sophisticated investors.
12. Culture can be simultaneously local and general, and as the Libor and FX scandals so clearly demonstrate, so can the regulatory challenges. Similarly the financial inquiry’s TORs have both a local and general focus because the Australian financial sector is so integrated with, and dependent upon, the international financial sector. So for example, developments in Australia’s growth, domestic and international competitiveness, cost, quality, safety and availability of financial services products and capital for users (TOR 1), the ingredients of a well-functioning financial system, including a balance between

⁵ ASIC Accepts Enforceable Undertaking From UBS, 23 December 2013, <https://www.asic.gov.au/asic/asic.nsf/byheadline/13-366MR+ASIC+accepts+enforceable+undertaking+from+UBS?openDocument>

⁶ ASIC Accepts Enforceable Undertaking From BNP Paribas, 28 January 2014, <http://www.asic.gov.au/asic/asic.nsf/byheadline/14-014MR+ASIC+accepts+enforceable+undertaking+from+BNP+Paribas>

competition, efficiency, effectiveness, risk management, innovation and consumer protection and how these interact with the roles of Government and financial regulators (TOR 2), opportunities and challenges as drivers of change, including technological impact, international integration, corporate governance, capital sourcing and distribution (TOR 3), and the regulation of the general operation of companies and trusts as it impacts upon efficient and effective capital allocation (TOR 5) can only be made locally in Australia if they have synergy with market realities internationally.

Recommendation Four: In line with the UK, assess the precise nature of culture and its impact on competition and advance concrete mechanisms to hold stated commitments to account, thus enhancing accountability.

13. Similarly, international market realities, especially normative influences such as prevailing operational cultures within the financial sector, shape how financial business is carried out in Australia and what benefits such financial business can bring to Australia as per the Inquiry's TORs specified above. Australia is a jurisdiction with not only a robust financial regulatory infrastructure but also an economic profile which has allowed it to survive and deal with the GFC's effects better than most other nations, so it is well-placed to make a substantial contribution to discourses on how operational cultures in financial sectors can be improved both nationally and internationally.
14. In 2014, Australia's capacity to provide regulatory leadership is further enhanced by its Presidency of the G20. We strongly recommend to the Inquiry that it examines how operational cultural norms within the financial services sector determine the levels of integrity, manageable risk and accountability that may be achieved in capital markets.⁷ In this way the Inquiry can respond to the challenge stated by Melbourne University's Professor Ian Ramsay to 'look at how to create the right sort of culture - one that encourages innovation but not at the cost of mis-selling financial products.'⁸ It is hard to argue against the innate good sense in such a statement and we are sure that the Inquiry will give this issue due consideration.

⁷ See J. O'Brien and G. Gilligan, 'Regulating Culture: Problems and Perspectives', 'Introduction' in J. O'Brien and G. Gilligan (eds.), *Integrity, Risk and Accountability in Capital Markets: Regulating Culture* (2013) xv-xxx, <http://www.hartpub.co.uk/pdf/samples/9781849465670sample.pdf>

⁸ R. Gluyas, 'Ramsay Says that Proposed financial Inquiry Should Look at Bank Culture', *The Australian*, 17 June 2013, <http://www.theaustralian.com.au/business/financial-services/ian-ramsay-says-a-proposed-financial-inquiry-should-look-at-the-banking-culture/story-fn91wd6x-1226664710509>

15. As the recent case, (discussed below), involving local councils (*Wingecarribee v Lehman Brothers Australia*), made clear, there has been a major problem in Australia in relation to the sale of complex financial products to investors who passed the ‘sophisticated’ or professional test enshrined in the Corporations Act but were in fact nothing of the sort.
16. ‘How was it that relatively unsophisticated Council officers came to invest many millions of ratepayers’ funds in these specialised financial instruments? That is the fundamental question at the heart of these proceedings,’ reflected Rares J, before pronouncing judgment in a case that has far-reaching implications for the regulation of financial services.⁹ *Wingecarribee Shire Council v Lehman Brothers Australia* addresses directly, therefore, a critical issue: what specific duty of care does an investment bank owe to its clients and can these be voided by contractual terms or legislative exceptions?
17. The Rares judgment provides the first definitive affirmative answer to the former and a negative to the latter. It holds that a critical bifurcation in the Australian securities legislation between sophisticated and unsophisticated investors cannot be used to evade responsibility to act in the best interest of clients. It finds that Grange Securities, a wholly owned subsidiary of Lehman Brothers, had breached its fiduciary duty in facilitating individual transactions for complex products without explaining the risks. Of potentially greater significance, in what is a damning indictment of financial engineering and the methods used by its leading practitioners, it holds that the placing of highly complex Collateralized Debt Obligations (CDOs) in the investment portfolios of councils occurred because of misleading and deceptive conduct.
18. The litigation’s significance focuses on the interplay between three inter-connected factors. First, the judgment reveals a serious and unresolved conflict over policy implementation of legislative intention in determining how complex securities instruments can and should be marketed. Second, it derives from rather than spawns a class action. That the testing of obligation was left to commercial funders, listed on the Australian Securities Exchange (ASX) for profit, rather than the regulator funded by the taxpayer to uphold the public interest is even more surprising given that the entities representing that action are themselves an arm of government. Third, precisely because *Lehman Brothers Australia* is in administration it is unlikely to appeal. The legal advisors to the litigation funders, IMF, have already signaled intention to file against other solvent providers of complex financial products. The ruling is, therefore, likely to herald a wave of litigation.

