THE INTELLECTUAL FOUNDATIONS OF THE GLOBAL FINANCIAL CRISIS: ANALYSIS AND PROPOSALS FOR REFORM

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I INTRODUCTION

The past two years' financial, and then economic, crises have led to widespread calls for rethinking market practices and regulation. A complex of specific market practices that have developed in the transition from an 'originate-and-hold' to an 'originate-and-distribute' model of banking[1] have been the focus of industry reports, domestic regulatory proposals and multilateral initiatives.[2] Many bank practices have been understood to have contributed to the crisis, and so are targeted for reform. These include, among others, excessive leverage; off-balance sheet accounting for special-purpose vehicles; securitisation practices that left banks with few incentives to exercise careful credit screening; the

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1 For an excellent early discussion of this transition, see Treasury Committee, *Financial Stability and Transparency*, House of Commons Report No 6, Session 2007–8 (2008).

2 As of this writing, there are a number of quite comprehensive reports with suggestions for reform. Those that these authors particularly recommend for their clarity and depth of analysis include the Turner Review in the United Kingdom: Lord Adair Turner, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009) Financial Services Authority <http://www.fsa.gov.uk/pubs/other/turner_review.pdf> at 12 September 2009, and also: Kern Alexander et al, *Financial Supervision and Crisis Management in the EU* (2007) European Securitisation Forum <http://www.europeansecuritisation.com/Market_Standard/Finance%20sector%20study.pdf> at 12 September 2009, IP/A/ECON/IC/2007-069; Jacques de Larosière et al, *The High-Level Group on Financial Supervision in the EU: Report* (2009) European Commission <http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf> at 12 September 2009; Commission of Experts on Reforms of the International Monetary and Financial System, *Recommendations* (2009) United Nations <http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf> at 12 September 2009.

complexity of financial products and lack of regulatory oversight or central clearing facilities for derivatives, especially credit default swaps; pro-cyclical risk models adopted in Basel II; and conflicts of interest at credit ratings agencies. As this paper is being written, the situation is in flux and what regulatory solutions will emerge is far from clear.

It is not surprising that the interrelated failings in the global financial markets are difficult to untangle and therefore to address, particularly since the economic crisis is not yet past and the regulatory challenges continue to evolve. Nor it is surprising that with the systematic deregulation of the financial markets, amongst other industries, over the past three decades in the United States and to a somewhat lesser extent the United Kingdom, the dramatic empirical demonstration of the results of that trend have convinced many that deregulation went too far, and that it is now time to restore an effective regulatory balance.

What is perhaps surprising, though, is the extent to which leading believers in 'light-touch' or 'no-touch' regulatory financial market approaches have publicly rejected at least some aspects of their prior catechism. Most notably, former chairman of the United States Federal Reserve Bank Alan Greenspan, a key architect of deregulation in the Reagan, Bush, Clinton and Bush administrations, has expressed surprise that one of the fundamental pillars of market self-regulation proved faulty. Thus, one axiom of orthodox economics is that individual self-interest will lead people and firms to make economically rational decisions. Another axiom is that market participants do a better job than government regulators in evaluating financial risk and thus determining the contours of necessary protection against that risk: protection that in a more regulatory environment would otherwise be provided by legal constraints. So it was a reversal for Greenspan to write in March of 2008 that '[t]hose of us who look to the self-interest of lending institutions to protect shareholder equity have to be in a state of shocked disbelief' since 'significant parts of [today's financial risk valuation system] failed under stress'.[3] And yet one must not overstate Greenspan's crisis of faith. In that same editorial in the Financial Times he also wrote that he hoped 'that one of the casualties [of the financial crisis] will not be reliance on counterparty surveillance, and more generally financial self-regulation, as the fundamental balance mechanism for global finance'.

A more searching critique was offered in the Turner Review for the United Kingdom's Financial Services Administration ('FSA'), issued days before the April 2009 London meeting of the G20 was convened to discuss financial system reform. Prior to the crisis the FSA had been celebrated for its principles-based 'light-touch' approach to financial regulation, and shared with the United States and Chairman Greenspan a faith in financial self-regulation. This is no longer the case. The Turner Review discusses in elegant detail 'the extent to which the crisis challenges past intellectual assumptions about the self-correcting nature of

3 Alan Greenspan, 'We Will Never Have a Perfect Model of Risk', *Financial Times* (London), March 17 2008, 9.

financial markets'.[4] Given the breadth of the critique in the Turner Review, we will discuss it in further detail below.

This is a moment in history which calls for reflection about the regulatory – and deregulatory – philosophy that has animated capital market regulation in the United States and United Kingdom. Part II takes that reflection forward. In Part III, we will discuss a number of important re-evaluations of capital market deregulation by regulators themselves. While the FSA in the United Kingdom goes further in challenging the intellectual underpinnings of existing capital market regulation than do the discussions yet forthcoming in the United States, we conclude Part III by observing that further insights on capital market regulation can be gained by comparing the theoretical and methodological commitments of different approaches to capitalism and corporate governance systems, which we do in Part IV. Thus, we discuss the neoclassical appreciation of liberal market systems and compare that to the Dutch and other European governance systems.

Having sketched out the problems created by translating unreconstructed neoclassical market theory into capital market regulation, we will then discuss Northern European alternatives for market regulation in Part V. We discuss existing European corporate governance models as an important starting point for the re-evaluation of capital market regulation, while recognising that the European models also have their weaknesses. We discuss these corporate governance counterpoints to emphasise that alternative market models exist, models with different underlying assumptions in which, at least in theory, social values and long term relationships get more attention. Thus, Northern European governance models can offer a source of ideas for market reforms that could lead to more stable markets with a longer-term investment orientation.[5] While corporate governance and capital market regulation are typically treated as separate subjects, we bring them together to argue that the same networked social values of the European corporate governance system should be incorporated into healthier capital market regulation. In Part VI we suggest some specific policy ideas for how to do that. Part VII concludes.

This article is deliberately ambitious and as a result sketches out many points which could be discussed in greater detail. This is not a time for tinkering about the edges, however. Prevailing theory has created the worst global economic crisis since the Great Depression, yet bankers and many countries' leaders seem determined to return to business as usual, perhaps with a few extra regulatory bells and whistles but with no fundamental reform.[6] Yet fundamental reform is

4 See the Introduction of the Turner Review: Turner, above n 2, 5–6.

5 We recognise the difficulties of legal transplants and the institutional complementarities that undergird corporate governance systems, so we are not arguing that the Dutch or any other Northern European corporate governance system could be exported to the United States. What we do argue in this paper is that the networked social *values* of these corporate governance systems should be emphasised in capital market reform efforts, and in Part VI we provide some policy proposals for how that could occur.

6 For one expression of concern about a return to 'business as usual' as the global financial crisis seemingly moderates, see Stefan Stern, 'We Need a Responsible Recovery, Not Business as Usual', *Financial Times* (London) 11 August 2009, 10.

necessary, we argue, not only in how we regulate markets, but also in how we think about markets. This article seeks to advance that process.

