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Ties that bind in business ethics: Social contracts and why they matter [☆]

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Abstract

How should bankers respond to challenges about whether to separate stock analysis from the other financial functions of financial services companies, or whether to maintain relationships with socially discredited customers? We wrote a book recently, *Ties That Bind* (Donaldson and Dunfee, 1999), out of our conviction that answering many of these questions requires a new approach to business ethics, one that exposes the implicit understandings or “contracts” that bind industries, companies, and economic systems into communities. In this article we unpack the fundamental elements of our approach called Integrative Social Contracts Theory (ISCT) and demonstrate how the theory can be applied to a particular question currently asked in the financial services industry, namely, “How should accounting firms and banking institutions deal with the increasing criticism alleging that new forms of conflict of interest impair the objectivity of auditors and security analysts.”

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1. Introduction

How should bankers respond to challenges about whether to separate stock analysis from the other financial functions of financial services companies? How

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should they respond to challenges about whether to maintain relationships with socially discredited customers? And how about whether to encourage “American” standards of sexual harassment training for nationals working for bank subsidiaries abroad? We wrote a book recently, *Ties that Bind* (Donaldson and Dunfee, 1999), out of our conviction that answering many of these questions, and indeed many of the most challenging questions in any industry, requires a new approach to business ethics, one that exposes the implicit understandings or “contracts” that bind industries, companies, and economic systems into moral communities. It is in economic communities, and in the often unspoken understandings that constitute their ethical glue, that we believe many of the answers to business ethics quandaries lie. We think that answering ethical questions in banking and elsewhere requires understanding both the extant but often unspoken “contracts” that pervade business and also a yet deeper, universal “contract” that supersedes even individual ones, thus resulting in an approach to business ethics that integrates deep and shallow social contracts. Over the years we have articulated this integrative theory, which we call “Integrative Social Contracts Theory” (ISCT) in a series of articles (Donaldson and Dunfee, 1994; Donaldson and Dunfee, 1995; Donaldson, 1996) and most recently in the book, *Ties that Bind* (Donaldson and Dunfee, 1999). In the short article that follows we will unpack the fundamental elements of ISCT, not because we believe it resolves all ethical issues in finance and banking, but because we believe that it offers the best conceptual framework for resolving such issues. At the close of the article, we demonstrate how the theory can be applied to a particular question currently asked in the financial services industry, namely, how should accounting firms and banking institutions deal with the increasing criticism that one of their service functions compromises another? When analysts and stock underwriters live under the same institutional roof, can their analysis be unbiased? And when accountants and financial consultants live under the same roof, can the accounting be unbiased? Just how high, and how successful, are “Chinese walls?”

2. The structure of integrative social contracts theory

ISCT does not overturn popular wisdom. While it asserts that the social contracts that arise from specific cultural and geographic contexts have legitimacy, it acknowledges a *limit* to that legitimacy. It recognizes the moral authority of key transcultural truths, for example, the idea that human beings everywhere are deserving of respect. The social contract approach we detail holds that any social contract terms existing outside these boundaries must be deemed illegitimate, no matter how completely subscribed to within a given economic community. In this sense, all particular or “micro” social contracts, whether they exist at the national, industrial, or corporate level, must conform to a hypothetical “macro” social contract that lays down moral boundaries for any social contracting. ISCT thus lies midway on the spectrum of moral belief separating relativism from absolutism. It allows substantial “moral free

space” for nations and other economic communities to shape their distinctive concepts of economic fairness, but it draws the line at flagrant neglect of core human values.

Our approach takes “moral free space” seriously. It insists that morality can be “conditional” or “situational” at least in the sense that two conflicting conceptions of ethics can sometimes both be valid, and that community agreements about ethics often matter. Two economic systems need not have precisely the same view about the ethics of insider trading. Their views about what is wrong with insider trading may differ, yet both may be legitimate. Nor does every corporation have to follow exactly the same conception of fairness as it designs flextime or seniority rules. It follows from our view that all economic actors must recognize the critical role of social contracts in the communities they impact. To fail to do so, as many companies have done in the past, is to display moral blindness.

