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A Hollow Cultural Core? An Inquiry into New Institutional Approaches to Incentive Based Regulation

Abstract

The trans-disciplinary New Institutional framework identifies the importance of incentive structures in preventing opportunism in market making. In recent decades this theoretical tradition has increasingly shifted its attention from formal institutions to identify the significance of cultural processes in countering uncertainty, bounded rationality, and information asymmetries. More specifically the New Institutional perspective tends to focus on the formal mechanisms producing and reproducing culture, as opposed to an examination of specific cultural content. This attention to formal mechanisms means that value-rational action and commitments in market making receive insufficient attention. In order to examine the problems entailed in this trend, the case study of a financial market in which market making was constituted by the values of loyalty, duty, and honor of traders is used.

Keywords: Culture; Institutions; Markets.

Flawed incentive systems have figured prominently in scholarly and policy analyses of the 2008 global financial crisis. From such assessments it is possible to imagine financial markets as chains of contracting relationships involving agents with divergent interests. If proper functioning incentive structures had been present the predatory lending, excessive risk taking, regulatory arbitrage, and other questionable practices underlying the crisis would have been curtailed. While there is a diversity of spaces where incentive structures can intercede, from trader-manager to regulator-private firm relations, the recognition that markets are not spontaneous formations draws attention to a particularly important subset of relationships—the daily practices constituting market making. In order for markets to function a variety of commitments, ranging from delivering payments to quoting a fair price spread, need to be

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guaranteed. If the incentive structures governing these market making practices are flawed, they can negatively impact the chain of contracting relations in global financial markets (as the London Interbank Offer Rate—or LIBOR—scandal has demonstrated).[1]

One of the intellectual traditions most concerned with incentives and market making is the New Institutional framework. This transdisciplinary perspective argues that incentive structures prevent opportunism from running amok and contribute to market actors recognizing and achieving their collective strategic interests. Initially New Institutional theorists focused on formal incentive systems, such as state backed property rights. In the last two decades, however, this perspective has identified the significance of "other-regarding" preferences and culture in the structure, functioning, and regulation of markets.

Within this scholarly tradition, the mechanisms producing and reproducing culture, i.e. mutual monitoring and reputational sanctions, are the significant factors curtailing opportunism and facilitating market making. By incorporating culture and social dynamics into market incentive structures, important limitations to standard neoclassical frameworks are redressed. Regulation expands beyond a reliance on pecuniary incentives; market actors cease to be autonomous; and rationality becomes contextualized. Yet even with its more nuanced analysis, the New Institutional approach to culture and markets still faces a quagmire.

Due to uncertainty, bounded rationality, and information asymmetries this theoretical tradition recognizes that perfect supervision is impossible. The factors producing and reproducing culture—mutual monitoring and reputational sanctions—are clearly important elements for solving this contractual tangle. They can yield, however, both a "network of malfeasance" (Granovetter 1985) and behavior that protects stakeholders not directly involved in market making. The specific content of culture, i.e. predatory versus honorable normative orders, thus emerges as a key variable. Yet the New Institutional analysis tends to sideline this dimension and the original quandary remains.

[1] Each day in the London interbank money market the largest banks are asked a single question: "At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m.?" Based on these replies interest rate benchmarks for fifteen maturities in ten currencies are calculated. These are then used as pricing benchmarks for a wide-range of financial products. In May 2012, news broke that traders had repeatedly and even systematically colluded to provide false answers for the benefit of the institutions employing them or their colleagues.

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A critical step in demonstrating the challenges confronting the New Institutional framework involves exploring the centrality of cultural content in market making. This is by no means a new topic. For the past several decades scholars have examined how culture constitutes the economy, whether it be through rational myths, categories, or the performativity of economic theory (DiMaggio and Powell 1991, Meyer and Rowan 1977; MacKenzie 2006). Yet, efforts to avoid "oversocialized" accounts of culture (Granovetter 1985) have shifted the emphasis away from normative orders and their values to cognitive and strategic dimensions. As a result, value-rational action in markets has received insufficient attention. Any critique of the New Institutional tradition emphasizing the importance of cultural content is thus somewhat curtailed.

To show the problems entailed in the New Institutional approach's inclination to sideline cultural content, a case study of the London gold market is used. Evidence of trading practices from the 1970s indicates the centrality of the values of loyalty, duty, and honor in the structure, function, and regulation of market making. Traders' compliance with the normative order went, moreover, beyond strategic concerns such as legitimacy or sacrificing short-term interests for longer-term gains. Rather they expressed a value-rational commitment to its core principles. To further emphasize the challenge faced by the New Institutional approach to culture and markets, the dynamics of an ongoing investigation into fraudulent dealing further suggest the significance of normative content in market making. Through an exploration of this case study, the possible existence of a hollow cultural core in the New Institutional framework is discussed.

New institutional approaches to culture and markets

The New Institutional Economics (NIE) has examined how culture and informal institutions—the socio-historical nexus of norms, traditions, customs, cognitive scripts, etc. —provide the foundation for market development and operation.[2] Whether it was the role of beliefs and values (internalized social norms) in the cognitive models of boundedly rational market participants, or informal institutions acting

[2] While there are differences in the NIE approaches to culture, they tend to follow an approach modeled by Oliver Williamson (2000).

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as substitutes for laws and courts, culture shaped the rewards and sanctions—or incentive structures—limiting opportunism, information asymmetries, and uncertainty in exchange (Denzau and North 1994; Grief 1998; North 2005; Williamson 2000; Zerbe and Anderson 2011).

