View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by Research Papers in Economics

INTERNATIONAL CENTRE FOR ECONOMIC RESEARCH

WORKING PAPER SERIES

Peter Koslowski

BUSINESS ETHICS IN GLOBALIZED FINANCIAL MARKETS

Working Paper No. 23/2006

Business Ethics in Globalized Financial Markets

by Peter Koslowski

Free University Amsterdam and ICER

Summary

Globalization extends the space of the things that are simultaneous for the human. This applies particularly to the decision-making in financial markets. The global market for capital is one of the main causes for globalization. How is this process of globalization to be judged from the point of view of business ethics?
The paper investigates the ethical foundations of capital markets and of financial consulting. It analyzes the foundational theories of corporate governance in the Anglo-American and in the German context. Their difference can be described as external control by competition versus internal control by consensus. The paper gives merit to the different models of governance and to their origin in different conceptions of government. It argues for a twofold strategy: to strengthen the external control of firms by competing teams of management that are able to make an effective take-over threat and to implement elements of workers' participation in corporate governance as long as increases the efficiency of management - provided that these elements maintain the control rights of the firm's owners.

Space, says Leibniz, is the order of all things that are simultaneous, time is the order of all things that are non-simultaneous. Space and time order the things. The things that are simultaneous are arranged through the space, the things that are non-simultaneous through the time. All things are in space and in time and therefore spatially and temporally ordered.

I. The extension of the simultaneity in space and the decrease of the non-simultaneity in time of humankind through the process of globalization

With the Internet and the new technologies of communication, the basic order relations of the human being, space and time, have been changed, and thereby the simultaneity and the non-simultaneity of the things for the human being have changed as well. Leibniz's definition describes the absolute space and the absolute time, not the space and the time of the human being. The definition is, however, also valid for the space and the time of the human being: It holds true that the space of the human being is the order of the things that are simultaneous for the human, and that the time is the order of the things that are non-simultaneous for the human being. The space of the human being is made up by the things which are simultaneously accessible for the human. The time of the human being is determined by what is non-simultaneous for the human. The time is the things in their succession, the space is the things in their simultaneity.
With the Internet the relations of simultaneity and temporal succession as well as the relation of the centre and the periphery change. Through the Internet, also far away places which were formerly not simultaneous for us become simultaneous. Transactions and information over large distances, that were formerly non-simultaneous and outside of the individual's space or range of decision-making, become simultaneous and move into the individual's range of decision-making. Transactions that were formerly to be carried out only with great delay and therefore did not belong to the human's space, to the human's space of simultaneity, become simultaneous and move into the individual's space or range of decision-making. The individual's space of decision-making and action increases because the control of large spaces in simultaneity becomes possible.
Financial investments contain always the element of entrepreneurial decision-making and control. To the degree in which effective control becomes possible over great distances, the spatial range and the simultaneous control possibilities for investments increase. With the aid of online-brokerage, a portfolio of shares can be controlled from every place of the world without high transaction costs.
The process of globalization resulted in the years 1990s in the extension of finance investments to areas which before were not the aim of such investments, particularly the countries of the former East bloc as well as China and India. At the same time, the instrument was created by the Internet, by online-banking, and online-brokerage that facilitated the information circulation and transmission about the new investment space. Globalization brought these countries into the relationship of simultaneity and virtual proximity with the finance centres of the Western metropolitan cities, moved them into the decision-space of these centres.

II. The globalization of the capital markets as a central feature of the process of globalization

Three large extensions of world-wide financial investments were caused by the process

of globalization which, in the field of financial investments and markets, is not only a process of spatial extension but also of intensification. The first factor, the spatial extension in geographical respect to new countries, was closely connected with the second factor, the extension and intensification of financial information, and the third factor, the social extension of financial investments to new groups of investors in the population. With the extension of financial investments to wider circles of the population that up to now did not participate in the capital market, a third element of extension appears in the historical dynamics of globalized capital markets besides the spatial and informational extension and expansion.
The following processes must be regarded as the central definitional features of globalization according to Klaus Müller:

Liberalization of the financial markets,
Internationalization of cross-border ecological dangers,
Trans-national mergers of corporations,
Circulation by mass media of Western images and patterns of consumption,
Increasing streams of trans-national and transcontinental migration,
Decreasing effectiveness of policy making by the nation state.[1]

Müller names the liberalization of the financial markets at first place, and, in fact, one will have to refer to the liberalization, internationalization, and extension of the financial markets as the strongest influential factor in the process of globalization. The increasingly location- and space-independent, ubiquitous access to knowledge and information is common to all the mentioned features of globalization. The decision-maker's space and range of decision-making have become global, the time for effectuating the decisions instantaneous, since knowledge about the entire world is faster available and can be documented better on storage media than in former times.[2] The decision-space becomes larger, the decision-time, the time to gather and process information about far removed places becomes almost negligible. The space made up by the things that are simultaneous for the human increases. In reverse, we can only perceive globalization since our information systems provide us with instantaneous knowledge about the global reality or at least about parts of it. With the Internet and the globalization of information processing, another effect is happening. The former difference, or even hiatus, between the centre and the periphery of the knowledge is increasingly levelled or even abolished. The catalogues of the largest libraries of the world are now accessible from the most remote village of the world via the internet as far as this village has a telephone line to the outside world.
What is to be meant by the social extension of financial investments and financial institutions? The main drivers towards this extension are the pension funds. Peter Drucker published his book *The Unseen Revolution: How Pension Fund Socialism*

1 Klaus Müller: *Globalisierung* (Globalization), Frankfurt, New York (Campus) 2002.
2 Robert J. Shiller: *Irrational Exuberance*, Princeton and Oxford (Princeton University Press) 6th edition 2001, points to the fact that installing the first transatlantic telephone cable has had a similar effect as the Internet on economic growth and on a stock market boom. It is, however, important to note the difference that the Internet, unlike the telephone, facilitates also the instantaneous documentation of the long-distance communication.