II HOW MAINSTREAM ECONOMICS LED TO MARKET FUNDAMENTALISM

The last thirty years have been dominated, in theory and practice, by a complex of beliefs about the operation of the capital markets and global financial integration that Nobel laureate and former International Monetary Fund ('IMF') Chief Economist Joseph Stiglitz has called 'market fundamentalism'.[7] The macroeconomic version of the theory is that global 'capital-market liberalization should be good for economic growth and [reducing] the volatility of consumption' of developing economies.[8] In contrast to the theoretical predictions, by 2003 even the IMF Board recognised that 'it becomes difficult to make a convincing connection between financial integration and economic growth once other factors, such as trade flows and political stability are taken into account'.[9] Actual capital market liberalisation and global integration have thus been associated with greater financial instability, more frequent currency crises, real economic dislocation and pro-cyclical flows of 'hot money' that do not necessarily lead to long-term growth.[10] In part this disconnect between neoclassical economic theory and real world results is because the underlying assumptions of the neoclassical model, assuming 'perfect information, perfect capital markets, and perfect competition' are 'a poor description of developed economies, and an even poorer description of developing countries and international capital markets'.[11]

Notwithstanding their weak descriptive validity, regulators in the developed economies of the United States and the United Kingdom have relied upon some of the same fundamental assumptions of neoclassical economic theory[12] in promoting capital market liberalisation within domestic economies. As we interpret these underlying assumptions for capital market regulation, they include:

(a) Market prices of capital assets efficiently incorporate all available public information ('the efficient capital markets hypothesis') and reflect

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7 Joseph Stiglitz, 'Capital-Market Liberalization, Globalization, and the IMF' (2004) 20 *Oxford Review of Economic Policy* 57, 57.

8 Ibid 59.

9 Eswar Prasad, Kenneth Rogoff, Shang-Jin Wei and M Ayhan Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence* (2003) International Monetary Fund <http://www.imf.org/external/np/res/docs/2003/031703.pdf> at 12 September 2009.

10 See Dani Rodrik, *Has Globalization Gone Too Far* (1997); Francisco Rodríguez and Dani Rodrik, 'Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence' (2000) 15 *National Bureau of Economic Research Macroeconomics Annual* 261.

11 Stiglitz, above n 7, 59.

12 For an overview and critique of neo-classical methodology see Geoffrey M Hodgson, *Economics and Institutions: A Manifesto for a Modern Institutional Economics* (1988) 28–48.

rational judgments about the discounted present value of future income streams from those assets ('the capital asset pricing model').

(b) So long as markets are transparent and do not suffer from information asymmetries then,

(c) Self-interested investors will make rational economic decisions to maximize their own utility consistent with their preferences for risk, return and liquidity,

(d) Which will lead to capital being allocated efficiently amongst a range of all possible productive uses of that capital; and

(e) As a result, social utility will be advanced, as the 'best' uses of productive intellectual and financial capital will prevail in the market.

Given such assumptions, governments have a number of important roles in capital market regulation. First, governments must establish the background conditions that are necessary for deep, liquid capital markets to thrive. These background conditions include well-developed rule of law norms; the potential for contracts to be enforced and property rights to be respected; sufficient securities law development and enforcement to protect against fraud. Second, governments have a role to play in addressing information asymmetries and other information imperfections so that investors can all have access to comparable information. Securities disclosure regimes are thus important, including the establishment of generally applicable, intelligent accounting standards that present a fair picture of a company's financial status.

Beyond that, though, as described by the Turner Review:

> the predominant tendency of financial markets theory of the last 20 to 30 years has been to assert that:
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> (i) efficient and liquid financial markets deliver major allocative efficiency benefits [by the above means] …
>
> (ii) markets are sufficiently rational as to justify a strong presumption in favor of market deregulation; and
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> (iii) that even if markets are theoretically capable of irrational behavior, policymakers will never be able to judge when and how far they are irrational with sufficient confidence to justify market intervention.[13]

As a result of the efficient capital market assumptions and the 'predominant tendency' as described in the Turner Review, unregulated aspects of the financial markets have flourished. These include many derivatives markets, hedge funds, private equity funds, leverage ratios, securitisations and off-balance sheet accounting. All were deregulated or never regulated, given the underlying

13 Turner, above n 2, 40.

assumptions that sophisticated investors could fend for themselves,[14] and that sophisticated math would keep firm-level risk within acceptable bounds.[15]

This is not to suggest that there were no academic criticisms of market fundamentalism and its underlying assumptions, or that there were no qualifications that were made to the theory.[16] In fact, the relatively simple version of neoclassical economics that has been used to justify deregulation in the United States for the past thirty years has been under theoretical pressure from some important economists over that same period of time. Most of the assumptions have been tested by economic research, which has led to criticisms and in some

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14 One clear example of this deregulatory trend in the United States concerned the attempts in 1998 of the Commodities Futures Trading Commission ('CFTC') Chair Brooksley Born to regulate derivatives. The CFTC issued a concept release identifying a broad range of concerns that the unregulated derivatives markets posed, including those issues posed by the Credit Derivative Swaps that came to be so central in the global financial crisis: Commodities Futures Trading Commission, *Over the Counter Derivatives: Concept Release*, (1998). The suggestion that the derivatives market might be regulated was met with resistance from senior Clinton administration officials, who under the auspices of the President's Working Group on Financial Markets, produced a report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, stating that:

> The members of the Working Group agree that there is no compelling evidence of problems involving bilateral swap agreements that would warrant regulation under the CEA [Commodities Exchange Act] … The sophisticated counterparties that use OTC derivatives simply do not require the same protection under the CEA as those required by retail investors. … In general, private counterparty credit risk management has been employed effectively by both regulated and unregulated dealers of OTC derivatives, and the tools required by federal regulators already exist.

President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (1999) United States Department of the Treasury, 15–6, 34, <http://www.ustreas.gov/press/releases/reports/otcact.pdf> at 12 September 2009. For an overview of deregulatory initiatives during the late Clinton administration and the entirety of the George W Bush administration, see Joseph Stiglitz, 'Capitalist Fools' (2009) 51 *Vanity Fair* 48; Consumer Federation of America, *Reform of Financial Markets: The Collapse of Market Fundamentalism and the First Steps to Revitalize the Economy* (2009).

15 See, eg, Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version* (2006) Bank for Institutional Settlements < http://www.bis.org/publ/bcbs128.pdf> at 12 September 2009.

16 Here we refer to extensive debates on methodology in the outskirts of economics and between economics and management science. Joseph Stiglitz is well known for criticising the influence of mainstream economic thinking on development policies; see, eg, Stiglitz above n 7. Also, the thoughts of George M Frankfurter on the current limited paradigm in modern finance are worth mentioning: see George M Frankfurter. 'The Theory of Fair Markets (TFM) toward a New Finance Paradigm.'(2006) 15 *International Review of Financial Analysis* 130. Methodologists such as Geoffrey M Hodgson and D Wade Hands have criticised almost every element of neoclassical economics, but especially the practice of economists of neglecting the theoretical and practical limitations of the underlying assumptions: see, eg, Hodgson, above n 12, e.g. 42–9; D Wade Hands, *Reflection without Rules: Economic Methodology and Contemporary Science Theory* (2001). In comparative analysis see Bart Nooteboom, 'Voice- and Exit-Based Forms of Corporate Control: Anglo-American, European, and Japanese' (1999) 33 *Journal of Economic Issues* 845; Ruth V Aguilera and Gregory Jackson, 'The Cross-national Diversity of Corporate Governance: Dimensions and Determinants' (2003) 28 *Academy of Management Review* 447; Gregory Jackson and Richard Deeg, 'Comparing Capitalisms: Understanding Institutional Diversity and Its Implications for International Business' (2008) 39 *Journal of International Business Studies* 540. Both methodological and comparative is the work of Nooteboom: See Bart Nooteboom, *Learning and Innovation in Organizations and Economies* (2000); Bart Nooteboom, 'Governance and Competence: How Can They Be Combined?' (2004) 28 *Cambridge Journal of Economics* 505.

cases modifications of the theory. A number of Nobel laureates have criticised parts of the neoclassical paradigm, including some, such as Amartya Sen (Nobel Prize 1998), Joseph Stiglitz (2001) and Paul Krugman (2008), who have advanced fundamental criticisms.[17] Yet neoclassical thinking still represents the mainstream in today's economics and almost every other theory starts from neoclassical reasoning. For example, transaction cost economics, institutional economics,[18] and behavioural economics are directly linked to this thinking, as is current financial theory, such as modern portfolio theory, as it is taught in universities and practiced in financial institutions.[19] On a microeconomic level, agency theory, in which the firm is modeled as a simple principal/agent relationship between shareholders, understood to be the principal, and management as their agents; and contract theory, in which firms are seen as a nexus of contracts, derive from the neoclassical economic theoretical perspective. Agency theory has been the bridge that law scholars and some economists, mainly in institutional economics and finance, have used to do comparative analysis between various economic models.[20] This is in contrast to a more

17 Besides Stiglitz (Noble Prize 2001), Amartya Sen is an example of a Nobel laureate (1998) who has a perspective on economics which goes further than neo-classical. Sen relates economic freedom with political freedom and states that economic and social development are intertwined and dependent of social preconditions: see, eg, Amartya Sen, Development as Freedom (1999).