In our view, as social contracts change, so too do the challenges for business. The ethical “game” of business today is played by different rules and harbors different penalties and benefits than it did decades ago. Broad shifts of moral consensus have occurred. In subtle, far-reaching shifts, managers and members of the general public have gradually redefined their view of the underlying responsibilities of large corporations. Half a century ago, companies were basically expected to focus on producing goods and services at reasonable prices; today, corporations are held responsible for a variety of issues involving fairness and quality of life. In companies throughout the world, gender issues, racial issues, and questions of the clash between work and family, are included in the agenda of corporate management.

The challenge that we accepted in *Ties* was to find a theory that accepts basic moral precepts, such as “Do not lie,” “Be fair,” and “Respect the environment”, even as it refuses to pretend that these broad-brushed concepts provide full moral clarity. The challenge was to articulate an approach that holds fundamental truths to be relevant even as it accounts for legitimate differences in business communities and historical periods. We believe that ISCT is such a theory.

The concepts that inform ISCT are at the same time simple and complex. The simple idea, as stated already, is that implicit agreements constitute part of the basic software of business ethics. Without these “social contracts” knowing what matters and what does not ethically in a specific context is impossible. This very simple idea, however, needs explication and justification. Hence, ISCT is fitted with a more complex rationale and set of concepts.

In the extensive description of ISCT that we undertake in *Ties*, we begin with the same kind of thought experiment that was used to justify the traditional social contract arguments of Locke, Rousseau, Hobbes, and Rawls. We utilize the approach of the classic contractarian thinkers such as Locke, Hobbes, Rousseau, and Rawls, but we add an important point. They asked about what citizens would require of the government and how they would define political justice. We, on the other hand, inquire about what economic participants would agree upon as defining *business ethics*. In the traditional manner, we begin with a thought experiment that envisions the terms of a contract for the foundation for economic ethics that would be acceptable

to a diverse set of imaginary contractors (some greed driven egoists, some deeply religious altruists, most probably in-between) representing the varied attitudes of the modern world. We assume that these contractors are rational, i.e., not afflicted by inconsistency or logical confusion, and that they are knowledgeable i.e., they know the range of facts accepted at the time as being true. We assume not, as Rawls does (Rawls, 1971), that these hypothetical contractors are ignorant of all facts concerning themselves. They may or may not know that they are Christian, Moslem, of a risk-adverse or risk-prone personality, etc. We assume only in this regard that they do not know in what economic communities they are members. For example, they do not know that they work for XYZ corporation, participate in country *N*'s economic system, that they pay dues in worker union *K*, or ply their trade in profession *P* or industry *Q*. These facts about their economic membership are hidden to them. In a similar way, their level of personal wealth is obscured from them. They are ignorant of whether they possess a massive fortune, or nothing at all. Hence, one might envision all of rational humanity capable of voluntary choice, afflicted with the partial amnesia just described, gathering for a global congress to construct an agreement that would provide a fundamental framework for ethical behavior in economic activities.

We do not assume, as Rawls would assume, that the contractors are ignorant of their economic and political preferences. An individual may know her preferences, that she prefers to be rich rather than poor, wine to beer, employment in a worker-owned firm over employment in an investor-owned firm, a Libertarian to a Socialist form of government. The question then becomes what terms, if any, would be acceptable to these contractors?

We assume that the contractors do not come to the table entirely bereft of moral principles. They at least bring with them the underlying senses of right and wrong with which they have grown up. They bring with them these settled understandings of deep moral values. Because the contractors are unaware of other economic preferences and memberships, they lack detailed knowledge of their economic morality. Yet even as they lack such detailed knowledge, they know the basic values to which they subscribe. Some may profess philosophical utilitarianism. Some may profess philosophical Kantianism. Others may adhere to ethical principles articulated in their preferred religion (in Judaism or Christianity this might be the Ten Commandments; in Buddhism it might be the principles of the “Dharma-pada”). And some may subscribe to the traditional principles that have been handed down to them historically through their family, their village, or their culture.