Came to America in the year 1976.[3] The retirement or pension funds led already in the nineteen seventies to a socialization of investment. They further enforced the tendency recognized already by Marx in the joint-stock company, the dissolution of the class of capitalists into a larger group of capital owners or into a kind of socialized capital ownership. The question whether pension fund capitalism is already real socialism must be left unanswered here. The pension and investment funds as well as the widening of ownership of shares through online-brokerage contain an element of the socialization of the property in the means of production and are a drive towards the expansion of the capital market.

A further factor driving towards the expansion of the capital market is the attempt of many employees observed in the USA since the nineteen eighties to improve their income through speculation in shares and thereby to provide a second income for themselves.

All the four tendencies mentioned have caused an expansion of the capital market with the effect that a volume of the investment amounts and a volume of trade in shares have occurred that had been unknown before in economic history. The expansion and the worldwide internationalization of financial investments and of the capital market are probably the most important feature of the present globalization. As in the other fields of globalization, globalization is also in finance more than mere internationalization. It implies not only that a corporation becomes internationally active and is present in many other countries. Globalization requires, rather, an integration of the national capital markets into a global capital market, that the corporations act globally also with respect to corporate finance in an integrated space of financial investment and refinancing since global investment has become technically possible through the new global means of communication and the internet.

III. On the ethics of the capital market

How can one analyze ethically the institutions of and the individual actions in the capital market? From the approach of ethical economy developed by the author,[4] the ethical presuppositions of the functioning conditions and of the rationality of the capital market and the actions therein are at the centre of an economical and ethical analysis of the capital market. A decisive test for the functioning conditions of a set of institutions or of a market is the question whether being active in these institutions or in this market causes unintended side-effects which contradict the institutional objective or purpose and disturb its workings. If the side-effects become considerable, institutional changes must be carried out. If, for instance, the trade runs smoothly but extreme "churning" of investors occurs, institutional precautions against this churning must be taken. Churning of investors describes a situation in which high commissions and fees are paid due to a high volume of share trading but in which these fees and commissions paid by the investors are higher than the investors' returns on investment. The situation is particularly problematic if the investors are not made aware of this by an appropriate disclosure of the fees and commissions by the brokerage firm or bank.

Before one asks the question as to the ethical quality of an action within an

---

3 New York (Harper and Row) 1976.

4 P. Koslowski: *Principles of Ethical Economy*, Dordrecht, London, Boston (Kluwer) 2001. German Original: *Prinzipien der Ethischen Ökonomie*, Tübingen (Mohr Siebeck) 1988.

institutional setting, of an acting person's intention and values, the question must be asked as to the norms, the rules and duties of this institutional setting. In order to be able to determine the rules and duties, it is to be asked what the right law would be in the institutional setting under consideration. The question about the ideal right or the right law and right order of rules is to be answered according to Radbruch by applying three principles: first, the question about the purpose of the institutional field or institutional setting that is supposed to be ruled by norms, secondly, the idea of justice as formal justice and equal right of all acting or being concerned by the institutional field under consideration, and thirdly, the principle of legal security that requires that those who act in the institutional field are able to form constant expectations with respect to the perpetuity of the law and the continuity of the jurisdiction. Without constancy of expectations with respect to the legal norms, no effective legal order and no adequate ethics are possible.[5]

If one applies these principles to the institutional setting of the capital market, at first the purpose of the capital market is to be clarified. A set of institutions as complex as the market for capital and corporate control serves, in general, several purposes that can even stand in a relationship of tension towards each other. The purposes or functions of the capital market can be distinguished into four partial purposes: 1. the saving function: The capital market absorbs savings; 2. the wealth function: The capital market is used for the storage of purchasing power over longer time periods; 3. the liquidity function: The capital market offers investors the possibility to convert their financial assets into cash again in order to have liquid financial means at any time; 4. the economic policy function of the capital and money market: Through capital market policy and monetary policy, the economic policy maker can influence the economic situation and trade cycle and can control macroeconomic demand.[6]

Through a rise or decrease of the money supply the government induces an increase or reduction of the demand for shares and in this way influences the share prices. A rising or lowering of the share prices increases, in turn, reduces the consumption expenditures of the economic agents since the individuals' consumption expenditures are influenced by the value of their wealth assets. If the share prices, and therefore their perceived wealth, are higher, the investors have a higher net wealth and will increase their consumption expenditures. If the government reduces the money supply and induces a rise of the interest rate, it causes a decrease of the share prices. Decreasing share prices cause that the share owners, the consumers, consume less because they have the perception that they are less prosperous.

By means of the money supply and the interest rate, the government can influence the value of the wealth invested in shares and, thereby, the rate of consumption that is partly determined by the capital value of the shares the consumers hold. In this way, economic policy is able to influence the trade cycle, accelerate it or slow it down. The American government stabilized, for instance, the share prices in the years 2002/3 through a politics of easy money in order to maintain a pattern of high consumption rates by keeping the value of the private wealth in shares stable since both, share prices and consumption expenditures, threatened to decrease even further in the recession. As

---

5 Cf. Gustav Radbruch: *Rechtsphilosophie* (Philosophy of Law), Stuttgart (Koehler) 8th edition 1973.

6 For the functions of the capital and money market, cf. Peter S. Rose*: Money and Capital Markets. Financial Institutions and Instruments in a Global Marketplace*, Boston et al. (McGraw-Hill) 7th edition 2000, p. 6ff.

consumption is also a function of the consumer's net wealth, private consump tion had been pushed by a policy of easy money and by the increased share prices induced by the low credit rates credit enabled by the easy money policy.

In the capital market, the objective of the efficient allocation of capital stands at the centre. The question where capital is supposed to be invested is of the greatest importance for every economy. The objective of optimal capital allocation implies the solution to the question, in which projects, technologies, industries, regions etc. the economy invests and which future projects get a chance and receive investment. Since the investors decide ex ante which developments they hold to be the right and desirable ones, their decisions are always burdened with high uncertainty. The consumer in the market decides, on the other hand, ex post, after the investment being done, what he likes in the supply of firms that have made their decision in the past. The market decides after the investment being made which investment decisions of the firms have been right.