18 Oliver Williamson can be seen as the main proponent of both transaction cost economics and new institutional economics. This latter economic perspective focuses on transactions in their institutional context. Institutional is here defined as legislative, being the best and only relevant representation of social norms: see, eg, Oliver Williamson, *The Economic Institutions of Capitalism* (1985); Oliver Williamson, 'The New Institutional Economics: Taking Stock, Looking Ahead' (2000) 38 *Journal of Economic Literature* 595.

19 Slowly more critique is being brought to bear on modern portfolio theory. Alfred Slager and Kees Koedijk state that not much has been empirically proven in investment theory: see Alfred Slager and Kees Koedijk, 'Investment Beliefs, Every Asset Manager Should Have Them' (2007) 33(3) *Journal of Portfolio Management* 77, 78. Both Nassim Nicholas Taleb and George Soros criticise the non-reflective character of modern economic theory as it is applied in investment. This non-reflective character is seen as a critical driver for herding and other irrationalities on financial markets, which endanger long term sustainable economic development. See Nassim Nicolas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007), e.g. 3–21, 62–83, 295–8; George Soros, *The Crisis of Global Capitalism: Open Society Endangered* (1998), part 1*; See generally George Soros,* The New Paradigm for Financial Markets. *The Credit Crisis of 2008 and What It Means* (2008). This is directly related to the methodological critique of Hands, Hodgson and Bart Nooteboom that economic methodology does not take reflectivity into account or, in other words, neglects the social constructive dimension of much that is happening on financial markets. Frankfurter questions the unwanted consequences of current market practices and tries to outline some suggestions for a different market paradigm: Frankfurter, above n 16.

20 Within this tradition the work of Rafael La Porta, Florencia Lopez-De-Silanes, Andrewi Shleifer and Robert Vishney is well known, even with their own acronym, LLSV. These authors compare economic systems by relating the legal protection of shareholders with the successful financial development of a country, often measured in stock price development, but, more recently, some GDP measures have also been taken into account. See Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46(2) *Journal of Economic Literature* 285; Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 24(2), *Journal of Finance* 471.

sociological view of the economy in which normative and cognitive aspects of economic transactions are also taken into account.[21]

Of course, parts of the criticisms of the neoclassical model have reached and been taken forward by mainstream economists themselves. Much economic research today is focused on further describing, detailing and specifying the assumptions of the neoclassical model and making clear when they work and when they do not. Behavioural finance can be seen as an example here. It has established the existence of common biases and heuristics in the way people process information; understanding these biases has informed and led to the modification of key rationality assumptions.[22] Information imperfections are now well understood to undermine the smooth functioning of real markets and to create credit and equity rationing.[23] Critical commentary has also shown that empirical results in real world financial markets and real world economies defied Panglossian economic predictions. Herding, asset bubbles, 'irrational exuberance' and momentum effects, just to name a few have undermined theories of fundamental value efficiency.[24] Even the self-interest assumption was subject to empirical examination and found to need significant qualification. Thus, people generally exhibit fairness constraints on their self-interested behaviour in laboratory experiments (less so economics students), in their relationships and even within firms, depending on the justice climate of the firm.

And yet an alliance of 'ideology and [economic] interests'[25] convinced regulators and policy makers to continue promoting capital market deregulation based on simple neoclassical models, particularly in the last decade, and particularly in the United States. One result – before the global financial and economic crisis – has been the rapid expansion of the financial sector within the United States and the United Kingdom.[26] By 2006, approximately 40 per cent of corporate profits in the United States and United Kingdom were based on finance – producing 'activities internal to the banking system [that were] growing far more rapidly than end services to the real economy'.[27] (These profits have been shown to be ephemeral, as US$7.2 trillion of public funds have been committed to shore up decimated bank balance sheets in the United States alone.[28]) Another result is that American investors, hungry for profits and with enormous pools of assets (pension funds, hedge funds and private equity) to invest increasingly (a)

21 See, eg, Aguilera and Jackson, above n 16; Jackson and Deeg, above n 16.

22 See Daniel Kahneman, Paul Slovic and Amos Tversky (eds), *Judgment Under Uncertainty: Heuristics and Biases* (1982).

23 Stiglitz, above n 7, 59. See also Taleb, above n 19, 215–52.

24 Robert Shiller's book *Irrational Exuberance* (2000) is the provenance for the quoted term. *See* Stiglitz above n. 7 and Turner, above n 2 for discussion of herding, asset bubbles, momentum effects, home country biases and other real-world conditions inconsistent with neoclassical economic theory.

25 Stiglitz, above n 7.

26 See Turner, above n 2, 16.

27 Ibid.

28 Judge Richard Allen Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (2009) xi. The US$7.2 trillion figure includes US$5.2 trillion by the Federal Reserve in various standby arrangements and acceptance of unmarketable securities as collateral for prime rate loans; and US$2 trillion by the Treasury Department.

justified their search for yield by claiming that private, shareholder wealth-maximising behaviour by firms and finance was the path to social wealth-maximising and (b) increased the pressure on European firms and countries to adopt clearer allegiances to shareholders and to abandon 'old European' versions of stakeholder capitalism.[29]

III DEREGULATORS AS CRITICS OF DEREGULATORY MARKET THEORY

While theoretical debate and empirical evidence were not sufficient to challenge deregulatory capital market trends, the evident failings of finance and economics over the last three years have caused some re-examination of the efficacy of financial system self-regulation by even some quite prominent deregulators. The FSA, the United Kingdom regulator of the financial markets, has put forward a thorough critique of financial market self-regulation. United States authorities such as Alan Greenspan, former Chairman of the United States Federal Reserve Bank, and Judge Richard Posner, father of the influential United States-based law and economics movement, have also recognised that certain aspects of their fundamental preconceptions about markets were wrong. These developments are worthy of further exploration.

A Self-Interest does not Protect the Market

As noted above, Alan Greenspan, for decades recognised as one of the most important global authorities on the financial markets, said in October 2008 to the United States House Committee on Oversight and Government Reform: 'Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief'.[30] This admission suggests an acknowledgement that one of the foundational elements of deregulated capital markets cannot bear the weight given it. That individuals' pursuit of their own self-interest is an adequate regulatory mechanism to promote the well functioning of the markets is one justification for deregulation. If self-interest cannot be relied upon to develop capital markets that intelligently allocate capital to the best productive uses (and it is perhaps astonishing that it was thought to have that capacity, given all of the theoretical attention that has been paid for decades to the problems of self-interest within the firm, given the assumptions of agency theory), the fundamentals behind market thinking have to be redesigned.

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29 Marie-Laure Djelic and Jabril Bensedrine, 'Globalization and Its Limits: The Making of International Regulation' in Glenn Morgan, Peer Hull Kristensen and Richard Whitley (eds), *The Multinational Firm: Organizing across Institutional and National Divides* (2001), 253.

30 Edmund Andrews, 'Greenspan Concedes Flaws in Deregulatory Approach', *The New York Times* (New York) October 24 2008, B1.