When these hypothetical yet rational global contractors confront the fact that it would be impossible to obtain an intellectual consensus concerning adoption of a single morality as the framework for global economic ethics, then how would they go about resolving their dilemma of finding a basis for agreement? We believe that they would nonetheless be motivated to find such a basis. First, we assume that many are driven by an innate moral sense which will lead them to seek and to recognize elements of a foundational morality. That is, most humans are “hardwired” to be ethical. Second, our focus is on *economic* ethics. In this domain there are spe-

cial considerations that must be of concern to rational, knowledgeable contractors. For example, rational contractors would realize the vital importance of having a framework of morality as a foundation for economic interaction. Without a core common morality, the result would be the economic analogue to a Hobbesian state of nature. Economic life would be, using Hobbes's language, "nasty and brutish," if not also "short". Such chaotic economic conditions have prevailed from time to time in nations that lacked the social and political background institutions necessary to sustain an ethical framework. In such a state, promises are not kept. Property is not respected. Violence is used to obtain economic advantage. Capital markets either become distorted or fail altogether owing to a fundamental lack of trust.

Finally, we believe that rational contractors would rely upon a limited set of core assumptions in framing their search for a common set of economic ethics, where "economic ethics" refers to the principles establishing the boundaries of proper behavior in the context of the production and exchange of goods and services. These are as follows:

- All humans are constrained by bounded moral rationality. This means that even rational persons knowledgeable about ethical theory cannot always divine good answers to moral problems without being acquainted with community-specific norms.
- The nature of ethical behavior in economic systems and communities helps determine the quality and efficiency of economic interactions. Higher quality and more efficient economic interactions are preferable to lower quality and less efficient economic interactions.
- All other things being equal, economic activity that is consistent with the cultural, philosophical, or religious attitudes of economic actors is preferable to economic activity that is not.

In virtue of these three propositions (above), individual contractors would desire the option to join and to exit economic communities as a means of leveraging their ability to achieve the benefits of either greater efficiency or greater compatibility with preferred religious, philosophical, or community norms.

The hypothetical members of the global economic community would be capable of considering which norms would be best to guide all business activity in a way that achieves fairness. In this hypothetical state of nature, we argue that such rational global contractors would agree to the following *de minimis* macrosocial contract setting the terms for economic ethics:

1. Local economic communities have moral free space in which they may generate ethical norms for their members through microsocial contracts.
2. Norm-generating microsocial contracts must be grounded in consent, buttressed by the rights of individual members to voice and exit.
3. In order to become obligatory (legitimate), a microsocial contract norm must be compatible with hypernorms.

4. In cases of conflicts among norms satisfying macrosocial contract terms 1–3, priority rules or “rules of thumb” must be established through the application of rules consistent with the spirit and letter of the macrosocial contract.¹

We use certain core definitions throughout the book as we discuss the implications of the ISCT macrosocial contract. “Hypernorms” are principles so fundamental that they constitute norms by which all others are to be judged. Hypernorms are discernible in a convergence of religious, political and philosophical thought. An “authentic norm” is one that is generated within a community’s moral free space and which satisfies the requirements of terms 1 and 2 of the macrosocial contract. Authentic norms are based upon the attitudes and behaviors of the members of their source communities. A “legitimate norm” is an authentic norm that is compatible with hypernorms. A norm has to be established as legitimate before it may become binding for members of the norm-generating community.

Ties details these core concepts and suggests ways in which they can be applied to business decisions. For example, we describe at some length an example of a structural hypernorm that we call the “hypernorm of necessary social efficiency,” or “efficiency hypernorm” for short. This hypernorm identifies duties to maintain the efficiency of societal systems, including economic institutions, designed to promote economic welfare and social justice. A norm, policy, or institution satisfies the efficiency hypernorm when it contributes to the efficiency of the provision of necessary social goods, that is, aggregate economic welfare or social justice. The hypernorm entails, among other things, that *economic* actors have duties to support efficient policies and institutions that promote liberty and due process, as well as minimal possibilities for health, food, housing, and education.

Ties emphasizes the role of communities as the source of authentic norms. The familiar concept of the corporate “stakeholder” is often useful in identifying relevant ISCT communities. Stakeholders of corporations usually also constitute ISCT communities. In the book we offer many proxies and presumptions for use in identifying relevant communities, authentic norms, and hypernorms. The type of evidence required for such identifications will often be commonly known and readily available.