Fundamentally, three social decision mechanisms are available to an economy for capital allocation: The economy can leave the allocation decision with banks or with the government as in a centrally administered economy or with a specialised market of its own in which savers/investors as suppliers of capital and enterprises as demand for capital coordinate their plans and their expectations by the price mechanism. A capital market corresponds better as a coordination mechanism for the allocation of capital to a democratic society than the coordination through large banks or through centrally administered economic direction by the government.[7] The capital market is, like other markets, a means to diversify and to control economic power since it creates competition between the supply and demand of capital. This market as venture capital market is furthermore open to new ideas and offers a chance to the new and the unknown yet and even to the outsider.

If the capital market is supposed to take over this function, however, a high degree of speculation is needed. Speculation is inevitable and even desirable for two reasons in the capital market. On the one hand, about future possible returns on investment can only be speculated to a certain degree since the future demand for products and goods can not be known today yet. It is a phenomenon known also from philosophical and theological speculation that the speculative starts where complete information and complete empirical knowledge are impossible, where, however, there is at least some empirical insight. The greater overall scheme is inferred from fragmentary experience and incomplete empirical knowledge.

Stock market speculation is not only a game and gambling, but an anticipation of future developments based on incomplete information and empirical data that include also the anticipations of the anticipations of the other speculating players and contains also an element of gambling. The theories of the justification of the speculation in the 19th century took as a basis mostly the question whether the stock market speculation is gambling or betting. Gambling was not hold to be ethically justifiable whereas betting was taken to be ethically permissible. The result of the considerations in 19th century on speculation was that speculation is a bet and not gambling and that, as a bet, it is

7 This positions was also taken by von Nell-Breuning*: Grundzüge der Börsenmoral* (Fundamentals of Stock Market Morals), Freiburg i. Br. (Herder) 1928, p. 9, and O. von Nell-Breuning:: „Volkswirtschaftlicher Wert und Unwert der Börsenspekulation“ (The Economic Utility and Disutility of Stock Market Speculation), *Stimmen der Zeit* (Voices of the Time), 114 (1928), p. 46-56, here p. 52.

ethically permissible because in the case of betting more strict institutional conditions and a stronger intellectual element of correct anticipation of reality are given than in the case of pure gambling where the correct anticipation of the future outcome results just from good luck.

The inevitability of speculation results from the problem of uncertainty about the future. In the capital market, two central uncertainties play a role, the uncertainty about the future profits of enterprises and the uncertainty about the future development of the value of enterprises or their shares, about their future capital value. Correspondingly, speculation aims at both, at the correct anticipation of the firm's profits or - in the case of the joint stock company – of its dividends paid and at the correct anticipation of the development of the stock, of the share price.

On the other hand, speculation is also necessary to create those volumes of trade for shares that are necessary to fulfil the liquidity function of the capital market. The strength of the share market is that the shareholders' long-term investments in enterprises can be liquidated and reconverted into cash at any time - even if not always with a profit. This liquidation of long-term investments and their transformation into cash is, however, only possible if there is professional speculation and professional share trading because investors would run otherwise the risk of meeting no effective demand for their wish to sell and liquidate and would be locked into their investment.[8]

For both reasons, for the inevitable uncertainty about future corporate profits and for the necessity to create liquidity in the market for shares in corporations, speculation is inevitable in the capital market, and no efficient capital market conceivable without speculation. The resentment against stock market speculation finds, therefore, no rational justification.

Since speculation is useful and satisfies the purpose of the capital market, it should not be hindered. Popular slogans that one should stop speculation do not find justification since they contradict the functional conditions and objectives of optimal capital allocation in the capital market. Also the possibility of low-priced "people's shares" that the German government proclaimed and offered to the public in the shares of the privatized state firms for telecommunication and the mail service, Deutsche Telekom (German Telecom Service) as well as Deutsche Post (German Mail), must be criticized from the understanding of the inevitability of the speculative character even of these shares. Since the share market is necessarily speculative, there can not be a low-priced share which would be certain to rise and not be subjected to speculation and uncertainty about its future price. Every stock, also the stock of former state monopoly firms as the telephone or mail service, is subject to the share price risk and the fluctuations of the stock market. It is one of the weaknesses of small investors that they usually underestimate the risks in the development of the share price. The realistic assessment of risk is also a postulate of the ethics of business. The sense of reality is a morally relevant quality.

Instead of propagating and offering assumedly low-priced shares, it would have been more reasonable to follow the objective of developing a people's capitalism instead of issuing "people's shares". In a democratic society, it is desirable that as many people as possible participate in the decisions about investments and enterprises, and in this way

---

8 Cf. also Peter Koslowski: *Ethik der Banken und der Börse. Finanzinstitutionen, Finanzmärkte, Insider-Handel* (The Ethics of Banking and of the Stock Exchange. Financial Institutions, Financial Markets, Insider Trading), Tübingen (Mohr Siebeck) 1997.

about future economical strategies, and that the entire economic knowledge of a nation and the individuals' appraisal of future share value enter the valuations of the capital market. In this sense, the objective of a "people's capitalism" which serve the efficiency of the capital market is quite desirable. In order to achieve the objective of an efficient capital allocation, the concentration on of a few "people's shares" is, however, not a viable strategy. Rather, an investment activity scattered as widely as possible amongst social groups and an investment as widely diversified into the stocks of innovative and small enterprises should be aimed at.

If one summarizes the purposes or functions of the capital market, it becomes visible that the efficient allocation of capital into purposes of investment under conditions of information efficiency and capital liquidity or the transformability of the investment into liquid means are at the core of the objectives and the conditions of functioning of the capital market.[9]

In this way, it becomes possible to answer the question which ethical and economic values must be taken into account in the globalized capital market. In order to fulfil information efficiency and the liquidity function, as many parties in supply and demand in the market for capital should be active to make the volumes of the supply and demand for capital so large that real markets for corporate control and corporate strategies arise. The globalization supports, therefore, the information efficiency and the liquidity of the capital market through the enlargement and greater liquidity of this market. An efficient capital market requires sufficient liquidity so that investors are not locked into their investments.[10] On the other hand, the wealth preservation function and the savings function of the capital market require that the fluctuations in the value of shares do not reach too large amplitudes in the capital market. As a result, two criteria must be realized in the capital market at the same time: On the one hand, the investment and disinvestment decisions in the capital market must allocate quickly and smoothly capital to its best use. On the other hand, the high degree of allocation and reallocation as well as the level of trading volume must not cause exaggerated and unnecessary fluctuations in the share prices that make savers and investors feel insecure and drive them out of the capital market.