Another prominent advocate of market self-regulation who has reversed course is Judge Richard Posner, Chief Judge of the US Court of Appeals for the Seventh Circuit, Senior Lecturer at the University of Chicago Law School, and important architect and theorist in the development of the law and economics movement in the United States since the early 1970s. Law and economics theoreticians have generally, and vigorously, supported deregulation in a range of industries, including finance, as has Judge Posner. Yet, he now has the following to say about the current financial and economic crisis, which he is not shy to label a depression:

> Some conservatives believe that the depression is the result of unwise government policies. I believe it is a market failure. The government's myopia, passivity, and blunders played a critical role in *allowing* the recession to balloon into a depression, and so have several fortuitous factors. But without any government regulation of the financial industry, the economy would still, in all likelihood, be in a depression. We are learning from it that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience – the self-healing powers – of laissez-faire capitalism.[31]

Further on, Judge Posner contrasts the system of American capitalism that has failed with its more resilient cousin, the European system:

> The point is only that excessive deregulation of the financial industry was a government failure abetted by the political and ideological commitments of mainstream economists, who overlooked the possibility that the financial markets seemed robust because regulation had prevented previous financial crises. The depression is a failure of capitalism, or more precisely of a certain kind of capitalism ('laissez-faire' in a loose sense, 'American' versus 'European' in a popular sense), and of capitalism's biggest boosters.[32]

Notwithstanding this identification of the problems of American-style capitalism, in his review of Judge Posner's book, Nobel laureate Robert Solow concludes that Judge Posner has not come to any clear solutions to recommend, other than supporting a list of possible reforms that is shared by many other analysts (more transparency, limits on leverage, more control on managers, for instance).[33] Solow views the critical question in financial market reform as how to ensure the social function the financial system is meant to perform. 'Risks arise in the everyday business of economic life, and some human institution has to transfer them to those who are most willing to bear them', writes Solow, further stating that:

> I find it hard to believe, and I suspect that Judge Posner shares my disbelief, that our overgrown, largely unregulated financial sector was actually fully engaged in improving the allocation of real economic resources. It was using modern financial technology to create fresh risks, to borrow more money, and to gamble it away.[34]

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31 Posner, above n 28, xii (emphasis in original).

32 Ibid 260.

33 Robert Solow, *How to Understand the Disaster* (2009) The New York Review of Books <http://www.nybooks.com/articles/22655> at 12 September 2009.

34 Ibid.

Indeed, Judge Posner wrote that '[a]s far as I know, no one has a clear sense of the social value of our deregulated financial industry, with its free-wheeling banks and hedge funds and private equity funds and all the rest',[35] about which Solow concludes that:

> As Posner sees it, talk about greed and foolhardiness is comforting but not useful. Greed and foolhardiness were not invented just recently. The problem is rather that Panglossian ideas about 'free markets' encouraged, on one hand, lax regulation, or no regulation, of a potentially unstable financial apparatus and, on the other, the elaboration of compensation mechanisms that positively encouraged risk-taking and short-term opportunism.[36]

With this conclusion, both Solow and Judge Posner seem to ask for more fundamental ideas about how to restore the social value of financial markets. The authors of this article submit that the social value of financial markets is, at a minimum, allocating capital to socially productive uses so that new ideas and technologies can flourish, and so that successful companies can continue to pursue effective long-term strategies. As we discuss below, combining the values of Northern European models of corporate organisation with capital market regulation suggests a way forward to address the instabilities of deregulated markets and socially unproductive uses of capital, and thus provide some solutions to the problems of modern markets that both Judge Posner and Professor Solow perceive.

B Market Regulators Start Questioning the Fundamentals

While the comments of Alan Greenspan and the commentary of Richard Posner are nothing less than astonishing to anyone schooled in law in the last three decades in the United States or familiar with American political debates, they fall short of sustained intellectual engagement with the underlying reasons for these failures of deregulatory policies. The Turner Review of the FSA in the United Kingdom addresses that gap. Thus, the Turner Review concludes that each of the following five assumptions of the theory of efficient and rational markets 'is now subject to extensive challenge on both theoretical and empirical grounds': [37]

(i) Market prices are good indicators of rationally evaluated economic value.

(ii) The development of securitised credit, since based on the creation of new and more liquid markets, has improved both allocative efficiency and financial stability.

(iii) The risk characteristics of financial markets can be inferred from mathematical analysis, delivering robust quantitative measures of trading risk.

(iv) Market discipline can be used as an effective tool in constraining harmful risk taking.

35 Posner, above n 28, 295.

36 Solow, above, n 33.

37 Turner, above n 2, 39.

(v) Financial innovation can be assumed to be beneficial since market competition would winnow out any innovations which did not deliver value added.[38]

From its careful canvassing of empirical evidence and evaluation of each of these assumptions, the Turner Review draws a number of conclusions that are relevant to reforming capital market regulation. First, the Turner Review recognises that efficient markets can be irrational. While the assumption had been that independently acting market participants would react to new information based on rational assessments and that prices would tend towards a rational equilibrium, recent events have shown that efficient reactions to new information does not imply fundamental value rationality as there can be herd effects, momentum effects and price overshoots.[39] Moreover, and of more serious significance for regulatory policy, even if individuals act rationally, that does not imply collective rationality or that social welfare will necessarily be advanced. We see that today with concerns about the implications of the savings trap: the negative collective effects on an economy that can occur if every individual acts rationally and saves more money and spends less in light of insecure economic conditions, which drives demand down and further undermines collective economic security.[40] The Turner Review further concluded that allocative efficiency benefits have limits, so that 'beyond a certain degree of liquidity' the additional allocative efficiency benefits of further liquidity and market completion are outweighed by the risks of creating asset bubbles and additional instability – a risk it thought particularly prominent concerning securitisation.[41] A major theme throughout the Turner Review was that stricter, counter-cyclical regulation is needed to promote collective market welfare, rather than relying upon notions of individual rationality, the accuracy of market signals and self-interest to advance important social goals. This counter-cyclical presumption extends, analogously, to the level of theory. Recognising that accepting "conventional wisdom" was part of the problem leading to excessive risk-taking, dangerous leverage levels and systemic instability, the Turner Review suggested considering instituting mechanisms for bringing in '"deliberately counter conventional wisdom views" to challenge regulators' and market participants' preconceptions.[42] Together with Greenspan and Posner, the Turner Review acknowledges the limits of the theory that free, rational, well-informed market participants, by only striving for their own interest, create social welfare.

C What do the Current Evaluations by Market Regulators Teach Us?

If we summarise these leading criticisms on current market thinking, we can draw the following conclusions.

38 Ibid.
39 Ibid 40–1.
40 Ibid.
41 Ibid 41.
42 Ibid 85.

First and foremost, many now seem to agree that self-interest cannot be the only value shaping market regulation. In our view, there should be better mechanisms for collective interests and social values to supersede individual self-interest, since self-interest can promote conditions of excessive risk taking, short-term gratification and greed. The legitimate interests of market participants that regulation ought to promote should be defined to coincide with market conditions that will promote longer-term investment decisions and reduce systemic risk.

Second, current regulation does not lead to integrity per se, so governments (and educators) have to find other solutions to stimulate the integrity of both markets and market participants. This questions the fundamentals of regulatory design.

Third, stability is not something that is dependent on regulation only, but is an intrinsic characteristic of how market participants behave and which time horizon they use to express the reward of their actions. It is about how market participants interact when making transactions and what they take into account when they make these transactions.

These conclusions lead us to think it is necessary to develop a new perspective on the regulation of the capital markets, as do some of the authorities discussed above. Judge Posner's conclusion that American capitalism failed, while Europe's proved more resilient as a general matter, supports our view that there is much to learn from Europe, and specifically European corporate governance systems as we canvass for ideas for capital market reform.