In *Ties* we illustrate the application of ISCT to specific issues. For example, we discuss at length how ISCT can be used to unravel the phenomenon of bribery around the world. ISCT reveals that bribery is typically condemned by high priority authentic norms and that most forms of bribery also violate hypernorms.

¹ ISCT priority principles (also sometimes referred to as “rules of thumb”) are: (A) Local community norms have priority unless adopting them harms members of another community. (B) Local community norms designed to resolve norm conflicts have priority unless adopting them harms members of another community. (C) The more global the source of the norm, the greater the norm’s priority. (D) Norms essential to the maintenance of the economic environment in which the transaction occurs have priority over norms potentially damaging to that environment. (E) Patterns of consistency among alternative norms add weight for priority. (F) Priority is given to well-defined norms over less well-defined ones.

Thus, we offer ISCT as a means to highlight the ethical relevance of existing norms in industries, corporations, and other economic communities, even as it also must limit the acceptable range of such norms. Our aim is to reach beyond the generality of, say, Kantian Deontology or “virtue” ethics to allow a more detailed normative assessment of particular ethical problems in business. It is a theory that accommodates the widely-held intuition that different ethical precepts are sometimes appropriate for different industries, companies, and professions. The ethics of professional doctors need not be precisely the same as the ethics of journalists. Nor do the gift and entertainment practices within a Japanese keiretsu need to conform to the practices for government contracting within the United States. In accommodating diversity, ISCT recognizes variety in individual and cultural values and preferences. Thus, it refuses to impose a broad conception of the “Good” upon dissenters, even as it recognizes the relevance of transcultural moral understanding.

One may have followed the argument so far, yet remain puzzled. Why, one might ask, should we agonize with the mental gymnastics of ISCT when markets themselves allow huge latitude for voluntary arrangements? Free exchange in a market economy encourages agreements of all stripes: explicit, implicit, formal, and informal. John Boatright, contributing an article to this journal, asks this very question. Why make a big deal out of what the market economics and, for that matter, financial theory already blesses? From this perspective, “social contracts in a market economy” amounts to a redundancy.

The reason for social contracts goes deep, and reaches to the very heart of what markets bestow – and neglect. One’s ability to contract and to rely on adherence to contractual obligations is a crucial component of basic economic activity and business ethics. Predictable compliance of contracting parties promotes economic freedom and what economists call “Pareto Optimal outcomes.” (No one can be made better off without someone being made worse off). Implicit or informal agreements, in turn, are important forms of contract in a competitive market. They embody freedom-of-transfer mechanisms that lie at the heart of the market’s ability to provide optimal outcomes for society. But they are prey to certain limitations that invalidate simple market freedom as constituting a comprehensive moral theory. In short, market freedom is fine, but requires ethics to be complete. A social contract in which a minority of women are forced to submit to sexual harassment or risk losing their jobs, or social contracts that, while not coercive, allow bribery, environmental degradation, or government corruption, might formally count as “voluntary” while nonetheless offending fundamental principles of fairness. ISCT entails mechanisms that utilize market freedom but correct its ethical shortcomings. Its requirement of “voice” eliminates the possibility that a microsocial contract is legitimate without incorporating the interests of the relevant economic community. Its inclusion of core values or “hypernorms” ensures that fundamental rights, such as the right not to be discriminated against, or the right to political participation, are relevant no matter what a given community happens to think at the historical moment. ISCT, hence, would have proscribed slavery as an illegitimate economic arrangement even in an era when a majority of Americans would have accepted it.

3. Applying ISCT to an issue: Chinese walls as a safeguard against conflicts of interest

How might ISCT be applied to a current issue in the financial world? For example, how might it be applied to newly-heard conflict-of-interest issues for accounting and financial services firms who perform multiple services for the same client? As such firms grew rapidly during the 1990s, concern grew with them about possible compromises to their internal integrity. Can a banking firm that sells substantial financial services such as underwriting to a company also evaluate that company objectively as a part of its overall stock analysis service for brokerage customers? And can an accounting firm that draws large revenues from consulting to a particular client also perform truly independent audits for that same client? To be sure, “Chinese walls” are among the protective devices touted by such firms and were designed precisely as antidotes for the conflict-of-interest disease inherent in cross functional service delivery². But a string of legal and ethical disasters in the 1990s and early 2000s made many people wonder whether even these walls of China could keep irresistible forces of corporate self-interest at bay.