The conditions of the high mobility and efficient allocation of capital, on the one

---

9 Cf. also Gerhard Picot: „M&A aus Sicht der Kapitalmärkte" (M&A from the Point of View of the Capital Markets), in: G. Picot: *Handbuch Mergers & Acquisitions* (Handbook of Mergers & Acquisitions), Stuttgart (Schäffer-Poeschel) 2000, p. 33-52.

10 John R. Boatright: *Ethics in Finance*, Malden Mass., Oxford (Blackwell) 1999, p. 116, shows how the missing possibility to liquidate high volumes of shares at the same time can be a problem for large pension funds because they are frequently not in the position to formulate their protest against low performance management teams by selling large packages of the shares they hold in these firms without undergoing a high share price risk. They must, therefore, influence the management directly through influence on the management decisions and stay invested in the enterprise. A pensions fund as CalPERS (California Public Employees' Retirement System) that manages assets worth 80 billion dollars would find it difficult to sell shares of General Motors worth 1 billion dollars at once without causing a loss of their value in the stock exchange. - The change of the form of capitalism from the private property and owner capitalism to the "pension fund capitalism" is indicated by the following figures: "In 1970, individuals held more than 72 percent of shares, while institutional investors (pensions, mutual funds, insurance companies, and private trusts and endowments) accounted for about 16 percent. By 1990, the holdings of institutions had risen to more than 53 percent, with private and public pension funds owning approx. 28 percent of the equities of US firms." (Boatright, *op. cit.*, p. 114).

hand, and the conditions of the stability of the share prices in the capital market, on the other hand, stand in a relationship of a certain tension towards each other that also influences speculation. On the one hand, the speculation in shares must trace every even very insignificant change in the chances for profits from investments and make visible in the market. On the other hand speculation must also avoid causing artificial value fluctuations that do not have any basis in the substantial value of stock.

From this Janus-headedness of speculation follows that speculation is supposed to be, on the one hand, highly speculative and to find out the smallest changes and differentials of value, but should, on the other hand, not produce any artificial volatility. In the formation of the value orientation that should direct the actions of capital market participants, a tension arises here in speculation that speculates because of the volatile value changes of shares between the speculation that destabilizes shares prices and the speculation that stabilizes the volatility of share prices.

It must not be overlooked, however, that the stock market speculation rewards such speculative anticipations which have anticipated improbable value increases correctly. By this measure, the capital market rewards at the same time highly speculative speculation that curbs the price fluctuations and takes price volatility out of the market.

Speculation can be regarded in general as the phenomenon of price arbitrage between different points of time. In the same way as spatial arbitrage produces a profit from mediating between price differences between different places in space, temporal arbitrage or speculation makes profit from mediating between differences in prices between different points in time. When differences in the prices of goods in two cities, transfers the goods from the city with a low price and high supply to the other city with high price and low supply,[11] he contributes to levelling the prices at the two places and earns a profit from the economically useful action of spatial arbitrage.

Speculation engages in arbitrage between the variations of value at different points or epochs in the course of time. The speculating person who speculates *à la hausse*, goes long, assumes that the corporate shares that he buys today will have a higher value in the future. As long as the speculators follow the general opinion in their speculation, they will not make any especially high speculative profit. If, on the other hand, they speculate against the prevalent opinion, their speculative gains will be considerable, provided they have been right. At the same time, these speculators will play a price-stabilizing role when the price of the share has risen since they will provide a higher supply of the share in question that will curb the share price at the point in time. A normativity of the processes effective in reality becomes visible here in as far as the interest of the speculators to realize a profit through the correct but improbable speculation goes hand in hand with the common interest of the market to stabilize share prices through a higher supply of those shares that are in high demand and that the speculators supply. If speculation made profit only by strategies increasing volatility, it would attack and destroy the legitimacy conditions of its own existence.[12]

---

11 Thomas Aquinas*: Summa theologiae* II-II, qu. 77, art. 3(4), discusses this question and grants expressly an important, morally justified, economic function to arbitrage and the arbitrageur.

12 Cf. for the business ethics of speculation and insider trading Peter Koslowski: *Ethik der Banken und der Börse*, loc. cit., p. 61-90.

IV. On the ethics of financial consulting<A[consultation|discussion]>

The question as to the ethical duties of financial consultants addresses the individual ethics of the correct action within the framework of the institutional setting of the capital market. Consultants are obliged, due to their fiduciary position towards their customers, to act in the customer's best interest, not in their own best interest. They are subject to fiduciary duties and duties of due diligence, duties that have been further differentiated in American law and its business ethics than in Continental European civil law and business ethics. These duties include the duty to prudence and due diligence or adequate care in working for the customer. Every performance of financial consultants that does not protect the customer' interest is not diligent or prudent is a breach of their duty and of the fiduciary relationship with the customer.

In the capital market, the financial consultant is tempted to engage in „churning", „twisting" or „flipping" the customer. The temptation to breach the fiduciary duty is always around. Churning is the excessive trading of stocks that creates only commissions and fees for the bank or the broker but does not produce any benefit for the customer. Recommendations of shares and of trading actions which lead to churning represent a breach of the broker's obligation as the customer's trustee to recommend only suitable investments and to reveal the risks linked to them. The financial consultant stands here under diverse role expectations which often lead to conflicts of interest which are ethically relevant. As an employee of a bank the consultant must realize, for instance, the customer's interest in a profitable investment and, at the same time, the interest of the bank in commission payments etc.