IV MARKET FUNDAMENTALISM AND GOVERNANCE SYSTEMS

In economics and management sciences, there is an extensive literature on corporate governance systems, the legal framework within which the relationship between stakeholders and a company may be constituted.[43] Most often, authors define two ideal types: an Anglo-American or market-based model, especially in the US, the UK and Australia, and a network-based model common in Europe and Japan, as well as in some rapidly emerging economies such as Brazil, China

43 Corporate governance systems go beyond legal requirements structuring the relationships between companies, the board, management, employees and shareholders. One can also consider legislation in the field of regulations protecting stakeholders, eg by legislation that organises consumer protection and antitrust law as part of corporate governance.

and India.[44] In Table 1, the predominant characteristics of the two types of governance systems are displayed. These characterisations have a highly theoretical nature and can be seen as idealised types on a continuum, in which the Market system defines one end of the continuum and the Network system defines the other. Thus, in every jurisdiction elements of both can be found, but the relative proportions of market versus social control of corporate and economic relationships vary.

Over the last decades, the agency perspective has been dominant in economic thinking about governance systems, concomitant with an emphasis on shareholders' interests. Agency issues began to draw academic attention with the recognition by Berle and Means of the separation of ownership from control in the modern American firm, a separation which gave rise in economic analysis to a preoccupation with agency issues at the core of the firm.[45] Clearly, as a matter of law whenever there is a principal/agent relationship, agency issues are central, and thus agency issues are important within every firm. Yet the 'agency perspective', as we are using the term, also encompasses the idea as it has been applied by many economists and law professors that shareholders are the principal in the relationship, and management and the board are the shareholders' agent. Contrary views, such as that the corporation is the principal, or that a team of stakeholders is the principal, are rejected within the dominant agency perspective.

The agency perspective has been supplemented by a conception of the firm as a 'nexus of contracts', operating in institutional environments in which governments set the framework in which capital flows freely.[46] Within an agency perspective on the market, since it is based on neoclassical economics, law has the somewhat minimalist remit described above: to safeguard a level playing

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44 See, eg, La Porta et al, above n 20; Aguilera and Jackson, above n 16. Within a tradition of comparative law, Pistor uses the terms 'liberal market economies' and 'coordinated market economies', following Peter Hall and David Soskice (eds), *Varieties of Capitalism: the Institutional Foundations of Comparative Advantage* (2001): Katharina Pistor, 'Legal Ground Rules in Coordinated and Liberal Market Economies', (Working Paper No 30/2005, European Corporate Governance Institute, 2005). It is possible to make further distinctions. Weimer and Paape distinguish four systems: the Anglo-American model, the Rheinland model (state employee involvement with dispersed ownership), a southern European model (large family-controlled holdings plus state involvement) and a Japanese system (state influence and many cross holdings): Jeroen Weimer and Joost Paape , 'A Taxonomy of Systems of Corporate Governance'(1999) 7(2) *Corporate Governance* 152; Richard Whitley, *Divergent Capitalisms: the Social Structuring and Change of Business Systems* (1999). Aguilera et al further distinguish between the American corporate governance system and the British, contending that the corporate governance system in the UK has a stronger accountability mechanism in the board and a greater sensitivity to social responsibility concerns than does the American: Ruth Aguilera et al, 'Corporate Governance and Corporate Social Responsibility: A Comparative Analysis of the United Kingdom and the United States' (2006) 14(3) *Corporate Governance: An International Review* 147.

45 See, eg, Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3(4) *Journal of Financial Economics* 305; Eugene F Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economics* 288.

46 See, eg, La Porta et al, above n 20; Williamson, above n 18; Michael C Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' in Jörg Andriof et al (eds), *Unfolding Stakeholder Thinking* (2002).

field for all economic actors, mainly by ensuring transparency; and to create clear systems of property rights and contractual enforcement mechanisms.

Ironically, in developing the 'nexus of contracts' view of the firm one important participant in the discussion, University of Chicago economist Eugene Fama, was clear that:

> ownership of capital should not be confused with ownership of the firm. Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this 'nexus of contracts' perspective, ownership of the firm is an irrelevant concept.[47]

Fama also recognised that fully diversified shareholders do not have 'a special interest in [any one firm's] viability,' even though they are residual claimants, since – unlike labour and management – shareholders can 'shift among teams [firms] with relatively low transaction costs and to hedge against the failings of any given team by diversifying their holdings across teams.'[48]

Yet, shareholders' 'ownership' status, and/or position as residual claimants, have been the rationales for 'shareholder primacy' corporate governance theories. The emphasis on shareholders has excluded broader consideration of other team members' interests in most American law theory as well, the primary counter-example being Blair and Stout's team production model of the corporation.[49] Moreover, the emphasis on shareholders as residual claimants has not distinguished the short-term financial interests of fully-diversified portfolio investors from the long-term financial interests of stable, sustainable operating companies and economies. If markets promote fundamental value efficiency and the intelligent allocation of capital, there should be no difference between the short-term and long-term perspectives. But as recent events and evaluations have shown, markets are not operating in this way.

There are a number of problems with the agency-influenced view of corporate governance worth exploring. In these theories, business relationships are defined as if they only exist in bilateral contracts and within stable institutional arrangements. Political, technological, cultural and ethical influences are seen as stable, and not changing in relevant ways in decades.[50] Within the leading economic models radical changes such as the current crisis, have not been taken into account,[51] nor have the influences of economic thinking on social and cultural changes been subject to reflective examination within economics. In other words, finance and economics have been treated as distinct from social phenomenon, notwithstanding the seminal work of economic sociologist Mark

47 Eugene Fama, 'The Disciplining of Corporate Managers' (Selected Paper No 56, Graduate School of Business University of Chicago, 1980) 4.

48 Ibid.

49 Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

50 Hodgson, above n 16; Hands, above n 16.

51 See generally Taleb, above n 19.

Granovetter showing their inter-related status in modern market economies.[52] With the fundamental assumptions of market efficiency by self interested economic actors under scrutiny, as in the Turner Review, we submit that shareholder dominated agency thinking should be re-evaluated as well. In the next section, we discuss the other major governance system, a network-based or stakeholder-oriented model, as a field to canvass for ideas on capital market reform. We recognise that this is quite familiar territory for many readers, but we use it to provide a context for developing the values that could influence the policy reforms suggested in the subsequent section.

V NETWORK SYSTEMS AS INSPIRATION IN THE DEVELOPMENT OF REFLECTIVE CAPITALIST MODELS

A Alternative Governance Systems

Within the outskirts of economics, in management science, the discussion about governance systems has been less decidedly shareholder dominated. Contrary to, or supplementary of, agency theory, stewardship theory and stakeholder theory have come into existence. Within this perspective, a company should not only be accountable to shareholders but also to a broader range of stakeholders.[53] The stakeholder perspective of a company supplements the agency theory, since no-one disagrees that shareholders are a stakeholder of the firm.

Proponents of stakeholder views take issue with certain aspects of shareholder-dominated agency theories. One critique of agency theory is that too much emphasis has been placed on conflicts of interest between rationally operating actors within the firm, often simply construed as conflicts between the managers and the 'owners' of a company, the shareholders. In such a view, not enough emphasis has been placed on cooperation within the firm and on the optimal conditions for cooperation. In addition, economic exchange relations are most often not one-to-one relationships, but occur in complex networks in which an agent is also hiring other agents, who in turn hires other agents. In a recent paper Johnson and De Graaf[54] describe this phenomenon for the pension fund industry. Pension funds trustees often hire investment consultants who hire a range of asset managers (corresponding to the range of asset classes in which the pension fund ought to be invested), creating such a complex network with so

52 Mark Granovetter, 'Economic Action and Social Structure: The Problem of Embeddedness' (1985) 91(3) *American Journal of Sociology* 481.