Culture's influence in properly functioning markets is, however, distal. Once state and other formal organizations effectively protect property rights and enforce contracts, the explanatory need for culture and informal mechanisms ceases. Their influence on market incentive structures becomes indirect through their shaping of the formal institutions creating the conditions for rational utility maximization (Denzau and North 1994; Grief 1998; North 2005; Williamson 2000; Zerbe and Anderson 2001).[3] Only under conditions of Knightian uncertainty and the absence of robust formal institutions will normative orders and culturally inflected cognitive models directly stabilize markets and ensure transactional security.

Legal scholars were at the forefront of challenges to the NIE contention that culture only mattered under these limiting conditions. They argued that contracts were always incomplete because it was impossible, or too costly, to specify the payoffs for every relevant action and the corresponding sanctions for non-performance. Using the court system to resolve commercial disputes was, moreover, time consuming and expensive. Based on rich and nuanced studies of grain, fish, rice, cotton, and diamond markets these private ordering scholars (POS) (Bernstein 1992, 1996, 2001; Richman 2005, 2006; West 2000) argued that outright fraud, breach of contract, and opportunism were prevented due to the extrinsic and intrinsic incentives grounded in the tight linkages between an individual's reputation in community and business networks.

Instead of a dysfunctional public order (McMillan and Woodruff 2000), informal institutions and meaning systems remained relevant because they aligned the incentives of instrumentally rational actors in an administratively and transactionally efficient manner. The content of culture, however, became a secondary concern to its role in lowering transaction and administrative costs. The difference between a value-rational versus strategic commitment to culture mattered only in terms of their relative efficiencies or alternative "market values"

[3] It was not simply that formal institutions naturally displaced their informal counterparts. Increased complexity in the economy and long-distance trade meant meaning systems and informal institutions had greater difficulty operating as incentive structures ensuring credible commitments by aligning the disparate interests of trading partners (Greif 1998; North 1991).

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(Bernstein 1992).[4] While recognizing a diversity of normative orders, the POS approach does not seem to attribute a significant cost differential between strategic and value-rational commitments to cultures (ibid 1992).

The New Institutionalism in Economic Sociology (NIES) also recognized that formal organizations were clearly important yet incomplete (Nee 2005). The question became what mechanisms within close-knit groups and interpersonal relationships mattered for market structure and functioning. As an incentive structure, culture played two critical roles in markets.[5] It ensured contractual commitments, limited opportunism, and combated uncertainty. The social approval and disapproval enforcing normative orders operated as an incentive system providing the foundation for everyday orderly exchange (Clay 1997; Ellickson 1998). In addition, culture also shaped boundedly rational action and contributed to market functioning by aligning the varied pecuniary interests of market participants to accomplish collective strategic long-term objectives. The role of meaning became epiphenomenal as culture remained external to individuals since it simply provided constraints on the boundedly rational pursuit of contextualized interests.

Through their somewhat varied approaches, the three New Institutional frameworks identified culture as an incentive structure promoting smooth market operation. The direction of their theorization threatens to yield a hollow cultural core. The New Institutional theorists' focus on the mechanisms producing and reproducing culture leaves the normative content unspecified. Reputational sanctions and social pressure can simultaneously facilitate trust and transactional security. But they do so in normative orders that can be either opportunistic or honorable in relation to those outside of the immediate market making context. By neglecting cultural content the New Institutional approach faces an obstacle in resolving their original problem.

[4] It is feasible that a market value of honor, loyalty, and duty could be arrived at even if the amount attached to it is a form of "pricelessness" as studied by Zelizer (1985). While POS theorists draw attention to both the strategic and value-rational dimensions of culture (Bernstein 1992) they do not attribute a significant difference to the respective market values.

[5] The NIES tried to avoid treating actors as cultural automatons and thus avoid the "over-socialized" actor problem (Wrong 1961). To address this issue, a "choice within constraints" model was employed in which standards of expected behavior emerged from the structure of ongoing relationships between individuals as they collectively problem-solved the question of how to achieve their context-dependent interests (Ingram and Clay 2000, Nee and Ingram 1998).

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At one level there is nothing new about the above critique. It is aligned with criticisms of rational-choice treatments of institutions made by the neo-institutionalism tradition (DiMaggio and Powell 1991, Meyer and Rowan 1977, Scott 2008, Zucker 1977). Whether it is the strategic adoption of institutional practices to signal external legitimacy, or how the moral is transformed into the factual through processes of institutionalization, scholars within this framework identify how cultural dynamics, not efficiency, are constitutive of institutions (Weber et. al 2009, Wesphal and Zajac 2001). The cultural-cognitive approach of neo-institutionalism thus draws attention to a variety of dynamics varying from the social construction of the foundational categories and scripts in markets, to the global diffusion of market forms (Weber *et al.* 2009). Despite these critical insights, their efforts to distance themselves from the "old" institutional tradition by focusing on cultural-cognition, has sidelined the value-rational and expressive dimensions of culture (Spillman 2012, Thorton *et al.* 2012).[6]

Drawing further attention away from value rational action, is the trend in economic sociology that emphasizes the cognitive-foundations of markets and the socio-cultural construction of instrumental rationality. This research has demonstrated that if *homo economicus* or the idealized neo-classical market exists, it is because they are produced through a complex of social, technical, cognitive, and institutional processes (Abolafia 1996; Aitken 2005; Beunza and Stark 2004; MacKenzie 2006; MacKenzie and Millo 2003; Zaloom 2006). Yet the focus on "economistic" markets inadvertently sidelines the significance of normative orders and value-rational commitments to them. Inquiries into the limits of existing New Institutional analyses through these research traditions is, as a result, somewhat curtailed.