Non-professional day traders that are churned not so much by their consultants, but by themselves are a special case. According to investigations of the German Federal Agency for the Supervision of Financial Services (*Bundesanstalt für Finanzdienstleistungsaufsicht*, BaFin), many day traders lose their invested capital through incessant buying and selling of the same shares because they pay ever increasing amounts of commission for their trades to their online banks or brokers. The commissions eat up frequently the profits from share sales which the day trader has only in view.[13]

Twisting is the replacement of an insurance contract through a new one that does, however, no represent a real improvement for the insured, but creates only commission for the insurance broker and produces cost for the insured. Flipping is the replacement of a given credit contract by one or several new ones that also pretends to create an improvement for the credit applicant in his debtor situation without realizing it since only the credit broker earns in these transactions by earning commissions.

All three phenomena of churning, twisting, and flipping are a breach of the fiduciary relationship. They are not only a breach of the value of good consulting but a positive

---

13 The Director of the Dept. III, German Federal Agency for the Supervision of Financial Services (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin), Günter Birnbaum, presented his agency's findings on day trading in his lecture „Einflussfaktoren am Kapitalmarkt: Autoritäten, Paragrafen, Leitbilder" (Performance Influencing Factors in the Capital Market: Authorities, Paragraphs, Guiding Ideas) at the conference „Ethik des Kapitalmarkts" (The Ethics of the Capital Market) organized by the Deutsches Netzwerk Wirtschaftsethik (German Business Ethics Network) and others at the Siemens Forum Munich, Germany, on 12 October 2001.

breach of the consultant's fiduciary duty. In serious cases, this breach of duty can not be combated only through an ethical value orientation of the financial service provider, but must be sanctioned by the law, i.e. by the sentencing of compensation payments and, where appropriate, of criminal punishment. However, this legal sanction is appropriate only, where a fiduciary relation has actually come into existence. Where customers renounce that a fiduciary relationship has been established and explicitly want to act according to the maxim *caveat emptor*, the buyer be aware, they can not claim afterwards an increased fiduciary duty of the financial service provider.

V. Mergers and acquisitions: the capital market as the market for corporate control and the importance of a globalized competition between management teams

In the newest development of the global capital market, it becomes increasingly visible that a central function of the capital market is not only the allocation of capital, but also the allocation of management capability and knowledge so that they find in each case their best use. The capital market is not only the market for capital, but also for corporate control, for corporate governance. Corporate control that is secured by the acquisition of the majority of the shares of a corporation becomes more and more important in the present day capital market. Its trading is part of the function of the capital market to secure the optimal allocation of capital. The ownership of the majority of the stocks of an enterprise provides the control over this enterprise. The acquisition of 51 per cent of the shares represents a radical advance in control as compared to the acquisition of 49 per cent. This advance is also expressed in the increased relative price of a majority share ownership.

Corporate control or corporate governance is carried out increasingly either by purchasing the majority of the corporation's shares, even against the will of the of the target company's management, or by mergers.

The question must be asked why there has been such an increase in mergers and acquisitions (M&A). The globalization of the world economy is an engine for M&A. Through the purchase of other companies, the company taking over gains advantages for it corporate network. The network advantages through the integration of whole new companies that continue to exist frequently as independent division of the firm after the merger gain in importance as compared to the classical vertical integration or to the efficiency increase through economies of scale of a mere increase in size.

The purchase of stages of product development and of production processes through the purchase of the companies which own the know-how of these stages leads to a shortening of the time for research and development. A company taking over can buy knowledge and know-how through the takeover. The takeover results in shortening the development of new products and processes.

A completely new form of using the time zones becomes possible: In research and development, 24 hours a day can be worked globally on the same projects provided a company acquires different companies with research and development activities in the same product that are active in all time zones.[14] Through the acquisition or sale of an

14 Cf. Stephan A. Jansen: *Mergers and Acquisitions. Unternehmensakquisitionen und –kooperationen Eine strategische, organisatorische und kapitalmarkttheoretische Einführung* (Mergers and Acquisitions. Corporate Acquisitions and Corporate Cooperations. A Strategic, Organizational, and Capital Market

enterprise or of parts of it, a corporation can carry out adaptations of the corporate structure, size, and borderline to other corporations which would require more time if the firm built up new parts of the corporation within the old organization. In this way, the borderline of the corporation becomes more fluid and varying. Also the complexity and increased obsolescence of products requires increasingly the acquisition or merger instead of research and development within the firm, not at last, in order to save time for R&D.

On the other hand, it is objected to the increasing number of hostile and of friendly takeovers that only a small number of corporate takeovers succeeds. Studies made by the consulting firms Price Waterhouse and A. E. Kearny show that 40.000 mergers occurred worldwide in the period 1996 to 2001 that had a total value of 5 trillion US-dollars. 80 per cent of the merged firms did not earn the capital costs of the merger transaction. 30 per cent of these mergers were either reversed or the firms bought were sold again. A. E. Kearny estimates that the rate of failure of mergers is about 60-75 per cent.[15]

These numbers are, however, not necessarily an argument against hostile takeovers since they do not consider the effect of the takeover threat on the management of companies which were *not* taken over. The effect of the takeover threat on the management of all firms in the market is that all management teams are forced by this threat to increase or at least to maintain their performance level. The effect of a takeover threat and of a lively market for corporate control is a kind of general prevention against the shirking of management, against a too comfortable life of management teams.

The effect of the general prevention measure against management shirking that the takeover threat exerts is not reflected in the number of successes of the takeovers that actually occurred. The possibility and the threat of being taken over represents a general prevention of the market for corporate control against shirking or becoming lazy of management teams. In judging the effect of the takeover threat, it is not the number of mergers and takeovers that actually occurred and were successful or unsuccessful that is decisive but the general threat and prevention of management shirking through the general takeover threat..