The application of ISCT does not offer a silver bullet solution to deeply challenging ethical issue. Ethical quandaries are quandaries for a reason. If a simple solution were waiting in the wings, smart people would likely have noticed it already. Nonetheless, we think ISCT illuminates critical parts of ethical quandaries and goes a long way towards framing their proper analysis.

To begin with, ISCT helps us notice that the “Chinese Wall” quandary has its genesis in the history of *earlier* social contracts. Its issues have arisen, as they often do, because new technology and forms of organization create behaviors that challenge the existing social contract. Perhaps the most striking historical example of such genesis is the printing press, a technological advance that ended up undermining the authority of the Catholic Church during the renaissance. A more modern example involving not only technology but also institutional change is the Industrial Revolution of the 19th century. The remarkable revolution that Adam Smith (Smith, 1976) built was positioned directly over the embedded cultural values that existed in earlier centuries. The Industrial Revolution was an economic tornado that forced technological innovation and new forms of corporate ownership into being, and its winds forced not only higher productivity and greater worker mobility, but also behavior such as assembly line repetition, and regrettably, practices such as child labor. Out of this twisting chaos emerged eventually a new social contract, one that constituted a contractual compromise between the behaviors driven by technological innovation and pre-existing social values. Both mores and laws emerged to enforce ethical minimums in areas such as child labor and producer liability.

² Many other safeguards may be used to mitigate conflicts of interest threats including disclosures to audit committees of corporate boards and peer review. We use Chinese Walls as a metaphor for the issue of using safeguards to mitigate threats to objectivity.

In the “Chinese walls” quandary, both institutional evolution and technology are at work. Institutional evolution is seen in the way in which large financial services firms have recently diversified by adding or combining functions. As accounting firms have grown, so too have their consulting services, services that in some ways may complement their auditing functions. And as investment banking functions and brokerage functions have mushroomed into giant, multi-functional firms, the lines that separate those functions have blurred. At the same time, technology, manifested in the so-called “dot.com” revolution fueled investor interest that demanded greater reliance on “making the numbers” of projected earnings, and less on current traditional performance measures, such as *P/E* ratios.

The result was a sizzling series of disasters with attendant caveats. In 2000 and 2001 *The Wall Street Journal* printed stories highlighting suspicious facts about financial services firms. For example it noted that Credit Suisse First Boston was appointed lead underwriter in 2001 on a new stock deal for GoTo.com, a Pasadena, California, internet search engine. The company beat out Merrill Lynch & Co. for the lucrative position, and in a striking coincidence, a few hours later, Merrill’s high-profile technology stock analyst Henry Blodget, bullish on GoTo.com shares only a day earlier, switched his view. He downgraded it to “neutral” from “accumulate” (Gasparino et al., 2001). Merrill Lynch & Co. denied any connection, but eyebrows were raised in the process.

Bill Burnham, who used to be an internet analyst with Credit Suisse First Boston is blunt: “In the technology world, there is no banking relationship without the analyst,” he once said. “The analyst is judge, jury, and executioner when it comes to deciding whether to pursue a company as a banking client, and it is the analyst who has the closest relationship with the company after the deal is done” (Schonfeld, 2000). And research by Mathew Hayward, professor at the London Business School, shows that companies get higher ratings from analysts they bank with than from analysts they don’t (Schonfeld, 2000). Finally, a 2001 study reported in *The Wall Street Journal* suggested that “investors should ignore advice on a stock if it comes from a brokerage firm that underwrote the shares” (Opdyke, 2001).

In the accounting world, alleged financial frauds such as Lernout and Hauspie, Cendant, Microstrategy, Waste Management, Sunbeam (Turner, 2001) fueled speculation about the futility of Chinese walls separating auditing and consulting services. The same cynicism has been leveled at the huge Enron bankruptcy, an event now exploding in the US media even as this article goes to press. Especially suspicious to critics has been the high percentage of accounting firm revenues revealed to come from consulting to existing and prospective audit clients. SEC Chief Accountant, Lynn Turner said in June of 2001 that whereas “as recently as the early 1980’s, the accounting firms’ principal source of revenues were from the performance of audits, a survey of 563 of the Fortune 1000 companies showed that for every \$1 of revenues generated for the performance of the reviews and audits of the quarterly and annual financial statements in 2000, \$2.69 in revenues were generated by providing other services” (Turner, 2001). In short, non-audit fees were 73% of total fees. And acting SEC Chief, Laura Unger, said that the fraud settlement with Arthur Andersen LLP over audits of Waste Management Inc provided the SEC with a

‘smoking gun,’ illustrating a clear instance in which an auditor’s independence was compromised (Weil, 2001).