53 See eg, R Edward Freeman, *Strategic Management: A Stakeholder Approach* (1984); James H Davis, F David Schoorman and Lex Donaldson, 'Toward a Stewardship Theory of the Firm' (1997) 22(1) *Academy of Management Review*, 20; Thomas Kochan and Saul Rubinstein, 'Toward a Stakeholder Theory of the Firm: The Saturn Partnership'(2000) 11(4) *Organization Science* 367.

54 Keith L Johnson and Frank Jan de Graaf, 'Modernizing Pension Fund Legal Standards for the 21st Century' (2009) 2, *Rotman International Journal of Pension Management* 44, 47 (Table 1).

many agents within the supply chain, that a clear agency relationship between the pension beneficiaries and the companies in which their money is invested has disappeared. From a European perspective it is problematic that in such a network there is no clear connection between the social preferences of beneficiaries and the investment activities of their agents.

In Scandinavia, the Netherlands, Germany, and Austria, economies can be seen as social market system or network-based system[55] (see Table 1), which can have a positive impact on both the financial and social performance of companies in those countries, but has a positive effect on societies as well.[56] Although often overlooked by academics in economics, the stakeholder perspective of the firm can best be illustrated by business practices in Northern European countries. Whitley has collected numerous case studies showing how shareholders and other stakeholders shaped economic systems in these countries,[57] and Arndt Sorge has written about the impact of globalisation on local communities, describing the Northern European systems, mainly by using Germany as example, as long-term oriented, which created a social welfare system and a shared responsibility for sustainable economic development. Sorge relates the technological strength of the German economy, for example, to the system of guilds in that country in the Middle Ages. Craftsmanship has been an important value in Germany from the Middle Ages, which is now institutionalised in various measures.[58] The studies of business systems by Sorge, Whitley and many others relate the development of business models to historical and cultural determinants in which societies for long have been seen as organisms: social systems in which various economic actors are tied to each other by a large set of implicit and explicit rules. De Graaf and Herkströter describe the establishment of the Dutch governance system in depth, stating that in developing a system which balances stakeholder interests, corporate social responsibility is embedded in the governance structure of the company.[59] The assumption that a company is not only accountable to shareholders, but accountable to other stakeholders, is

55 Network-based systems can be defined as systems in which reputational mechanisms in a network are seen as the most critical form of corporate control. This lies in contrast to market-based systems, in which 'exit' is the critical determinant for control. As such, it is the same distinction as market and social market governance systems, but with a different focus (corporate control). Network-based systems are most common in Europe and Japan; market-based systems predominate in the US and the UK. See generally Frank Jan de Graaf and Cor Herkströter, 'How Corporate Social Performance Is Institutionalized in the Governance Structure: the Dutch Governance Model' (2007) 74(2) *Journal of Business Ethics* 177.

56 Jeffrey D Sachs, *Common Wealth: Economics for a Crowded Planet* (2008) 258-64 collects data that compares the economic and social outcomes of the social welfare economies (which he defines as Denmark, Finland, Norway and Sweden), with the mixed economies (Austria, Belgium, France, Germany, Italy and the Netherlands, which straddles both the mixed economies and the social welfare model), with the free market economies on such measures as economic equality; income security, poverty reduction, labor market outcomes (employment rates) and standard of living; and finds that the social market economies outperform the market economies on each measure.

57 Whitley, above n 44.

58 Arndt Sorge, *The Global and the Local: Understanding the Dialectics of Business Systems* (2005).

59 De Graaf and Herkströter, above n 55, 177.

established in law by the development of a subtle system in which no stakeholder has, in the end, a disproportionate say in the company.

B The Dutch Corporate Governance System: An Example of Network Interaction

The Dutch network system was developed around 1970 by a group of lawyers strongly influenced by a 'corporatist' tradition, found in Roman Catholic and Protestant writing on economic development. They tried to bridge the tensions between labour and capital by helping employees and employers to understand their mutual dependencies. Within the 'corporatist' tradition, law functions differently than in (liberal) market systems. Within this perspective law is not (only) an instrument for ensuring proper economic transactions (assuming self interest, creating transparency, within a market space with no interference of other parties), but lawmakers and lawyers are also serving the objective of building long-term sustainable relationships. In his work on the German economic governance system, Arndt Sorge attacks market thinking, stating that British banks care for the money of those already have it, where German banks exist to make money available for those who do not have it yet.[60] He relates the German approach to 'metatraditions', a specific institutional context in which there is a balance between individual and collective interests, driven by a mutual understanding of interdependency.[61]

In the two-tiered governance system in the Netherlands, the executive board is accountable to a supervisory board. The supervisory board is responsible by law to balance the interests of the different stakeholders groups.[62] To be able to do so, the supervisory board is independent: while both shareholders and the works council can nominate new members to the board, they were until 2004 appointed by cooptation (the sitting members appoint new members). Although shareholders have recently achieved more influence with the corporate governance arrangements, consensus is a key characteristic of decision-making in this system, and members of the board have a shared responsibility for all decisions taken.[63]

To balance the interests of different stakeholder groups, the supervisory board holds the executive board accountable for the 'general interest' and 'continuity' of the company. This balancing act limits the say of all stakeholders.

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60 Sorge, above n 58, 206.

61 Ibid.

62 The Code is based on the principle accepted in the Netherlands that a company is a long-term alliance between the various parties involved in the company. The stakeholders are the groups and individuals who, directly or indirectly, influence – or are influenced by – the attainment of the company's objects: i.e. employees, shareholders and other lenders, suppliers, customers, the public sector and civil society. The management board and the supervisory board have overall responsibility for weighing up these interests, generally with a view to ensuring the continuity of the enterprise, while the company endeavours to create long-term shareholder value.

Corporate Governance Code Monitoring Committee, *Dutch Corporate Governance Code: Principles of Good Corporate Governance and Best Practice Provisions* (2009) 6[7] <http://www.corpgov.nl/page/downloads/DEC_2008_UK_Code_DEF__uk_.pdf> at 13 September 2009.

63 *Dutch Civil Code*, art 2:9.

For example, shareowners cannot instruct the supervisory board and executive board of a company.[64] They have a say in appointing or firing the supervisory board, remuneration, and must agree on the annual accounts and on major mergers and acquisitions.[65]

The resulting management stance is illustrated in a quote from a former CEO of a Dutch bank, ING, who commented on the reactions from stakeholder groups after a year with particularly good financial results:

> All our stakeholders were disappointed. Shareholders had wanted more dividends, employees' higher wages, [borrowers] lower interest rates, and retail clients more interest on their savings. Such criticism was a signal that we had done a good job. We would have had a problem if one of the groups had not complained. That would have meant that we had favored one of the groups over the others.**[66]**

The stakeholder model leads to a delicate interaction model, which can be illustrated by the role of the works council in the Dutch system. Together with shareholders, who have in some circumstances more rights than in the United States,[67] works councils have (by law) a critical role in companies that have more than fifty employees: they represent employees in decision making processes within the company, not only to safeguard employee' interests, but also to be in defined circumstances partly responsible for long-term decisions and to represent the company's interests.[68] Moreover, the works council 'shall do all in its power to promote environmental care on the part of the enterprise'.[69] Along with shareholders, the works councils were given a special place in company law, although their main roles are defined in the *Works Council Act*.[70] First, the works council nominates the supervisory directors. Given this power, the works council received three other rights (1) the right of information, (2) the right of advice and (3) for some decisions, the right of approval. The last-mentioned right relates to decisions regarding reorganisations, investments that critically influence the

64 Being independent, the board can have another opinion than the controlling shareholders. In critical issues, the shareholders can vote against management and thereby question the functioning of the supervisory board. Also, the shareholders can vote against appointing a new member of the supervisory board: *Dutch Civil Code*, art 2:142.

65 *Dutch Civil Code*, art 2:4.