How are so-called hostile takeovers to be judged ethically which occur against the explained will of the management of the company taken over? For the economic and ethical value of mergers and acquisitions, the question about the economic legitimacy in the sense of economic functionality of the hostile takeover is central. Is the hostile takeover to be refuted as a hostile process or does it serve the purpose of the capital market to secure and improve the optimal capital allocation and the control of corporate control? The central legitimacy for hostile takeovers lies in the right of the owners of a corporation to sell their part in the property of a firm to those that offer them the highest price for these parts or shares of the firm. If the owner of the firm is the owner of the majority of the shares, the central legitimacy for hostile takeovers is derived from his right to exchange the management if he reaches the justified conclusion that the management damages the enterprise or does not realize the maximum value creation of

---

Theoretical Introduction), Wiesbaden (Gabler) 3rd edition 2000, p. 5f.

15 Quoted in Nikolaus Schweikart: „Der getriebene Chef. Shareholder value über all – das US-Modell setzt sich durch“ (The Haunted Boss. Shareholder Value Above All - the US Model Gains Dominance), *DIE ZEIT*, no. 20, 10 May 2001, p. 26.

the enterprise.

From the logic of the owners' property right and of the owner or shareholder principle results that the management of the target enterprise must not refuse, if a takeover threat occurs, any offer that gives the shareholders the possibility of selling their shares at a price that is usually above the given share price. Measures of defence that hinder or stop this possibility of selling the shares must be judged, therefore, as value destruction because they deprive the owners or shareholders of the possibility to sell their property, their shares, at higher value. The functional use of hostile takeovers is unquestionable in case of an inadequate performance of the management of the target corporation or in case of the substantiated expectation that the management team taking over will create a higher corporate value.

In Germany, the objection is frequently raised against the owner- or shareholder value-principle,[16] that it violates the consensus principle, the principle that the firm should be managed with the consensus of everyone active in the enterprise, with the consensus of all stake-holders. It is also referred in the German context to the co-determination legislation applicable to German large-scale enterprises which safeguards the employee representation a share in the decision-making in the firm's management on the supervisory board level and, therefore, limits the shareholders' right to determine the management without consulting the employee representation.

The Anglo-American model, on the other hand, emphasizes the external control of the management and the enterprise through the shareholders' right of control which is a control coming from outside of the firm in contrast to the internal control by stakeholders in the German model. At the foundations of the Anglo-American model, one finds fairly realistic assumptions about the dangers that the enterprise faces by its internal stakeholders. Situations are conceivable and likely in which the management and the employees prefer management decisions that make life easier for them at the shareholders' expense by using up he firm's value and the shareholders' capital, e. g. by paying the owners or shareholders none or too small dividends or returns on investment and by concealing this value destruction to the shareholders and to the stakeholders themselves. If one assumes that all members of an organization are tempted to have an easy life for them personally in the organization and that this tendency is counteracted by the owners or shareholders from the outside, it is recognizable that the control of the enterprise by the shareholders is necessary. The shareholders are the countervailing power against the collusion of the firm's members.

Amongst the explanations given for hostile takeovers, it is especially the "free cash flow-hypothesis" introduced by Jensen that points to the danger of the management's shirking in mature corporations and industries.[17] In mature industries, high positions of free cash flow arise, high returns from turnover and depreciation which should be paid out as dividends to the shareholder and be reinvested by them in other projects or firms in order to secure the efficient allocation of capital. It is, however, in the interest of the managers of these firms to leave the free cash flows in the enterprise since they increase

16 Cf. on the debate Peter Koslowski: „Shareholder Value und der Zweck des Unternehmens" (Shareholder Value and the Purpose of the Enterprise), in: Peter Koslowski (ed.): *Shareholder Value und die Kriterien des Unternehmenserfolgs* (Shareholder Value and the Criteria of Corporate Success), Heidelberg (Physica) 1999, p. 1-32.

17 Michael C. Jensen: "Agencies Cost of Free Cash Flow, Corporate Finance, and Takeover", *American Economic Review*, 76 (1986), p. 323-329.

thereby the degree of their freedom and their potential for shirking in the firm by lowering the control of the capital market on their performance by diverting dividends into internal revenue of the firm.

The threat of hostile takeovers to be taken over by international management teams and investors in globalized markets reduces the management's inclination to keep returns on capital or profits in the firm. It also prevents the tendency to expand the firm's turnover without appropriate profits at the expense of the shareholder value. If the management's income is made to be dependent on its performance and this performance is measured in turnover the management will again expand turnover at the expense of dividend incomes.

The causality that the free cash flow hypothesis analyzes can also described as the more general phenomenon that people feel entitled to lean back and to work in a less hard way if they have founded and built up something, be it an enterprise or any other achievement. This is, of course, not in the interest of the institutions for which they set up something. On the other hand, the necessity arises here in the case of a hostile takeover to appreciate the building up achievement and to compensate by compensation payments that share that the management caused in the added value of the enterprise that had not been paid for by the management's contractual income. The criticism of high compensation payments or "golden parachutes" paid to managers that are fired because of hostile takeovers as it is frequently expressed after hostile takeovers must be put into perspective.

A further argument for the necessity to allow, if not to encourage, hostile takeovers is the argument that the shareholders, in general, are not able to be present all the time in the firm and can not defend their interests continuously within the firm, particularly not in the large joint stock firm with a large number of small "anonymous" shareholders. In this situation, the investors or shareholders are able to prevent their "exploitation" or their being taken advantage of by the management only through the right to hire and fire the management or at least to threat to be able to fire and displace it in a hostile takeover.

VI. The consensus of those concerned as internal self-control versus competition as external control through the takeover by the competitor: two models of (corporate) governance

In the German model of corporate governance, it is assumed that the consensus of the groups concerned makes already sure by its very quality of being a consensus that the best decision is taken for the enterprise and that consensus will secure that the decision best for the company is realized. Disagreement or decision-making without consensus between the groups working in the enterprise and concerned by its fate is regarded in this model as a sign of crisis and of inadequate management, whereas consensus is regarded, in full agreement with Jürgen Habermas's consensus theory of truth, as the guarantee of the correctness or "truth" of the decision taken.

It is easily recognizable that fundamental philosophical differences in the conception of governance, constitutional arrangements, governing, and control come into play at the debate about corporate governance and the constitution of the firm, at the question of consensus principle versus shareholder value principle. The questions about corporate governance reach as far as to the debate about the political constitution.