Hence, larger, and newly prominent forms of organizations have now combined functions in novel ways that challenge existing social contract norms. In effect, the norms that were part of the social contract, while “authentic,” came under fire from a deeper sense of moral unease, that is, from the higher vantage point of hypernorms. Some norms were already in place, for example, those under the banner of “Chinese walls.” Analysts weren’t supposed to be influenced by the investment banking activity occurring on the “other side” of the wall and certain procedures were supposed to make that happen. Auditors were not supposed to look over the wall at the activities of their firm’s consultants. But, new economic pressures have made complete separation difficult. For example, industry insiders knew in 2000 all too well that the pay of many stock analysts *was* tied, albeit indirectly, to generating business for the firm, and this was true even among better firms.

The clash of the old social contract with the new behaviors propelled by the new forms of organization had to be reconciled in some manner. Something had to be given up. From the standpoint of ISCT, the norms at work in the controversy were “authentic,” but questions remained as to whether they also were “legitimate,” i.e., did they conform to hypernorms?

Furthermore, one could easily spot conflicts among authentic norms. Novel arrangements typically create a conflict of microsocial contracts. Consider the instance of an analyst who works only for a brokerage firm, and another instance of an analyst who works at a large banking conglomerate. The latter may comply with the moral norms considered appropriate for an analyst in modern banking conglomerates, namely, ones that allow indirect compensation for generating business elsewhere in the firm. But the former analyst lives in a world where her moral norms do *not* embrace such a reward system. Which set of norms, i.e., which microsocial contract, should prevail?

In analyzing the issue from the standpoint of ISCT, it is also important to recognize the presence of at least some moral free space. When structuring complex economic institutions, there need not be one, univocal pattern of norms that a society and its financial firms must endorse. The solution to the so-called “Chinese walls” problem, then, may be slightly different in Japan or Europe than in the United States.

But if some moral free space exists, the challenge is to determine *how wide* that space is. To do this, ISCT asks first whether any hypernorms are at stake. Without delving into the sustained discussion a thoroughgoing discovery of hypernorms should involve, we note that two hypernorm candidates appear in the present instance. The first is the norm imposed on agents in a trust relationship, acting on behalf of another party, to avoid conflicts of interest. We might call this the “conflict of interest” hypernorm. Analysts or auditors deserve the trust of investors or corporate clients only if their judgment remains uncompromised by competing self-interest.

The second hypernorm is a broad one that asks participants in *any* economic system to adhere at least to those norms that *all* participants must observe to ensure

the system's efficiency. We discuss this hypernorm at length in *Ties* and dub it the "efficiency" hypernorm³. The efficiency of a market economy depends upon at least a threshold amount of informational accuracy, and this is especially true of financial markets. The 1999 and 2000 dot.com boom in the US is alleged by many to have been aggravated by shoddy, excessively optimistic, and in some instances compromised ratings of securities analysts. And, similarly, the Asian financial crisis of the late 1990s was alleged by many financial leaders to have been caused in part by inaccurate and missing information about company performance and valuation. To the extent such criticism is true, the efficiency of the financial system is harmed when market analysts or auditors systematically publish inaccurate information.

The next vantage point for ISCT is the adjudication of the clash of norms in authentic microsocial contracts. How, for example, can one adjudicate the class of norms in our earlier example of a traditional brokerage firm with those that are accepted in one of the newer, large conglomerate firms? As noted earlier, conflicts of authentic norms in ISCT are resolved by appeal to the ISCT rules of thumb or "priority principles." Again, these are:

- A. Local community norms have priority unless adopting them harms members of another community.
- B. Local community norms designed to resolve norm conflicts have priority unless adopting them harms members of another community.
- C. The more global the source of the norm, the greater the norm's priority.
- D. Norms essential to the maintenance of the economic environment in which the transaction occurs have priority over norms potentially damaging to that environment.
- E. Patterns of consistency among alternative norms add weight for priority.
- F. Priority is given to well defined norms over less well-defined ones.