⁹ *Wingecarribee Shire Council v Lehman Brothers Australia (in liq)* [2012] FCA 1028 at 14.

19. Moreover, it should be recalled that those responsible for the mis-selling were primarily Australian. The US investment bank Lehman Brothers entered the Australian market through its acquisition of Grange Securities and Grange Asset Management in March 2007. The clients had no ‘real appreciation of the true risks of SCDOs [Synthetic Collateralised Debt Obligations] or the financial wisdom of its [i.e. Grange’s recommendation].’¹⁰ Rares J is, disarmingly, forthright as to how and why this could happen: ‘The nature and risks of an SCDO are concepts that are beyond the grasp of most people. Indeed, after the benefit of expert reports, concurrent expert evidence and the addresses of counsel, I am not sure that I understand fully how SCDOs work or their risks. Nonetheless, Grange portrayed itself as an expert in these investments. Most certainly, none of the seven Council officers who gave evidence had any expertise in these financial products. And, Grange knew and preyed on that lack of expertise and the trust the Councils placed in its expert advice.’¹¹
20. There can be no doubting the level of judicial disquiet at corporate interpretation of the bifurcation between sophisticated and unsophisticated investors ‘given the subject matter involved, the prudent investment of public money.’¹² The severity of the offence and the robustness of the judgment calls into question the sufficiency of a range of options currently canvassed by the Australian Department of Treasury on how complex financial products were systematically sold to mid-market participants (i.e. those that were deemed sophisticated or professional in legal terms but were, arguably, nothing of the sort). An issues paper, which attracted 57 submissions, canvassed four options: (a) retain and update the current system; (b) remove the distinction between wholesale and retail clients; (c) introduce a new sophisticated investor test; or (d) no nothing.¹³ We still await a final conclusion from Treasury as to which option should be taken. The Inquiry offers an opportunity to move this debate to a conclusion and we respectfully suggest that it takes this to ensure that the Corporations Act is amended accordingly.

Recommendation Five: Provide definitive guidance to Government on how to address the issues posed in the Treasury Consultation on Wholesale and Retail Clients.

¹⁰ Ibid, 265.

¹¹ Ibid, 410.

¹² Ibid, 790.

¹³ Department of Treasury, *Wholesale and Retail Clients: The Future of Financial Advice* (Canberra: January 2011) 8-10.

21. A further unresolved policy question focuses on whether the conduct complained of in relation to Grange—for which Lehman Brothers was ultimately held liable—derived from a suboptimal culture within an individual firm or extended to the broader financial services community. Although a significant actor in the Australian marketplace, Grange was not the sole facilitator of the placing of complex instruments in investor portfolios. In this crucial respect the judgment in *Wingecarribee Shire Council v Lehman Brothers Australia* raises more questions than it answers.
22. An extension of responsibility and accountability to those involved in product design rather than clarifying the enabling conditions governing marketing and sale would constitute a seismic 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. This is a global debate to which Australia can make a substantial contribution as a strategic financial sector player in the Asia Pacific region, rather than merely follow a lead from any combination of the UK, US or the EU. What constitutes or should constitute optimal cultural traits necessitates extending beyond *efficiency* criteria (i.e. lower transaction costs) and a reliance on disclosure. Three additional distinct but overlapping subjective normative dimensions must be applied. First, *permissibility* (i.e. whether a particular product can be sold and if so to whom and on what basis); second, *responsibility* (i.e. who carries the risk if the investment sours and on what terms); and third, *legitimacy* (i.e. does the product serve a legitimate purpose). This, in turn, suggests the need for the dynamic integration of rules, principles and social norms within an interlocking responsive framework.