In the German or, more broadly, in the Continental European understanding of the

republican constitution and government, the idea of self-government through consensus, the general will model, is very influential although representative government prevails in fact. In the Anglo-American understanding of the republic, the idea of representative government through the representation of voter groups and the competition and alternating rule of competing political teams in politics and competition between management teams in the economy are the guiding idea. In both realms, in politics and in the economy, not the idea of consensus but of competition for voters or shareholders coming from outside of the decision-making groups is central in the American tradition, whereas internal consensus or agreement between the insiders in politics and in the economy is characteristic for the Continental European tradition since Rousseau's idea of the general will, the *volonté générale.*

The process of globalization of capital markets supports the competition principle, not the consensus principle. It requires and introduces the globalization of a market for corporate control and, therefore, the principle of competition between management teams, not the idea of a consensus of insiders in the economy. A foreign investor who is not an insider in the industry of another country can not rely on insider consensus as a means of controlling the performance of a management team of a foreign firm he wants to invest in.

Consensus does not guarantee the truth of the decisions made in consensus. A consensus of stakeholder groups is conceivable that decides at the expense of other stakeholders who have been contingently or systematically absent when the "consensus" had been formed. It is also well possible that all stakeholders of a firm decide and act under illusions - and might even have a systematic interest to confirm each other in these illusions - about the actual state and performance of the republic or of the firm. These illusions of insiders about their performance might be so pervasive that it can be destroyed only through the possibility that an outsider breaks through the delusion of the insiders' consensus from the outside by using the competition for corporate control and external alternative management teams for opening up the "consensualized" firms.

In the debate in the European Union about corporate governance, the constitution of the firm, and the role of capital markets, basic principles of corporate governance are at stake. The EU Commission urged Germany in 2001, to make the take-over directive of the Commission actual law in German legislation and jurisdiction. This directive requires the strengthening of corporate control through facilitating hostile takeovers and abolishing laws hindering market competition. Regulations are to be removed that allow the state or state owned firms to have privileges of restricting competition. Prominent cases are the Volkswagen-Law that grants special voting rights to the State of Lower Saxony as the main share holder of Volkswagen Corporation or the law that gives state owned banks the privilege that their liquidity is guaranteed by the state as in the case of the state banks (*Landesbanken*).

It is of philosophical interest that the former Commissioner for Industry, Mario Monti, has expressed the view <A[opin that the European Union can not make any difference between firms that are owned privately and firms that are owned by the state. State ownership in firms can not justify, according to Mario Monti, an institutionalized competitive advantage since this advantage disturbs the competition between private and governmental or semi-governmental firms.[18]

18 So Mario Monti, then Commissioner of the EU, at the Annual Meeting 2001 of the Verein für

One can look at this postulate from two perspectives. One could object that the EU Commission questions by its policy the distinction of state and society or economy which has been emphasized particularly in Germany.[19] The commission seems to deny the special standing of the state among the other social institutions since it refuses to grant any special position to firms in which the state holds shares compared to those firms that are completely privately owned. On the other hand, one has to raise the objection against this position that giving a privilege to the enterprise in which the state holds shares cancels the very distinction of state and society by creating a third hybrid form of political-economic control that is neither economic nor political.

The hybrid of the state owned business firm follows neither the market principles of competition, consumer sovereignty, and profit or loss nor the political principles of voter sovereignty and orientation on the common good. The semi-governmental firm is neither fully subjected to economic competition and completely for profit, nor is it completely not-for-profit and oriented at the common good. It can make profit, but the use of this profit is then decided frequently on political grounds that can neither be checked by the market nor by the voter. The semi-governmental firm belongs neither completely to the sphere of government and the state nor completely to the societal and economic sphere. It distorts, in fact, competition in the sphere of the economy and society since it can make use of privileges against its privately owned competitors.

The dynamics of the EU single market move here into the same direction as the dynamics of the global world market. Within the single market of the EU, it is difficult to give good reasons why Volkswagen should have competitive advantages due to the fact that the State of Lower Saxony holds a major part of its shares as compared to its French competitors like Peugeot or Renault that are, however, also partially state owned. It is hard to see why the politicians elected for running the State of Lower Saxony or the French Republic should have a higher competence to run Volkswagen or Peugeot or Renault respectively than managers coming from industry. The criterion that state and society, government and economy, should be functionally separated requires, for the sake of the protection of the essential state functions, that the hybrid forms of joint stock companies that are half state- and half privately owned should be given up in favour of companies that are fully privatized joint stock companies and a small number of companies that are fully state-owned and act completely in the public interest where this can be justified.[20]

If one asks the question which basic value orientations and which identifications with basic principles stand behind the dispute about the permissibility or non-permissibility of hostile corporate takeovers, one is led to the opposites of consensus and competition, self-control and control from the outside. The German model of corporate governance is based on the consensus principle and the self-control of insiders and stakeholders. It allots a subordinate role to the control of management from outside of the firm by the capital market. The essential control of the corporation is

---

Socialpolitik (German Economic Association) in Magdeburg on 27 September 2001.

19 Cf. Peter Koslowski: *Gesellschaft und Staat. Ein unvermeidlicher Dualismus* (Society and State. An Inevitable Dualism), Stuttgart (Klett-Cotta) 1982.

20 A well-founded judgment about the special position in Germany of the State Banks (Landesbanken) of the German States and of the savings banks is not easy to make. The support of these banks by the liquidity guarantee of the government makes credit for small- and medium-sized enterprises less expensive and can, therefore, be useful. On the other hand, this guarantee is paid by the tax payers who might not be interested in seeing their money to be used for this purpose.

supposed to be carried out as the self-control of the stakeholders within the firm. The Anglo-American model of corporate control, on the other hand, assumes that consensus does not necessarily imply efficiency and does not secure high performance since the emphasis on the value of consensus furthers the self-indulgence of those participating in the consensual discourse and eases their rash satisfaction with solutions and decisions pleasing them.