To demonstrate the importance of value-rational action, the ideal case study would be a market in which the mechanisms of mutual monitoring and reputation were coupled with two different normative orders—one leaning towards honorable dealings and another towards opportunistic behavior. The London gold market lends itself to such a comparison. First, as demonstrated through evidence from the 1970s, the structure, function, and regulation of market making was constituted by a normative order emphasizing the values of loyalty,

[6] Even though Thornton *et al.* (2012) argue for the interconnection of instrumental and value-rational action, their notion of a "market logic" tends to reproduce the very separation they recognize. "Market logic" is different because "a utilitarian perspective, based on the costs and benefits of specific actions, is the culturally appropriate form of behavior. Under alternative institutional logics, goals need not be driven by pure self-interest or by a rational calculation of costs and benefits" (87).

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duty, and honor. Compliance with this normative order was based, moreover, on both strategic and value-rational commitments. Second, a recent instance of fraudulent dealings in the London gold market also points to the problems entailed in the New Institutional focus on formal mechanisms and simultaneous sidelining of cultural content and value-rational action.

Data and methods

For a majority of the last three hundred years, the London bullion market dominated international precious metals trading. In the early seventeenth century it emerged as the most important silver market, and by the mid-nineteenth century it received the same designation in relation to gold (Green 1979). Until the second-half of the nineteenth century brokers and dealers traded gold and silver through individually negotiated bilateral contracts, i.e. it was an over-the-counter market. By the turn of the twentieth century the gold market's "modern" form emerged with the establishment of an auction in which all gold transactions were executed at a single price—what is traditionally known as the London Gold Fixing.[7] In most cases, business in the London Gold Fixing took less than fifteen minutes and, when the auction was not in session, dealers conducted gold trades on the phone in the over-the-counter (OTC) market. Since the late nineteenth century the term "London gold market" referred to both the auction and to the OTC market.

Due to the official monetary role of precious metals during the nineteenth and twentieth centuries, the London Gold Market (LGM) was at the center of the international monetary system. In the era of *Pax Britannica*, the LGM joined sterling and the City of London as core elements in the gold standard, with the London Gold Fixing establishing the world's most important gold price. Even with the decline of the British Empire and two World Wars, the LGM retained its centrality. In the post-World War II era the precious metal was at the center of the international monetary system due to its statutory linkage with the dollar ($35/ounce of gold). When the post-World War II monetary order collapsed in the early 1970s, gold's statutory role in the international financial system came to an end. The liberalization of

[7] London's bullion market also had a Silver Fixing that was established in the nineteenth century. Initially it appears that the London Gold Fixing took place within the Silver Fixing.

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gold meant that the LGM increasingly had to compete in the emerging network of precious metals trading centers that developed during the 1970s. While no longer the central node, the LGM remained vitally important in the globalizing precious metals market.

Despite the significance of the LGM in the international monetary system, most secondary sources focus on the operation of the nineteenth century gold standard or the Bretton Woods monetary system with little mention of the market's history, functioning, and development. The most sustained discussion of the LGM occurs in Timothy Green's insightful books about the international gold market (1968, 1970, 1981, 1993) and his history of the gold dealing firm, Mocatta and Goldsmid (1979). While Green provided nuanced discussions about the LGM in these works, his main focus was not on the history of the market. As a result, a sustained chronology of the LGM does not exist. It was thus necessary to use primary sources to develop an understanding of the role of culture in the structure, functioning, and regulation of the LGM. Documentary evidence from the Bank of England Archives, HSBC Archives, and the Federal Reserve Bank of New York Archives; and other primary sources such as periodicals and census data were central in this endeavor. They provided information about the Bank of England's regulatory style; the development of the LGM between the late nineteenth century and the mid-1970s; and the bullion firms and the families who were active in these organizations.

Due to temporal restrictions on viewing archival materials (a 30 year rule), interviews were also central for conceptualizing the normative order constituting the LGM. The names of potential interviews were obtained from the LGM self-regulatory organization, the London Bullion Market Association. The twelve individuals interviewed (some more than once) were active in the market for decades in several different trading and critical management capacities. They had intimate knowledge of the market; could provide descriptions of its structure, daily operation, and regulation; and were central in the governance of market making. Given the small and specialized nature of the market only limited direct quotations and descriptions of the interviews is used in order to protect the anonymity of each individual.

It is important to note that interviewees did not label the market practices they described with the moniker "ethos of genteel fair play", or "duty to market". Rather the cumulative descriptions clearly indicated the significance of the loyalty, duty, and honor in trading practices. Interviewees continually expressed a value-rational orientation

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to these elements and the LGM more generally. It was quite common to hear traders describing how another dealer "loved the market". The actual "duty to firm and market" moniker emerged when I asked an interviewee to describe the sociocultural order ("Gentlemanly Capitalism") in the City of London prior to the Big Bang, or the liberalization of the London Stock Exchange. After a pause, the individual stated, "duty to firm and market". Only later when analyzing the data, did I realize how this single phrase captured the core of the normative order governing the LGM.

Distilling chivalric masculinity

The normative order shaping the structure, functioning, and regulation of the LGM was a subculture of the chivalric ideal of gentlemanly conduct institutionalized in the late-nineteenth and early-twentieth century institutions of the British elite. The presence of a modified version of this ethos was grounded in the socialization of the bullion firms' owners and managers; the organizational structure of the bullion firms; and the small, dense social networks characterizing the LGM. Together these produced a "duty to firm" work culture in which instrumental and value rationality were intertwined.

