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FOR OPENING THE ACADEMIC YEAR 1996/1997

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The Polish greenfield financial markets emerging since 1990 are regulated according to economic standards. Their players oftentimes claim that these markets are overregulated. This view testifies to the poor knowledge of the rationale behind regulation and, consequently, its low acceptance. This fact is probably due to the strong influence of liberal views on the functioning of market economy. Lack of tradition in this field resulting from the weakness of the financial sector before the war is another contributing factor. The regulation of financial markets is therefore treated as a measure limiting the scope of efficient operations.

The beneficial effect of regulation on credibility and consequently on the development prospects of financial markets can be understood without direct pressure from the public if financial market agents realize the ethical evaluation of their activities.

1. INTRODUCTION

Financial activities are scrutinised both by businesspeople and by wide circles of financial risk bearers and the public. The first years of financial sector transformations in Poland saw many cases of public trust being betrayed, which undermined the creditworthiness of the financial market. Using the example of banks and securities exchanges, this paper aims at presenting relations between financial markets and the moral obligations imposed by stakeholders on the players operating in such markets. The examination of these relations and the discussion of their rationale aid us in understanding why financial markets function under an extensive set of regulations.

2. MORAL JUDGEMENT OF LENDING

Financial activities, and particularly lending money in exchange for interest, have been morally judged from times immemorial, usually unfavourably. Deuteronomy, the fifth book of the Old Testament, commands people to release their neighbours of debts every seven years. In the same vein, Solon instructed his people to cancel most debts and prohibited many types of loans, while Islam forbids loans in return for interest. Aristotle considered charging

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interest unnatural and unjustified, and his critical attitude to lending exerted significant influence on philosophers for many centuries; particularly on Albertus Magnus, Thomas Aquinas, Nicholas Oresmus, and representatives of the Franciscan school. It was not until the end of the 18th century that Jeremy Bentham provided a consequentialist apology for lending in his Defence of Usury.

Whence did such extremist views on credit arise? The deontological judgement of Aristotle and his followers on money-lending was based on the presumption that the very activity was internally improper. In his Politics, Aristotle maintained that an activity that made money produce money was contrary to nature (Aristotle 1996). Such a judgement comes as no surprise since in his time the economy was based on the oikos, not on the market. Aristotle supported his analysis by consequentialist argumentation pointing to the harmful consequences of lending money, which stemmed from the monopolistic position of lenders over those in need of a loan. In fact, what he analysed was an underdeveloped financial market, while the consequentialist analysis of Bentham concentrated on an already developed financial market.

The consequentialist justification for lending money at interest is not as unequivocal as the deontological condemnation of interest on the basis of the moral obligation to treat every person as a goal in themselves. This equivocality is a consequence of the premise that there exists a veil of ignorance. This assumption makes it possible to evade the question whether it is morally just that some people toil to increase the capital, while others take advantage of it. Economists try to defend interest by analysing the consequences of the alternative, i.e. lending without interest, and arrive at the conclusion that the propensity to save would then disappear. Interest, then, is defined as a reward for the deferral of consumption, without which incomes would be consumed immediately. This justification for charging interest, however, only to some degree takes into account the motivation to save. In fact people save for many different reasons more important than interest. The primary consideration in the consequentialist analysis should rather be taken to be the consequences of the inability to allocate temporarily available funds to those sectors of the economy where they could be used to increase prosperity. This consideration may be regarded as decisive in the moral acceptance of lending money to businesses, but it cannot be applied in the moral judgement of charging interest on consumer loans. The ambiguity of the consequentialist judgement is the reason why the moral judgement of interest also has to employ elements of the deontological judgement. This approach may be seen in the judgement expressed in Deuteronomy. This fifth book of the Old Testament, attributed to Moses, prohibits charging interest from fellow tribesmen. Additionally, in Maimonides' Code Mishneh Torah we find the requirement to support poorer
members of the Jewish community by lending them money without interest. Charging interest on money, then, was considered unjust, both because this activity was judged intrinsically immoral, and because of its negative consequences, i.e. passing the entire economic risk to the borrower. These consequences, however, were considered negative only for the members of the community. The Deuteronomist analysis of money lending was, therefore, not universalist. There still exist some traces of this attitude, as it is not acceptable to charge interest within the family circle.