66 See, eg, Whitley, above n 44; De Graaf and Herkströter above n 55. Recently, more attention is given to the role of stakeholders in governance structures and its impact on corporate social responsibility; see, eg, Frank Jan de Graaf and Jan Willem Stoelhorst, **'**The Role of Governance in Corporate Social Responsibility: Lessons from Dutch Finance' (2009, forthcoming) *Business & Society*.

67 For instance, under Dutch corporate law, it is easier to block appointments to the board of directors or to call special meetings than under US corporate law. This is related to the difference between plurality voting (US) and majority voting in the EU. See, eg, J Winter, 'Corporate Governance Handhaving in de VS, EU en Nederland' in M J Kroeze et al (eds), *Verantwoording (aan Hans Beckman)* (2006), 621.

68 *The Dutch Works Councils Act: English translation of the Dutch text of the Works Councils Act (Wetop de ondernemingsraden)* (2004) ('*Works Council Act*') Social and Economic Council, art 28, <http://www.ser.nl/~/media/Files/Internet/Talen/Engels/2004/2004_or.ashx> at 13 September 2009.

69 *Works Council Act*, art 28.4.

70 *Works Council Act*, art 28.4.

characteristics of the firm[71] and changes affecting the legal status of all employees, such as a spin-off where the resulting company would have fewer than fifty employees and thus no works council.

By giving the employees various ways to influence a company, an important interdependency came into existence.[72] For instance, the right of information may seem to be a toothless tiger, but it is not. It means that management has to explain its decisions, often on a monthly basis, to employees. If this is not done in a serious way, the works council could go to court.[73] Given the seriousness of this measure, today in the Netherlands management invests in stakeholder – in this case employee – relations. The management of a firm has to put serious energy into explaining its policies, which means it takes the perspectives of others into account in formulating those policies. The right of advice and the right of approval can be seen as similar measures, asking management to take the perspective of other groups into account. This is not done by strict regulation about how management should behave, or when it should disclose certain information. Rather what we see is reflectivity, organised by methods of dialogue.[74]

This Northern European thinking implies that courts are seen as last resort. In a healthy relationship, people do not have the intention to go to court to solve their disputes. Rather, they try to create mutual understanding that gives ground for compromises, or, even better, for the best solution. Critical to understanding almost all European countries is that social values within markets and in between companies are not only set by regulation, but by 'voice', by the necessity of companies to be in dialogue of various stakeholders, formalised by corporate law. The nature of voice also implies that courts do not only decide on which individual is right, but make decisions guided by the society's interest as well.

There are, of course, criticisms that can be brought to bear on European stakeholder systems. In the last two decades these systems have been criticised both inside and outside the EU, mainly because national peculiarities block the development of free international markets, making it more difficult for outsiders to enter a specific national market. Furthermore, law that tries to ensure long-term relationships makes labour markets less flexible. Thus, network systems can get sticky. The status quo is often more important than innovation and current positions can hinder necessary changes in corporate policies to adapt to challenging market conditions.

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71 All these questions are related to the notion of the 'continuity' of the firm. If the shape of the firm would change importantly, for example, were a firm to sell all the key assets, the works council would have a say.

72 De Graaf and Herkströter above n 55, 184.

73 If a group of shareholders, unions and works councils have a dispute with the management of a company, and regular influence pathways are not seen as effective, they can go to court. A special section of the Amsterdam court, de 'Ondernemingskamer' can decide in those circumstances whose opinion should prevail, although also in their rulings often committees are installed that should bring the two parties on speaking terms again.

74 De Graaf and Herkströter, above n 55, 184.

In our view, these weaknesses do not, however, give adequate reason to question the underlying principles of the stakeholder systems. Northern European countries have developed highly successful economies that nonetheless protect social welfare values. Germany is, for example, still the world's largest exporter and market leader in engineering, automotives and other high technology industries such as machine making for manufacturing. The automotive industries in Japan and Germany are enviable as the American automotive industry collapses. Scandinavia is leading in the development of mobile telephony, computer applications and renewable energy technology. While the US is still a market leader in a number of industries (computers and biotech, for instance, and aviation in addition to the French), those are all fields in which the government has had a major funding and coordinating role through military spending and government grants to universities. In other words, these are fields with long-term, stable relationships between government and industry, much like the coordinated economies of Europe, and not fields where 'the market has decided' how to allocate funds.[75] The US and UK are clearly market leaders in financial engineering and finance generally, but even Judge Posner and Lord Turner now question how socially valuable that leadership is.

C The Implications of Network Thinking

The creation of systems of interaction, that is network systems that help companies and stakeholders have dialogues, does not fit in neoclassical economic theory.[76] One critical difference is that within neoclassical economics the rational market actor makes decisions in a relationship between two parties. Social dynamics and social networks are not taken into account in the economic view of the market. A stakeholder or network view of the market assumes a different perspective on the market. In dialogue with relevant stakeholders, managers or other economic actors make decisions.

The Dutch corporate governance system is one example of a system that attempts to create conditions to encourage these values among parties with quite different perspectives and financial interests. Dialogue is critical in this system.

As has been stated above, the interaction between various stakeholders in economic decision making provides an important contrast to the assumptions of neoclassical economics and agency theory. In network thinking, the key assumption is not that actors make deals on a market only striving for their own personal interests. The underlying principle is mutual long-term dependency between various stakeholders that act in close networks in which states set some limited guidelines for how and when various stakeholders should interact. At critical moments, stakeholders representing different interests (often related to different values and beliefs) have to discuss issues with each other. The regulatory structure is less specific about the outcomes of these interactions than that the interactions are required.

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75 Ha-Joon Chang, *Bad Samaritans: The Myth of Free Trade and the Secret History of Capitalism* (2009).

76 See, eg, Hodgson, above n 16; Nooteboom, above n 16.

In European stakeholder systems, then, regulation sets standards for dialogue and in doing that it enables stakeholders to reflect on their own interests, the interests of others involved and the long-term interests shared by everyone. In focusing on dialogue, the legislator accepts the limitations of law. Law can never tackle all of the social implications of economic behavior, because of the general nature of law and because new technologies and financial engineering can emerge to allow parties to engage in regulatory arbitrage. Therefore on critical moments stakeholders with other interests need to be able to influence a company.

Another contrary principle within these stakeholder systems is that markets are not considered 'value free' and it is understood that the economic decisions of even private actors such as companies have important consequences for the well-being of society. Because of these values, stakeholders should have a voice in companies' economic transactions. This is not only because the interests of stakeholders are better protected by giving them influence. At critical situations companies also need societies, as we see today in the US in the banking, automotive, derivatives and insurance (AIG) industry. If there is mutual dependency, interaction is critical to safeguard the shared interests.

VI INTEGRATING SOCIAL VALUES AND REFLECTIVITY INTO CAPITAL MARKET REGULATION

We have discussed the Northern European system in detail as an approach to develop a broader perspective on market regulation than is currently predominant. Within this perspective, when evaluating proposals for market reform a critical question should be if stakeholder interests are represented. We do not (naively) suggest that the Dutch or German or other European systems could be exported to the US, given the historical and cultural roots of corporate governance systems. Neither is it our intention to idealise these systems, which have their flaws also. Comparative research can lead to important insights, though, and such insights are necessary in the current context, given the evident need for new regulatory approaches. When we try to extract from networked-based corporate governance systems some principles for thinking about embedded capital markets, we suggest that recognising the interdependency of various stakeholders should be an important cornerstone of legislation. Interdependency not only requires transparency, but also recognises the need for stakeholders to create long-term relationships to advance shared goals.

How might regulators take the values of reflective, stakeholder corporate governance into account in addressing capital market reform? We only begin the process of suggesting ideas here, a process we intend to take forward in more detail in further work.