Traditions are influenced by and specific to culture and religion. Cultural tradition and even religious denominations play a role in the positions on political and corporate governance. In the Puritan, Calvinist-Protestant tradition, there seems to be a stronger distrust in the individuals' self-control and self-appraisal than in the Lutheran-Protestant and the Catholic tradition. The denominational and, therefore, cultural differences have shaped the different models and ideas of republicanism which have developed from the American and from the French revolution.

According to the Anglo-American Puritan model, the persons concerned and also the leaders of government and business are unable to judge their own performance properly due to the distortion of human judgment by self-interest - or theologically speaking due to the distortion of human intention and self-interest by original sin. When we are supposed to judge our own performance we are always in a conflict of interest, in the conflict between our interest in objectivity and our self-interest to appear to be good to ourselves and to others.

On the other hand, the consensus model of republicanism, of political government and corporate governance, based on the assumption of the identity of the governing and the governed assumes that the consensus or Rousseau's *volonté générale* is the truth-generating element of political and other governing processes that removes the distortedness of self-interested decision-makers into decision-makers that are oriented at the common good or the *volonté générale*. That consensus nullifies the conflict of interest between self-interest and objectivity is the conviction of this tradition.

The identity-philosophical interpretation of democracy as the unity of the governing and the governed dominates the German and Continental-European political philosophy. Its understanding of government from Rousseau and Hegel to Habermas is not as theoretically superior as this tradition suggests to itself. It is based on the questionable basic assumption that there is an absolute identity of subject and object, an idea that originates from Hegel's and Schelling's philosophy. In the same way as the Hegel's absolute subject becomes conscious at the absolute object and in identity with this object, the nation as an object becomes conscious of itself in the subject of the state. Government and people are an absolute subject-object in which the nation or people becomes self-conscious. Consensus is the highest form of this subject-object in which there is identity between subject and object, state and society, governing and governed.[21]

---

21 Through the transition to popular sovereignty, the national state enables society to influence "itself" politically according to Habermas. Cf. Jürgen Habermas: „Die postnationale Konstellation und die Zukunft der Demokratie" (The Postnational Constellation and the Future of Democracy), in: J. Habermas: *Die postnationale Konstellation* (The Postnational Constellation), Frankfurt am Main (Suhrkamp) 1998, p. 100. - According to K. A. Schachtschneider: *Res publica res populi. Grundlegung einer allgemeinen Republiklehre. Ein Beitrag zur Freiheits., Rechts-, und Staatslehre* (Res publica res populi. Groundwork for a General Theory of the Republic. A contribution to the Theory of Freedom, Law, and State), Berlin (Duncker & Humblot) 1994, p. 4, is the republic founded on being in the „state and constitution of freedom from rule".

The identity-philosophical thinking deduces from this supposed identity of the subject and object of political power that a nation's becoming subjective-objective or conscious takes place in the republican state in the consensus of the governing and the governed. Consensual governance leads to the identity of the state and the nation/people, the legislator and the legislated, the author and the addressee of the law. Through this identity of consensus, political rule is sublated or abolished and transformed into self-government. Discourse theoretical approaches to corporate governance transfer the consensus and identity theoretical model of political government to the firm and its governance. They postulate that stakeholder discourse and consensus in the firm ought to be the principles of corporate governance and control.[22]

From the viewpoint of a general anthropological theory of human self-interestedness and of the human beings' missing objectivity towards themselves, the discourse theory of human decision-making remains below the complexity of the task of controlling power. The tendency observable in the corporatist state to collusions and coalitions of influential interest-groups or lobbyists forces one to emphasize the need for the control of political and economic power through competition, through individuals and institutions that come from the outside to check organizations. Hostile takeovers are one of the possible control mechanisms against mistaken forms of consensus and of coalitions between the management and the stakeholder or pressure groups within the firm. Hostile takeovers, therefore, should be rather encouraged than hindered by the legislation on corporate governance. A greater control of the management of large-scale enterprises through competing management teams and their takeover threat will result in an increased performance of these firms.

The need for a limitation of the consensus principle does not exclude to retain elements of the co-determination legislation as it is mandatory for German large-scale enterprises. The option for some worker participation does not imply, however, equal voting rights of the employees at the supervisory board level. Rather, it requires an end to the accumulation of power by the trade-unions in the supervisory board of large-scale enterprises as it developed in Germany where many CEOs claim that they can not decide against the worker representation in the board dominated by the unions that usually organize and represent the employees. Co-determination in the form of employee representation on the supervisory board does not violate the owner- or shareholder value-principle if and only if the clear majority of votes and therefore the right of the last decision remain with the owners or shareholders. At present, this is not the case in Germany. An enormous insider position has been built up by the unions since their representatives sit in practically all supervisory boards of large-scale enterprises as the representatives of the employee representation.

The participation or do-determination principle can increase corporate performance when it understood as a principle of representation and not as a consensus principle and when it is instituted together with the control principle of hostile takeovers. The co-determination of the employees on the board increases the learning capacity of the

22 This position is taken in publication of a discourse theoretical approach to business ethics in the group around Horst Steinmann. Cf. Andreas Georg Scherer: *Die Rolle der Multinationalen Unternehmung im Prozeß der Globalisierung* (The Role of the Multinational Corporation in the Process of Globalization), Heidelberg (Physica) 2003 (Ethische Ökonomie. Beiträge zur Wirtschaftsethik und Wirtschaftskultur - Ethical Economy. Studies in Economic Ethics and Economic Culture,Vol. 7).

organization and also fulfils a pacification function in conflict situations within the enterprise as long as the majority vote of the shareholders or owners is safeguarded.

The synthesis between the Anglo-American principle of the capital market as the market for corporate control and the German principle of co-determination as employee representation in corporate governance on the board level is possible also under conditions of globalization. This synthesis can improve the firm's ability to discover chances and weaknesses within the organization and to use this knowledge for increased performance. The synthesis of the capital market control model with the co-determination model of corporate governance is likely to be superior to the "pure" models of either the capital market control or the co-determination governance model. Globalization will move corporate governance in the European Union in the direction of such a synthesis. It is likely that this model will radiate from the EU to the global financial markets.