Recommendation Six: Assess the extent to which the Australian capital market remains too permissive and canvass the possibility of restricting sale of complex financial products in line with the Rares J judgment in *Wingecarribee Shire Council v Lehman Brothers Australia*.

23. In doing so, the Inquiry will be building on a critique offered by Professor John Kay, in a highly-regarded report commissioned by the UK government. As Professor Kay 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.¹⁴ The Kay formulation builds on an insight first advanced by the recently retired managing director of the Financial Services Authority, Hector Sants. Sants had famously complained that it was impossible for principles-based regulation to work when those charged with informal authority to maintain the integrity of the system had no principles.¹⁵ This was not simply a particularly memorable aside. It reflected belated cognizance of the importance of what Oliver Williamson has termed the ‘non-calculative social contract.’¹⁶ Sustainable reform must also be consistent with principles of good regulation. It must be proportionate, consistent in application, transparent and targeted. The danger is that an ill thought out structure will exacerbate rather than resolve conflicts within the industry.¹⁷ It risks creating another layer of regulation that does little to change either corporate practice or facilitate voluntary progression towards higher ethical standards. It is also clear, however, that the construction of accountability mechanisms cannot rely on self-certification. It demands external validation. The recent history of financial regulation has demonstrated conclusively the dangers of past self-referential framing.

24. Efficiency and effectiveness are privileged in capital market discourse, often by conflating what are, at times, conflicting objectives. Ostensible improvements to both, measured largely through short-term financial performance, provide a proxy for societal progress and, as a consequence, political legitimacy.¹⁸ Ineffective or inefficient markets do not necessarily result in a crisis of legitimacy. The structure of the discourse can be and often

¹⁴ See John Kay, *The Kay Review of Equity Markets* (July 2012) 9. According to Professor Kay, this necessitates a move away from short-termism, as ‘trust and confidence are the product of long-term commercial and personal relationships: trust and confidence are not generally created by trading between anonymous agents attempting to make short term gains at each other’s expense’: at 5. <<http://bis.gov.uk/assets/biscore/business-law/docs/k/12-217-kay-review-of-equity-markets-final-report.pdf>>.

¹⁵ H. Sants, ‘Delivering Intensive Supervision and Credible Deterrence’ (Speech delivered at the Reuters Newsmaker Event, London, 12 March 2009) 2 (‘The limitation of a pure principles-based regime have to be recognized. I continue to believe the majority of market participants are decent people; however a principles-based approach does not work with people who have no principles’).

¹⁶ O. Williamson, ‘The New Institutional Economics: Taking Stock, Looking Ahead’ (2000) 38 *Journal of Economic Literature* 595 at 597. Williamson notes that analysis of this ‘level one’ component of social theory is conspicuous by its absence with regulatory studies. The other three levels comprise institutional arrangements viewed primarily through property rights and positive political theory, governance mechanisms through transaction cost economics and resource allocation frameworks generally examined through agency theory.

¹⁷ Critically, it must also be based on a re-conceptualization of the regulatory architecture, see Kay, above n 13 (‘Bad policy and bad decisions often have their origins in bad ideas...Regulatory philosophy influenced by the efficient market hypothesis has placed undue reliance on information disclosure as a response to divergences in knowledge and incentives across the equity investment chain. This approach has led to the provision of large quantities of data, much of which is of little value to users’: at 10).

¹⁸ Such an approach conflates proximate with ultimate goals and objectives, see S. Miller, ‘Institutions, Integrity Systems and Market Actors’ in J. O’Brien (ed.), *Private Equity, Corporate Governance and the Dynamics of Capital Market Regulation* (2007) 339, 347. Moreover, as Miller points out, ‘even the most staunch free marketeers have normative or ethical commitments: they are committed, in particular, to the ethical value of the social institution of private property, the moral force of contractual obligations, and the human right of individual freedom:’ at 342.

is remarkably resilient. Past inefficiencies can be—and often are—redressed by the passage of further ostensibly more stringent rules 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.¹⁹ More often than not, however, these same initiatives tend to favour the politics of symbolism²⁰ or find their utility undermined by what the Chief Executive of the Financial Conduct Authority (FCA), Martin Wheatley recently termed an ‘ethic of obedience’ rather than an ‘ethic of conduct.’²¹

Recommendation Seven: Place verifiable conduct at the heart of the Inquiry’s response to changed financial conditions to be informed by legislative change.