Some context is in order to begin, though. These suggestions assume that certain regulatory changes will be taken forward by the international community

in order to stabilise global finance. As this article is being written, it seems that counter-cyclical capital charges (as in Spain,[77] and as recommended by Lord Turner)[78] may be enacted, that there will be some greater regulation of the use of derivatives, particularly credit default swaps, and that there might be limits enacted to risk-creating executive compensation systems. Excessive leverage is another causal element of the global financial crisis that may be addressed. These authors consider each of these aspects to be necessary but not sufficient to create conditions for global financial stability. What is also needed is to put the world's financial system onto a more sustainable path, one that can project into the future with confidence that we are solving critical issues of systemic risk, misallocation of capital, underinvestment in human capital and accelerating depletion of critical natural resources. We sketch out below a number of other areas where global financial markets could be, and should be, reformed to incorporate more of the social and environmental values that European network structures work to include.

First, to moderate excess financial churning and to fund critical sustainable development worldwide, financial transactions should be assessed and taxed by their contribution to the economic benefit of a country, from currency transactions to mergers and acquisitions. Lord Turner has recently suggested a version of the Tobin tax could be used to tame financial speculation, a policy idea worthy of serious consideration.[79] While the Tobin tax on financial transactions was first suggested in 1972, it may be an idea whose time has finally come.

Second, creating mechanisms to incorporate social values into capital market functioning is critical. The language of markets is accounting. At a microeconomic level, International Financial Reporting Standards ('IFRS') need to be revised to include measures for all of the positive and negative social and environmental externalities companies produce. So, for example, when companies invest in training their employees, that investment should be treated as a capital investment, not as a cost. When companies use water, produce greenhouse gas emissions or other pollution, undermine habitats, those should be treated as costs. Measures such as Yale University environmental economist Robert Repetto's 'True Economic Value Added', which incorporates measures of environmental harm into an integrated measure of financial results, have been developed with intellectual rigor and are ready to be implemented into national and international accounting standards.[80]

Third, also at a microeconomic level, companies should be required to disclose specific environmental, social and governance data, including

77 See 'Spanish Steps: A Simple Way of Curbing Banks' Greed', *The Economist,* 15 May 2008 (discussing Spanish bank regulation, including counter-cyclical capital charges) <http://www.economist.com/specialreports/displaystory.cfm?story_id=11325484> at 17 September 2009.

78 Turner, above n 2, at 53-67.

79 Ibid.

80 Robert Repetto and Daniel Dias, 'TRUEVA: A New Integrated Financial Measure of Environmental Exposure, *Yale Center for Environmental Law and Policy, Working Paper No. 200602*, 15 October 2006.

discussions of how boards of directors are evaluating human rights, social and environmental risks, and what stakeholder consultations inform the company's analysis. Requiring companies to disclose such data, with some potential liability consequences, can create conditions of reflexivity in smart companies.

Fourth, at a macroeconomic level, projects such as the French President's Commission on the Measurement of Economic Performance and Social Progress for replacing GDP as a measure of a country's economic health are of great value. Led by Nobel-laureates Joseph Stiglitz and Amartya Sen, it attempts to address known issues with GDP measures, as well as to incorporate quality of life and sustainable development and environmental factors, into country level measures.[81] This suggested measure could be translated into domestic practice if adopted by the Financial Stability Board.

Each of these initiatives, albeit incomplete and imperfect, would start a process for incorporating stakeholder concerns into capital market financial values, and thus permit greater reflectivity at both company and country levels.

We recognise the irony of suggesting that social concerns and values be incorporated into the capital markets in significant part through the reductionist language of numbers. However, we think a stakeholder perspective on this language can overcome the reductionist tendencies. Within our assumption that markets have to serve people, new regulation has to be understandable for stakeholders and has to serve their common interests. This directly relates to the principle of fairness that is a cornerstone of every regulatory system. In the end, regulation is a framework that allows actors to make the best possible decisions. We are proposing that market regulation should no longer be conceptualised to serve the rational self-interest of individuals, but should help individuals – all within their own limited responsibility – to make the best decisions together, decisions that serve the common interest. This is not an idealistic plea only. It is a lesson we can learn from that other governance system, as it is active in some Northern European countries.

VII CONCLUSION

In recent decades, an unrefined version of neoclassical economic thinking has been the primary influence on market regulation in the US and, to a lesser extent, the UK. The market was assumed to be only a set of discrete transactions on interconnected sub markets. In this definition the market is a separate area of society, apart from social and cultural concerns, in which individual self-interest could be expected to advance both personal and social interests. That expectation has proved naïve. This paper argues that the rigid use of neoclassical theory, defined, following Stiglitz, as 'market fundamentalism', has been one of the

81 Draft Summary, International Commission on the Measurement of Economic Performance and Social Progress, 2 June 2009, <http://www.stiglitz-sen-fitoussi.fr/documents/draft_summary.pdf> at 15 September 2009.

causes of the current financial crisis. In this market the self-interest of actors, which can develop into greed as a pathology, is the key driver of social progress; and under the assumption of full information, the market was assumed to develop towards a certain equilibrium between demand and supply on a consistent basis. By copying neoclassical economic thinking, methodological flaws have been incorporated in market regulation. The deterministic, individualistic, rational view of markets tending to equilibrium has led to neglecting the critical role of social values and change in economic progress.

Market regulators have accepted the role of neoclassical protagonists too easily. By focussing on self-interest within assumed value free markets, in the end every individual market participant is suffering and the well-being of societies is endangered.

If regulators want to facilitate sustainable and innovative economic growth, they should accept a more complex, less theoretical view of markets. In this view transactions are embedded in societies and must incorporate social values. Regulators could develop regulation that facilitates productive economic change by enabling informed transactions and interactions among market participants.

This paper argues that Northern European market systems, although pressured by market fundamentalism, offer relevant perspectives for regulation that enables global financial markets in which economic development is driven by social values. In these Northern European countries, law facilitates a proper dialogue between companies and stakeholders on critical moments in economic progress. Law does not only protect individual interests, but also offers opportunities for companies and other actors to act in the interest of the collective, of society.

Dialogue is critical in this thinking, because within interaction ethical values come into existence. This dialogue should not focus on the limited self-interest of the stakeholders, but on objectives formulated in more general terms, for example 'the continuity of the firm' or 'the health of society.' What is critical within this perspective is that no one group's interest is thought to predominate. Besides shareholders, employees, customers, suppliers and governments are seen as critical partners in economic progress. If participants get the opportunity to take each other's interests into account and are offered pathways to exert influence, social values are institutionalised within economic processes.

When we compare the network perspective with the proclaimed measures the G20 wants to take, we see an under-defined set of suggestions in the G20 declaration. No preconditions are defined for more cooperation, no underlying principles are defined. It gives the impression that more supervision on a global level will help the financial markets out of the current crisis and government support is critical for long-term development. The longer-term question of how to create sustainable long-term economic development has not even been asked.

TABLE 1
The Characteristics of Governance Systems

Governance system	**Market-based**	**Network-based**
General characteristics	Market orientation *Short-term relations* *Competition*	Internal orientation *Long-term relations* *Cooperation*
Governance structure	Capitalist form, focus on the financial markets, the shareholders	Collective form, focus on a group of stakeholders
Forms of corporate control	Exit-based: when dissatisfied, stakeholders leave	Voice-based: when dissatisfied, stakeholders complain in the network
Governance mechanism	Contract	Trust
Governance evaluation	Third parties	Networks
Theory	Agency theory	Stewardship theory/ normative stakeholder theory
Research orientation	Agency problems between the management and shareholders	Balancing stakeholder interests
Countries	US and UK	Continental Europe and Japan
Stakeholder influence strategies	Emphasis on indirect influence strategies (law)	Emphasis on direct influence-strategies (codecision)
Characteristics of stakeholder influence-pathways	Regulation	Consultation

(De Graaf and Herkströter, above n 55, 180).