A majority of the family partners/managers of the bullion firms active in the LGM (all were men) spent their formative years in the institutions shaped by the waning social and cultural hegemony of Britain's landed classes. Even though the decline of the gentry was well underway by the late-nineteenth century, their cultural influence did not immediately disappear (Cain and Hopkins 2002, Cannadine 1999, Cassis 1994, Harris and Thane 1984, Weiner 2004).[8] As late as the start of the World War II, the institutions, i.e. public schools and sporting activities, of the British elite continued to promote a patrician way of life and a particular conception of masculinity—i.e. the chivalric gentleman. This ideal stressed acting with "bravery, loyalty, courtesy, truthfulness, purity, honor, and a strong sense of protection

[8] By the nineteenth century the British upper classes were composed of the landed gentry, manufacturers, merchants, and bankers. They did not form, however, a unified social class and considerable divisions remained (Cannadine 1999; Scott 1982). The gentry continued to deprecate those engaged in business, and when manufacturers, merchants and financiers made their fortunes they did not necessarily transform themselves into landed magnates. Despite such distinctions, the gulf between the three groups had been narrowing for some time (Beckett 1986; Cain and Hopkins 2002; Scott 1982).

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TABLE
Gentrification of Bullion Families

Qualities of Gentrified Financier	Firm Name: *Mocatta & Goldsmid*	*Johnson & Matthey*	*N.M. Rothschild & Sons*	*Pixley & Abell*	*Samuel Montagu & Co.*	*Sharps & Wilkins*
Family Lineage	English-Jewish Gentry		English-Jewish Gentry	Potentially descended from Gentry	English-Jewish Gentry	
West End Domicile	Yes	Yes	Yes	Yes	Yes	Yes
Country Estate	Small		Several large estates		Swaythling	
Public School/ Oxbridge Education	Harrow	Eton/ Oxbridge	Harrow/ Oxbridge	Eton/ Oxbridge	Clifton College[a]/ Eton/ Oxbridge	
Connected to Gentry	Business Partners from the Gentry (Sir Hay, Villiers)	Family links in early 1900s to lower gentry	Family links to Earl of Southampton	Family links in 19th century lower gentry		Possible family links to lower gentry
Lifestyle	The Season, Presentation at Court, Horse Racing	The Season	The Season, Hunting, Brooks Club, Presentation at Court	Shooting, Hunting, The Season, Presentation at Court	The Season, Presentation at Court	Family member presented at Court
Religious Affiliation	Jewish	Anglican	Jewish	Anglican	Jewish	Anglican
Peerage			1885		1907	

a. Clifton College was called the “Jewish Eton” (Bermant 1971) and was bearer of the chivalric masculinity public school ethos.

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toward the weak and oppressed", i.e. the British Empire's colonial subjects and women (Cohen 2005: 326). While exhibiting some flexibility in terms of the types of men who could be counted amongst its ranks, certain groups, such as women, were excluded. While chivalric masculinity entailed certain obligations for high status individuals, it was fundamentally based on hierarchy, exclusion, and imperialism.

A majority of the families participating in the LGM were involved with the institutions of the British elite (see Table). They were, however, only partially integrated into this sociocultural milieu. Two crucial factors created a divide: wealth and religion.

These barriers were not, however, entirely insurmountable. Where the Pixley family lacked great wealth, for example, their lineage and marriage to members of the lower gentry were significant. Even though the Anglican and landed class establishment had strong anti-Semitic tendencies, they did not have a monopoly on values embodied in chivalric masculinity. All of the Jewish families active in the LGM were part of the "cousinhood" (Bermant 1971), the extended kinship group linking the wealthiest and most socially, culturally, and politically prominent individuals in the Anglo-Jewish community. The "Jewish" values of this milieu not only dovetailed into those of the landed classes (Bermant 1971), but the former's educational and social institutions also championed core attributes of the gentlemanly ideal, i.e. loyalty and honor.

The family partners/managers' partial integration into the British elite cannot fully explain the "duty to firm" workplace culture. The partners structured the bullion firms in a manner that utilized elements of the chivalric ideals. Their capacity to do so was not simply related to the fact that they were at the head of their firms, but was further enhanced by the bullion firms' small size and relatively flat organizational structure. These factors facilitated the integration of the "partially-gentrified" partners' attitudes into the general atmosphere and organizational practices of the workplace. The chivalric masculinity was thus distilled into a genteel ethos promoting the values of loyalty, duty, and honor. In this way, the very structure and demography of the firm made it a "natural" nexus for socializing new members of the firm—i.e. other members of the "chivalric class" as well as young men from the middle- and working-classes (some of whom might have been exposed to the chivalric masculinity ideal during their grammar school education).

In the relationships between employers and employees evidence of the chivalric ethos was prominent. Employees often worked for one

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firm their entire lives and movement between bullion dealing organizations was a rare event until the 1980s. Moreover, when a trader moved between one of the gold market's firms to another for the first time in the 1970s, his mobility was a carefully orchestrated maneuver laced with discrete patrician overtones. The circumstances surrounding the move were likely to be tense since the individual left because of a disagreement with their original employer. Paternalism did not mean there was an absence of conflict. Yet, instead of punishing the employee, the move was negotiated and agreed upon by all the concerned parties. The transfer was structured, in part, around the strategic motivation of avoiding the loss of proprietary information. At the same time, the efforts to assure a smooth relocation alluded to the paternalistic bonds between the partners and managers of the firm and their employees. Other examples of mutual obligation included the bullion firms helping employees through loans, financing the purchase of homes, and outright gifts ranging from wedding gifts to assistance with medical bills.[9] Capturing the character of these relations, an employee of a prominent bullion firm recalled how his employer "looked after people, and, made sure they were all right, and all that sort of thing".[10]