25. We submit there is much merit in the changed regulatory philosophy adopted by the FCA, which builds on an outline first sketch by Hector Sants in 2010 but not implemented. On 12 March 2010, Hector Sants, the then chief executive of the FCA’s predecessor, the Financial Services Authority (FSA), used an address at the University of Oxford to outline a new consumer protection strategy.²² As with his speech the previous year on the failure of principles-based regulation,²³ Sants emphasised that changed societal preferences had altered the risk-security calculation. The preference for security over innovation, he argued, required a radical shift from principles-based regulation towards an outcomes-based approach. Crucially, he accepted that past reliance on disclosure and financial literacy was not only insufficient, but also was deleterious to consumer welfare. The regulator went on to emphasise the importance of ‘culture, behaviour – dare I say it, ethics?’

We need to answer the question of whether a regulator has a legitimate focus to intervene on the question of culture. This arguably requires both a view on the right culture and a mechanism for intervention. Answering yes to this question would undoubtedly significantly extend the FSA’s engagement with industry.

My personal view is that if we really do wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of both society as a

¹⁹ For application to the politics of corporate governance, see P. Gourevitch and J. Shinn, *Political Power and Corporate Control* (2005) 57-94.

²⁰ See M. Edelman, ‘Symbols and Political Quiescence’ (1960) 54 *American Political Science Review* 695.

²¹ See M. Wheatley, ‘Address on Financial Benchmark Reform Agenda’ (Speech delivered at the Centre for Law, Markets and Regulation/Allens Workshop, Sydney, 26 March 2014).

²² H. Sants, Annual Lubbock Lecture in Management Studies, (Speech delivered at the Said Business School, 12 March 2010).

²³ Sants, above n 15.

whole, and the management of major financial firms. This will not be easy. A cultural trend can be very widespread and resilient – as has been seen by a return to a ‘business as usual’ mentality.

Nevertheless, no culture is inevitable. But changing it is a task that cannot be achieved by policymakers alone - we need to collectively address these issues. From the regulators’ perspective it is probably the case that seeking to set ourselves up as a judge of ethics and culture would not be feasible or acceptable. More realistic would be to relate the consequences of culture to regulatory outcomes. However, developing this line of thinking requires much further debate, which I would welcome.²⁴

26. This emphasis on culture is a critical point of departure. It suggests that a reduction in risk can only occur if compliance and ethics are explicitly linked to deterrence and accountability agendas within the firm and across the regulatory regime. The outreach to industry suggests that creating or sustaining structures that facilitate the weakening of ethical obligation (or provide opportunities for gaming) are, by definition, self-defeating. The approach is built on a synthesis between an appreciation of context, the need for virtuous behaviour and the importance of prescriptive rules and consequential principles of best practice within an overarching framework that is not subverted by compartmentalized responsibilities.²⁵ This offers the opportunity to build organically from principles of self-regulation and embed them within a much more clearly defined conception of business integrity.²⁶
27. Contrary to media perception, most crises represent wasted opportunities. Until the exposure of the Libor scandal and now wider problems in currency manipulation and other benchmarks, it was clear that this crisis was following a desultory pattern in which institutional memory of past failure was lost. If the market has been corrupted, there is no basis on which to trust.
28. At the outset of the crisis, the UK Prime Minister Gordon Brown suggested the time had come to negotiate a new compact with banking. The UK has gone further than most with the Vickers Report from the Independent Commission on Banking and the

²⁴ Ibid. See also Kay, above n 14 (‘Regulation should focus on the establishment of market structures which provide appropriate incentives, rather than the fruitless attempt to control behaviour in the face of inappropriate commercial incentives. We look forward to a future of less intrusive and more effective regulation, the product of a new emphasis on the incentives market participants face, and to the creation of trust relationships which can give savers and companies confidence that the equity investment chain meets their needs and serves their interests’: 11).

²⁵ Micro social contract norms must be compatible with hyper norms (i.e. norms sufficiently fundamental that they can serve as a guide for evaluating authentic but less fundamental norms), see Thomas Donaldson and Thomas Dunfee, *Ties that Bind: a Social Contracts Approach to Business Ethics* (1999).