The financial markets of today are organised in such a way that lending money and trade in other financial instruments is done by intermediaries between the owners of spare capital and other financial values and people who need them. This mediatory function is performed mainly by banks and securities exchanges. The business of those companies is to earn a profit on mediation in financial transactions. Like other companies, they compete with one another to win customers and increase their profits. They are faced with moral problems similar to those of manufacturing companies: problems of responsibility to the shareholders, of fair competition and marketing. There are, however, problems specific to different financial operations; the problems of banks are different from those of stock exchanges.

3. BANKS — FIDUCIARY RESPONSIBILITY

The centuries-long condemnation of lending money at interest relied on two consequentialist arguments: taking advantage of credit monopoly and shifting the economic risk onto the borrower. Objections to monopolist practices of lending banks that can be raised today apply equally to other companies. What is unique is the problem of bank risk.

Bank depositors are concerned about the safety of their deposits. The bank is the trustee of their funds, which means that it undertakes to accept their property and to represent their interests for a specified time or until further notice. Banks take, therefore, the responsibility to act as trustees for their depositors. Meeting this consists mainly in transforming the credit risk in such a way as to ensure that the deposits are safe. Therefore the collected deposits are put to use at the bank’s risk.

The depositors expect to earn profit in the form of interest. Consequently, the bank is faced with a conflict of interests. On the one hand, it strives to decrease its risk to fulfil its fiduciary responsibility; on the other hand, it has to offer a favourable interest on deposits and loans to remain competitive against other banks. This conflict can be regarded as purely economic — it is possible to apply procedures and banking instruments that minimise the liquidity and
credit risks. However, the interest rate risk is, to a high degree, beyond the banks’ control. That is why time and again banks, preoccupied with their own profits, engage in risky operations, thus showing irresponsibility to the depositors. This problem also concerns mutual funds.

It comes as no surprise that Polish banks cannot cope with this problem, as they have only started to learn how to function in the financial market. But this lack of fiduciary responsibility can also be seen in banks in developed market economies. In 1978 the president of Continental Illinois Bank, at that time the ninth largest USA bank, declared that in five years his bank would become the biggest, and embarked on a risky portfolio building strategy. The managers of the bank’s assets were not sufficiently supervised, and they invested the customers’ funds in high-risk industries. The employees followed the strategy of their president, which was based on ambitions and a profit motive that was excessive in terms of their fiduciary obligation. As a result, the depositors suffered losses, and two thousand bank employees were sacked (Gellerman 1989). A similar situation occurred in 1994 in Barrings Bank, one of the oldest English banks. It turns out that bank managers have problems with finding a balance between increasing profits, which they are obliged to do as agents of the bank’s shareholders, and fulfilling their fiduciary responsibilities. Consequently, above doors to many banks there should be a notice: *caveat emptor* (let the buyer beware). This is not meant to be a joke. Banks and mutual funds engage in risky operations and are morally obliged to inform their customers about the degree of transformation of the bank risk. It should be especially important with some of today's banks that specialise in venture operations. This moral obligation of banks can be proved both by deontological and consequentialist arguments. The deontological justification is based on the prohibition against the instrumental treatment of people — in this case the depositors of banks and mutual funds. If such instrumental treatment of customers became widespread, the financial system would become unreliable, which might cause many direct and indirect negative consequences, not only for banks and their customers, but for all participants in the economic exchange. Banks, therefore, should balance their profit maximisation with consequentialist arguments (Sen 1993).