Such patron/client relations between employee and employer had an impact on compensation practices. A majority of the individuals I interviewed were drawn to the City by instrumental concerns—to earn money, advance their career, and, more generally, "make their way in the world".[11] The desire to make money was not, however, equivalent to unbounded ambition. It had a genteel value-rational orientation. The participants I interviewed described how a wholesale or excessive pursuit of money was frowned upon in the 1970s gold market. This aspect of the gentlemanly culture was conveyed by some pejorative comments concerning the high level of bonuses in present-day financial markets. Several individuals noted that current compensation practices had corrupted the social relationships between firms and their employees. With the cessation of life-time employment, it was necessary to pay higher salaries and bonuses in order to secure employees' loyalty. Inflated compensation had led, moreover, to cut-throat competition as individuals scrambled to get ahead. Interviewees noted that camaraderie within the firm was undermined. Such comments suggested that, within the gentlemanly

[9] HSBC Archives, 0329/093, 1936-1948.

[10] BLSA, Jack Spall interviewed by Cathy Courtney, 1991-1992, City Lives, British Library Sound Archive, catalogue reference, C409/061.

[11] Interview, London, 2006.

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normative order, unrestrained greed in markets was not, in fact, considered to be a virtue.

The presumption of life-time tenure in a firm, fostered by the bonds of loyalty and duty, helped to stabilize the genteel ethos in the market even as the pre-existing conditions that once produced it were fading in the face of an increasingly prevalent aggressively individualistic ethos. Before employees began moving regularly between firms, advancement was often based on the retirement or the death of one's superiors. Employees were only fired if they engaged in flagrantly fraudulent behavior; otherwise, as noted earlier, more genteel sanctions were used. As a result many of the core dealers who retired in the early 1990s, for example, had been active in the LGM since the late 1960s and 1970s. Their lengthy tenure meant they were socialized into the firms' way of doing business. The existence of this cohort of traders meant that they transmitted key components of the patrician spirit to new entrants who learned their craft through unofficial "apprenticeships". Thus, crucial elements of the genteel spirit survived as longevity fostered its relatively stable transmission. As detailed in the next section, the impacts of the subculture were not, however, confined to a workplace culture.

Genteel fair play and the market

Through the course of my interviews, dealers described how they bullied each other, competed aggressively, and tried to "kill each other with a smile". Yet such accounts simultaneously communicated a parallel system of conduct characterized by cooperation, honorable forbearance, and a sense of overarching duty to create a healthy and sustainable market. Instrumentally rational behavior was supported by a genteel spirit of "fair play". The presence and role of the ethos simply reinforces, at one level, the idea that culture acts as an incentive system that facilitates strategic interests. Such a conclusion is partial. Whether it was liquidity, credit relations, or clearing mechanisms, traders did not conform to the ethos simply for strategic concerns. Rather a value-rational commitment to the "duty to market" ethos also constituted market making practices.

Even though the existence of state-mandated exchange controls already placed restrictions on who could trade in the wholesale gold

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markets in the 1970s (with the five firms in reality dominating all trading), numerous gentleman's agreements were used to further restrain competition. These informal arrangements ranged from fixed dealing commissions to discouraging the poaching of another firm's clients.[12] These agreements were not always static, as competition would alter the terms, for example, by lowering commissions. When operating, however, they served to limit competitive behavior. Even if backed by the threat of exclusion from the LGM, due to their codified yet informal characteristics, these agreements relied upon the honorable and dutiful compliance of all parties.

Along with these gentlemen's agreements, honor was also important in structuring trading and market infrastructure. Gold dealers were expected to quote both buy and sell prices with a reasonable spread (the difference between the buy and sell figure). Such a practice was essential for ensuring liquidity—a foundational element of any market making. Besides frowning upon excessive spreads, once a price was quoted the trader could not alter the figure. They needed to maintain the quoted prices even if it meant they would lose money. The reliance upon the counterparty's honor was particularly important since market transactions and settlement at the day's end were handled in an informal manner. Normally a trade was scribbled into a dealing book or recorded on a trading slip. During hectic periods, however, it could get lost in the shuffle. If unmatched sales or purchases emerged when the day's deals were tallied, then the transaction would be split among the parties—regardless of whether it resulted in a profit or loss for them. Along with structuring such dealing practices, personal honor was a *sine qua non* for building trust between counterparties. Well into the late 1970s a majority of the bullion firms were owned by merchant banks. In comparison to the American, Japanese, and German financial conglomerates, they were thinly capitalized entities. Trust was placed in the firm and its managers that they would honor the obligations of their traders; even if it meant the firm took a large loss. Reputation and honor were the basis of credit control.[13]

The presence of the ethos was also evident in the approach of the institution regulating the market, the Bank of England (the Bank). While a sociocultural history of the central bank does not exist, secondary (Courtney and Thompson 1996; Hennessey 1992; Kynaston 1995; 2000; 2001; Moran 1984) and primary sources suggest that the institution's informal, as opposed to legalistic, governance style was

[12] Interview, London, 2006.

[13] Multiple interviews, London, 2006 and 2007.