²⁶ L> Stout, ‘Social Norms and Other-Regarding Preferences’ in J. Drobak (ed.), *Norms and the Law* (2006) 13 (reviewing results from social dilemma, ultimatum games and dictator games and postulating ‘taken as a whole, the evidence strongly supports the following proposition: *whether or not people behave in an other-regarding fashion is determined largely by social context tempered-but only tempered by considerations of personal cost* [emphasis in original]: at 22); see also L. Stout, *Cultivating Conscience* (2011).

Parliamentary Commission on Banking Standards.²⁷ Australia has yet to even begin a national conversation on these lines.

Recommendation Eight: Convene a major national conference on the question of business culture, with participants drawn from industry, government, consumer groups, regulatory authorities and academics, informed by cutting edge research to generate a set of shared understandings and commitments.

29. Professional, structural and cultural embeddedness condition the interplay of regulatory authority and regulatory responses. Moreover, contemporary regulatory conditions shape future regulatory structures. Consequently, ingrained cultural forces can distort perceptions within organisations about risk and incentives, especially in the hyper-competitive environment of finance, which may adapt ever-increasing matrices of risk as the norm.²⁸ These processes were central in the damage wrought by the GFC and in the inadequate regulatory oversight of the Libor and FX markets. Moreover, the complexity of modern finance and globalized, fragmented chains of command governing the production and dissemination of specialized knowledge increases the information asymmetry risk. As a consequence, the risk that the unscrupulous will take advantage of what the economist David C. Rose has termed the ‘golden opportunities’ of deception is increasing.²⁹
30. If countries such as Australia are going to have a sustainable and efficient financial sector it is essential to build the governance of that sector on an explicitly normative foundation. This is not merely a matter for academic debate or conceptual modelling; it is a truism recognised by senior financial regulators internationally.
31. The FCA Chief Executive Mr Martin Wheatley, who also serves as joint chair of the IOSCO taskforce on benchmark regulation, established as a multi-lateral regulatory response to the Libor scandal, suggests the question of culture lies at the heart of his vision and mission: ‘The FCA is firmly at the heart of the global regulatory landscape, and is here to drive forward a changing global agenda that emphasises conduct and culture. A

²⁷ UK Parliament, *The Independent Commission on Banking (the Vickers Report)*, December 2013, <http://www.parliament.uk/business/publications/research/briefing-papers/SN06171/the-independent-commission-on-banking-the-vickers-report-the-parliamentary-commission-on-banking-standards>

²⁸ D.C. Langevoort, ‘Chasing the Greased Pig Down Wall Street: A Gatekeeper’s Guide to the Psychology, Culture and Ethics of Financial Risk Taking’ (2011) 96 *Cornell Law Review* 1209.

²⁹ D.C. Rose, *The Moral Foundations of Economic Behavior* (2011) 16; see also P. Pettit, ‘Republican Reflections on the Occupy Movements,’ in F. O’Toole (ed.), *Up the Republic* (2012) 169–81 (noting ‘it is a sad fact of human nature that while not many of us might be corrupt, not many are incorruptible; when opportunity offers not many are capable of resisting the temptation to make a quick buck. The timber may not be rotten but it is crooked.’ at 177).

lot of the work since the crisis has focused on strengthening the resilience of our institutions and infrastructure. As this work nears completion, the spotlight is shifting. It is shifting towards market practices, industry culture, and individual behaviour.³⁰

32. The above quotes demonstrate that the thorny normative challenges presented by the interdependent relationship between market integrity and industry culture are acknowledged in both national and international fora.

Recommendation 9: Establish a research centre, co-funded by industry, government and the academy to develop and execute an integrated research agenda capable of informing and influencing the trajectory of this most crucial debate and in so doing demonstrate Australia's capacity to exercise global thought leadership

Conclusion

33. The Financial System Inquiry is an opportunity for Australia to acknowledge the inextricable links between delivering a well-functioning financial system (TOR 2) and the prevailing industry behaviours and standards that constitute that financial system. Importantly this Inquiry is an opportunity for Australia to articulate normative benchmarks for organisations and individuals operating in the financial sector that will substantively improve the stability, risk management and governance of the Australian finance sector that in turn will promote its competitiveness and efficiency in capital allocation (TORs 1,2,3,5).

³⁰ M. Wheatley, 'Modeling Integrity through Culture' (Speech delivered at the FCA Markets Conference, London, 19 November 2013), <http://www.fca.org.uk/news/firms/modelling-integrity-through-culture>