Here, "D" stands as especially relevant to the present instance. It emphasizes "norms essential to the maintenance of the economic environment in which the transaction that occurs has priority over norms potentially damaging to that environment." And as Lynn Turner, Chief Accountant for the SEC noted recently in a speech in Stockholm, Sweden,

The enduring confidence of the investing public in the integrity of our capital markets is vital. In America today, approximately one out of every two adults has invested their savings in the securities markets, either through the purchase of individual stocks or shares in a mutual fund or by setting aside funds for their future in pension and plans, which in turn have been invested in companies (Turner, 2001).

³ See Chapter 5, "Hypernorms revealed: The structural hypernorm of necessary social efficiency" in Donaldson, T., Dunfee, T., 1999. *Ties That Bind: A Social Contracts Approach to Business Ethics*. Harvard University Business School Press.

Hence, to the extent one believes that the confidence of the investing public may be compromised by biased auditing and stock analysis, priority principle “D” is relevant to the “Chinese Wall” issue.

From the standpoint of ISCT, it is obvious that the ethical issues embedded in the Chinese walls controversy are profound and intense. Indeed, not only are behaviors at issue subject to at least two hypernorms, but it is also true that a key priority principle from ISCT reflects precisely the concern implicit in one of those hypernorms, namely the integrity of the surrounding financial system. ISCT’s sensitivity for these issues should give us pause as we engage this issue. While not fully decisive, ISCT’s outlook implies that solutions to the Chinese walls dilemma will require more than Band-Aids, and that they will involve attention to the long-term integrity of markets.

In this vein it is interesting to note that in May of 2001 the Securities Institute of America (SIA) introduced stronger guidelines regulating the conduct of financial firms and their analysts. The new guidelines from SIA were agreed to by 14 major Wall Street firms, but most of those firms said that their analysts already adhere to most of the recommendations. Moreover, because of current adherence, most firms don’t plan to make significant changes in their operations (Opdyke, 2001). Similarly, on November 15, 2000, the Securities Exchange Commission (SEC) issued new guidelines on conflicts of interest for accounting firms. But these guidelines fall significantly short of the original changes sought by the previous SEC Chairman, Arthur Levitt.

Nonetheless, many financial leaders and some leading financial services firms appear to reflect the yet more fundamental concerns that ISCT suggests. For example, in the accounting controversy, Levitt’s solution (not implemented) was far more dramatic: namely, split auditing and consulting into different companies. And for the analyst/financial services controversy, at least one leading financial firm, Merrill Lynch, was prepared to take dramatic action in the summer of 2001. The US’s largest brokerage firm announced in July 2001 that it would bar its research analysts from owning stock in companies they cover, making it the first major securities firm to do so. The policy affected all of Merrill’s 600 stock analysts throughout the world, about 120 of whom own shares of companies that they cover as part of their research activities. The rule could well put pressure on other firms in the US as well as Europe to follow suit (Gasparino et al., 2001). Still another more dramatic measure recommended by some observers, but to date implemented by no firm, would prohibit banking firms from selling stock at the same time they recommend the stock as a buy to others.

As can be seen from this example of the Chinese walls controversy, ISCT need not – indeed seldom does – eliminate all questions from a moral quandary. But it can provide logical vantage points from which to view the quandary and, in turn, point towards a solution. By isolating relevant elements even as it is mindful of the all-important implicit contractual and institutional settings, ISCT can help show what is important. A strength is that it does not, as many moral theories do, neglect the implicit understandings or contracts that pervade daily economic life.

In sum, then, we believe that the same logic that sanctifies a handshake between two individuals turns out also to sanctify the implicit understandings of economic

communities woven throughout the business world. These are the informal but critical agreements – or “social contracts” – that exist within industries, national economies, trade groups, and corporations. They provide the warp and woof of economic life, and are in the last analysis the “ties that bind.”

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