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characterized by an ethos emphasizing the values of loyalty, duty, and honor. While rule violators could face expulsion from the financial world (Moran 1984; Kynaston 1995), it meted out disapproval and appeared to effectively halt any problematic behavior with its own "raised eyebrows" and/or visits by rule violators to the Bank's premises for a quiet discussion. In the words of the prominent merchant banker, Michael Verey, the Bank expected "total trust" from its employees and the firms it regulated. This meant, "if you say you'll do something, you'll do it" (Verey in Courtney and Thompson 1996: 164-165). Much like the structure and functioning of the gold market, the elements constituting the ethos of genteel fair play were thus central to the Bank's governance order.[14]

The market making practices described above could comfortably fit within the New Institutional framework. As an incentive system, it contributed to market making by ensuring credible commitments, limiting opportunism, and facilitating the attainment of collective strategic interests. Being able to conduct trading with verbal commitments and an informal procedure for settling disputes also avoided the time consuming and costly task of designing complex contracts and utilizing the legal system. Individual profits were sacrificed for the collective realization of long-term gains. The regulatory style of the Bank could also be seen as efficient since discretion allowed for a great deal of flexibility, minimized the use of complicated rules, and even insulated market governance from Parliamentary politics.[15] The ethos of genteel fair play thus confirms many of the arguments regarding culture made by the New Institutional framework.

Yet such support is partial and ignores the importance of value rational orientations in market making. Interviewees described a value-rational commitment to the ethos of genteel fair play. The gentlemen's agreements fixing commissions and prohibiting the poaching of clients were oriented toward strategic concerns. Yet, such practices were also based on a sense of collective responsibility focused on fostering stable market making. Competition was valued, but it was seen to have limits. As one individual noted, the market should never be "bled for the margins" or fall prey to ruinous rivalry. The gentleman's agreements were not simply about assuring individual profits through collective means. Rather, traders had a collective, non-strategic custodial concern vis-à-vis the LGM.

[14] Supporting the effective operation of this regulatory style was the City of London's social homogeneity and its intimate relational networks. The Bank maintained this social order by limiting entry into financial markets and suppressing excessive competition (Moran 1984).

[15] According to Moran (1984), the Bank's reliance upon this regulatory style was based upon this collection of factors.

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Another instance of value rational orientations centered on the boundaries placed on earning profits from transactions. Several of the individuals who had been trading gold since the 1970s noted that they would not make money on a position if it involved taking unfair advantage of the other party. "Charles", an ex-dealer, for example, told me about a scenario in which he had an opportunity to profit from another dealer who recorded their transaction incorrectly. Charles explained to me that the right course of action had been to correct the counterparty's mistake. He explained how his reasoning was based, in part, on the fact that the person would never trust him in the future. At the same time, though, he noted, that if you acted in a dishonorable way then you were just that—dishonorable. As demonstrated by Charles' anecdote, genteel standards of fair play were not simply something he followed because of reputational sanctions and an instrumental orientation toward future profits. His commitment to acting in an honorable manner was value-rational.

Treating the ethos of fair play as an end-in-itself spread to client dealings as well. Traders could have made markets in a manner that collectively produced profits for dealers at the expense of their clients. In this instance social pressures and reputational mechanisms would have been operational in promoting collusion among traders, with the customer being unaware of any malfeasance (as in the LIBOR scandal). Yet evidence suggests that the normative order in the LGM frowned upon profiting at the expense of a client. For instance, before the onset of a round-the-world, round-the-clock market, when the LGM closed price movements ceased.[16] The practice was to telegraph clients in Europe sending them the closing price and asking whether they had any buy or sell orders to submit at that figure. In the morning the telegrams would be waiting. In one case, a client's telegram from Europe was delayed. In the meantime the price had moved upwards. Instead of selling them gold at the new price, the firm transacted the deal at the previous days' closing price. Honorable dealings in the market extended not only to fellow traders, but to clients as well. Making money from an unfair advantage was frowned upon. As one trader noted the saying in the United States, "let the buyer beware",

[16] Until the mid-1970s London and Zurich were the dominant gold markets. In the latter half of the decade Hong Kong emerged as an important market. The United States gold market only became significant in the late-1970s and early 1980s. The late development of both markets was related to restrictions on gold trading in both countries in the first half of the 1970s.

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did not characterize dealings in the LGM. Dealers had a value-rational commitment to being "ethical" and "honest". Summing up his experiences in the gold market, a retired trader noted that he had just "tried to do the honorable thing".[17]

A similar pattern is seen in regards to the Bank's regulatory style. Explaining the central bank's approach in terms of strategic concerns such as efficiency, flexibility, and insulation from Parliamentary politics misses an important element. Documentary evidence suggests that throughout the twentieth century Bank staff demonstrated a value-rational commitment to a genteel style. In the 1930s, for instance, the Bank made efforts to control speculative currency and gold transactions. Instead of utilizing legislation, the Bank circulated a letter explaining the guidelines to be followed. While they pondered legislation, they relied upon the "loyalty and discretion of the market" to follow and enact the principles regarding speculative transactions.[18] Such loyalty was not blind. If there were disagreements they were not to take the form of "malicious or subversive criticism" and instead simply required a visit to the Bank and a quiet conversation.

As detailed in an excerpt from a memo recording a conversation between the Bank and a staff member of the Federal Reserve Bank of New York, the same regulatory principles were in existence during the 1970s:

> This morning I called Mr. R.D. Galpin, Deputy Chief Cashier, Bank of England, to discuss the Bank of England's letter concerning guarantees by parent banks located outside the United Kingdom of their banking consortia and other subsidiaries in the United Kingdom [...] Mr. Galpin explained that in seeking guarantees from parents abroad the Bank of England was not requesting a legal document, but rather a "moral obligation". This obligation would express the desire and intention of the shareholders to assure their pro rata share of the liquidity of their subsidiary in the United Kingdom. This moral obligation was undertaken orally before each of the subsidiaries began operations in the United Kingdom. The written expression is taking either of the two forms–as resolution of the consortiums bank's board of directors or letters from the consortium bank's shareholders.[19]

The Bank thus expected all market participants, British and foreign owned institutions, to adhere to the principles it elucidated. Four decades after the document detailing the Bank's efforts to regulate speculative flows of currency and gold was issued, the Bank continued to treat honor, loyalty, and duty in a non-strategic manner. The Bank's governance style made it a sort of "moral authority of last resort".

[17] Interview, London, 2006.

[18] Bank of England Archives, C43/199/177, Outline of tactics, June 19, 1938.

[19] Federal Reserve Bank of New York, C261 – England, Bank of England, 1974, Memo of telephone conversation between Willey, Fed and Galpin, Fed, October 25, 1974.

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At one level market making in the LGM conforms to the incentive structure view of culture employed by the New Institutional approach. The ethos of genteel fair play ensured credible commitments, limited opportunism, and contributed to the attainment of collective strategic goals. It was an important system of "carrots and sticks" contributing to the smooth operation of the LGM. Yet the reach of the normative order went beyond strategic concerns. As captured through the interviews and archival materials, traders also treated the ethos in a non-strategic manner. Value-rational action constituted market making.

A "natural" experiment

In the wake of the LGM scandal, financial market regulatory agencies from around the world scrutinized a variety of pricing benchmarks. The LGM's twice-daily auction producing a globally referenced gold pricing benchmark, the Gold Fixing, was not exempt from this scrutiny.[20] While ongoing reviews have yet to reveal "clear evidence" of widespread fraudulent behavior,[21] the single instance of malfeasance discovered to date suggests the significance of normative content in curtailing fraud.

Since the 1970s the cultural, institutional, and social network infrastructure supporting the reputational mechanisms and normative content constituting market making in the LGM has changed. With the repeal of exchange controls in 1979, skyrocketing gold prices, and high inflation, participation in the market grew dramatically. By 1985 the market had expanded from five to over fifty-five firms. The small intimate environment dominated by British firms bearing the ethos of genteel fair play, gave way to a larger market in which a more aggressive trading ethos of "hire and fire" organizations dominated. Not surprisingly "duty to firm" was undermined and core characteristics of the "duty to market" normative order disappeared. The poaching of clients (and employees) became regular practice. Fixed commissions and spreads went by the wayside. Over time companies also became more reluctant to allow employees to volunteer in market infrastructure "maintenance" activities.

Countering these trends was the cohort who entered the market between the late 1960s and the mid-1970s and still worked in the market during the 1980s and the 1990s. These individuals became the

[20] Adrian Ash, "CFTC Wants to Fix the London Gold Fix", *Forbes*, March 15, 2013.

[21] Larkin, Nicholas, "No Clear Evidence of Gold Manipulation Seen by UK's FCA," *Bloomberg*, July 2, 2014.

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primary bearers of the modified genteel ethos. This included their efforts in spearheading the creation of the London Bullion Market Association (LBMA). The new organization, whose members were the core participants of the global gold market, formalized many existing market practices and developed written rules that, at the very least, implicitly embodied the "duty to market" principal.

Through its voluntary committees, annual conferences, dinners, and workshops, for instance, the LBMA fostered a sense of solidarity among market participants. The rules for joining the LBMA (its three membership levels are Associate, Ordinary, and Market Making) required potential members, moreover, to demonstrate a temporal and monetary commitment to the LGM prior to applying for membership.[22] Becoming a member was also dependent upon securing recommendations from three LBMA members. Another aspect exhibiting qualities of the "duty to market" ethos was the differentiated trading commitments of members to the LGM, i.e. only Market Making members are required to possess the relevant personnel and infrastructure to quote a continuous two-way price on a full range of products. Through these mechanisms the LBMA attempted to foster the presence of both reputational mechanisms and a normative order retaining aspects of the "duty to market" ethos.

A definitive determination of which elements of existing market structures either facilitated or curtailed fraud cannot be established until the ongoing review is concluded. Despite this limitation, the single instance of malfeasance that was discovered points to the significance of normative content. On June 28, 2012, Daniel James Plunkett, an options trader and Director on the Precious Metals Trading desk at Barclays Bank PLC, placed a series of orders during the 3:00 p.m. Gold Fixing with the intention of increasing the likelihood that the price would fix below a certain level (FCA 2014a). The purpose of these actions was to prevent Barclays from paying $3.9 million to the customer, a portion of which would be attributed to Plunkett's trading position. Securing a particular price level in the Gold Fixing meant, therefore, that both Barclays and Plunkett profited. Contrary to the "duty to market ethos", Plunkett placed his own pecuniary interest above those of his client and the collective interest in preserving the London Gold Fixing's reputation (2014 a).

While the UK's Financial Conduct Authority (FCA) held Plunkett accountable for his actions, his employer was also fined for not having the appropriate systems in place to prevent such malfeasance (FCA 2014b).

[22] http://www.lbma.org.uk/pages/index.cfm?page_id=65&title=joining_the_lbma

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More specifically Barclays Bank PLC, who is a member of the Gold Fixing, did not have adequate procedures for supervising trades during the auction. In addition, they only instructed employees on the mechanics of placing orders in the Gold Fixing and only communicated the general principle that conflicts of interest should be avoided (*ibid.*). Barclays did not delineate what types of orders traders could place in the Gold Fixing and how to handle conflicts of interest emerging from propriety trades transacted in this auction. Besides not having appropriate systems in place to prevent and identify fraud, the final ruling also seemed to capture a trading normative order at Barclays that did not frown upon traders profiting at the expense of customers. In particular, the day before Plunkett committed the fraud, he communicated electronically with the Barclay's commodity trading group about his desire for a lower price in the next day's Gold Fixing (FCA 2014b). Such communications, which could have triggered reputational sanctions, did not seem to facilitate the identification of the conflict of interests or prevent the specific instance of malfeasance.

The events delineated in the FCA ruling on Barclays and Plunkett (2014a, b) suggest that the "duty to market" ethos had weakened and was replaced by a more opportunistic ethos. As demonstrated by the actions of Plunkett, this cultural shift had negative consequences for market making. Supporting this claim were the actions taken by Barclays to prevent a repeat of the above events. Besides strengthening trade monitoring systems, they developed a code of conduct specific to the Gold Fixing that focused on dealing rules and conflicts of interest (FCA 2014b).

While this is currently the only instance of malfeasance to be revealed, actions taken by the LBMA to redress concerns about the susceptibility of the Gold Fixing to future malfeasance also point to the market-wide importance of normative content. To counter the increasingly tarnished image of the auction, the LBMA has focused on developing better trader monitoring systems (i.e. external oversight and electronic capturing of auction process) and setting up a code of conduct pertaining to the appropriate behavior in regards to establishing the benchmark.[23] Even though a definitive conclusion about which factors facilitated fraud clearly depends on the outcome of ongoing investigations, current developments provide additional support for the claim that cultural content is critically important for market making.

[23] http://www.lbma.org.uk/pages/index.cfm?page_id=65&title=joining_the_lbma and *Financial Times*, "Gold Traders Plan Benchmark Code of Conduct", November 22, 2013.

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As demonstrated by the 2008 crisis, flawed incentives structuring the daily practices of market making in a concentrated and hierarchical financial system can have dramatic consequences. New Institutional scholars are one of the theoretical traditions frequently associated with the analysis of incentives and market making. Through their nuanced studies, they have expanded traditional understandings of markets by showing the importance of sociocultural processes in strategic market action. Despite this contribution, they sideline the critical importance of normative content for market structure, functioning, and regulation.

A case study of the LGM was used to reveal potential challenges faced by the current New Institutional treatment of normative content. While many of the elements identified by the New Institutional approach were clearly operative, i.e. reputational mechanisms and sanctioning, a value rational commitment to the constituent values of this normative order was also key if not more important. Supporting this contention was the contemporary instance of malfeasance in the Gold Fixing. Thus the New Institutional focus on the formal mechanisms producing and reproducing culture, tends to sideline the significance of meaning and, perhaps inadvertently, risks developing a hollow cultural core.

A further obstacle potentially emerges from the tendency of the New Institutional approach to insufficiently address normative content. This perspective assumes markets are characterized by uncertainty, information asymmetries, and imperfect monitoring. In order for an incentive system to be fully effective, it must have mechanisms that lead to continuous monitoring or provide market makers with a sense that they are always being watched—a "financial market regulatory Panopticon" of sorts. Unless these conditions are met, incentive systems will risk failing and market making will be tenuous. Thus, and perhaps somewhat ironically, the case study of the LGM suggests that in order for the claims of the New Institutional framework to be effective they must assume a cultural content based on the antithesis of the individual and collective strategic action they attribute to markets. In other words, markets function most effectively with a value-rational commitment to a normative order that shuns opportunism and cheating.

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Résumé

L'approche transdisciplinaire néo-institutionnelle souligne l'importance des structures d'incitation pour prévenir l'opportunisme sur le cours ordinaire des marchés. Cette tradition théorique a progressivement déplacé son attention des institutions formelles vers les processus culturels destinés à contrebalancer l'incertitude, la rationalité limitée et les asymétries informationnelles. Plus particulièrement, la perspective néo-institutionnelle tend à privilégier l'étude des mécanismes formels produisant ou reproduisant la culture, par opposition à l'étude même du contenu culturel spécifique. Cette attention accordée aux mécanismes formels laisse toutefois dans l'ombre des dimensions telles que la rationalité en valeur de l'action ou la variété des formes d'engagement liées au marché. Pour examiner les problèmes associés à cette approche, l'article présente l'étude de cas d'un marché financier dans lequel le cours ordinaire du marché apparaît comme lié à des valeurs telles que la loyauté, le devoir ou le sens de l'honneur des traders.

Mots-clés : Culture ; Institutions ; Marchés.

Zusammenfassung

Der transdisziplinäre, neoinstitutionelle Ansatz unterstreicht die Bedeutung der inzitativen Strukturen, die dem Opportunismus des gewöhnlichen Marktablaufs vorbeugen helfen. Diese theoretische Tradition hat im Laufe der Zeit die Aufmerksamkeit der formellen Institutionen in Richtung kulturelle Prozesse verschoben, Unsicherheit, begrenzte Rationalität und informationelle Asymmetrien ausgleichend. Insbesondere die neo-institutionelle Perspektive bevorzugt eine Untersuchung der formellen Mechanismen, die Kultur produzieren und reproduzieren, gegenüber einer Studie mit einem spezifischen kulturellen Inhalt. Die den formellen Mechanismen zugesprochene Bedeutung stellt jedoch Dimensionen wie Rationalität des Aktienwerts oder Vielfalt marktabhängiger Engagementsvariablen in den Schatten. Laut der hier vorgestellten Finanzmarktstudie scheint der alltägliche Marktverlauf von Werten wie Loyalität, Pflicht oder Ehre der Trader bestimmt zu sein.

Schlagwörter: Kultur; Institutioner; Märkte.

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