It is worth noting that excessively risky management of depositors' funds, with a view to offering an interest rate more favourable than other banks, is a form of price competition. A question therefore arises whether banks, because of their fiduciary responsibility, should employ this form of competition, especially since they can compete by differentiating the product. This question should be addressed to the banking system, as the group responsible not only for their own public image, but above all responsible before their shareholders. This sense of responsibility would morally consolidate the banking sector, as it does in, for example, Germany.
The fiduciary responsibility of the bank towards its customers also applies to bank secrecy about customers' accounts. Banks willingly fulfil this trust function, often quoting people's right to privacy, since it is to their benefit. The deontological argument, however, gives only a weak justification for keeping bank secrets, there being situations justified by the public good when it is necessary to reveal bank secrets. Therefore, this argument only proves that bank secrecy is morally acceptable and not morally obligatory, since there are superior obligations that follow from the public trust in the banking sector which necessitate disclosing bank secrets concerning the accounts of its customers. Bank secrecy must not be a guise for criminal and immoral activities. For many years numerous banks (for example in Switzerland) reaped profits not so much from their skills and operations, but from abusing their right to bank secrecy, using it especially for money laundering.

Money laundering is defined as conversion or transfer of property in order to conceal or hide its illegal source (Wąsowski 1993). 'Dirty money' comes from criminal acts, such as trade in drugs, arms, stolen goods, human organs, and from blackmail, graft, procurement, etc., with about 80 per cent of 'dirty money' coming from drug trafficking. Money laundering consists of the separation of illegal income from its source and channelling it into legal circulation. The process may involve not only banks, but also insurance companies, trust funds, and the stock exchange. If, guided by the obligation of bank secrecy, those institutions facilitate money laundering, they bear a moral responsibility for contributing to illegal activities, which are the sources of dirty money. Who is, then, morally responsible for the 'cleanliness' of funds deposited with the banks and for the 'cleanliness' of money lent and invested? Partly responsible may be bank shareholders, bank managers and other bank employees, together with the depositors. Since there are too many people who bear a moral responsibility but have a limited scope for action (such as shareholders and depositors), the main burden of ferreting out money laundering rests with bank managers and key personnel.

Bank managers are in a moral conflict position. On the one hand, they are pressed by their shareholders to bolster profits, while on the other hand, they have to show restraint in their activities for moral reasons. If we equate what is moral with what is legal, then the profit motive cannot be considered illegal. However, if this identity does not hold, we are faced with doubts about the moral constraints on profit maximisation. For example, is it morally acceptable to render bank services to companies carrying out legal activities that may be harmful to many people, such as the production of alcohol or the manufacture of weapons? The manufacture of and trade in weapons sometimes is and sometimes is not moral. A business may operate legally some of the time, and engage in illegal activities at other times. Although banks may not always be
able to gather relevant data, they cannot shirk their responsibility claiming ignorance or the moral ambiguity of the situation.

Banks, or their managers and employees, have a moral obligation to find out about the background of their customer. They can claim ignorance by way of excuse for their actions or omissions to act only if they have demonstrated due diligence in trying to obtain the relevant information about their customer. The managers are therefore responsible for the implementation of such procedures for vetting the customer that may lead to the discovery and identification of immoral or illegal activities.

The moral ambiguity of different situations is taken to support the position that it is not right to constrain the profit motive of the banks on moral grounds. This reasoning is flawed, however. Firstly, there is a moral minimum that has to be respected by banks and that is expressed in terms of basic human rights. Cases of discrimination, violation of personal freedom, and treating a person as a means to an end are unequivocally judged immoral. Secondly, banks may accept social responsibility, which constitutes a kind of contract with society.

Banks assume this social responsibility mainly because of pressure from their customers, like other organisations yielding under pressure from consumers or environmental protection activists (witness the boycott of Nestlé).

4. THE SECURITIES MARKET:
A CAPITAL MARKET OR AN INFORMATION MARKET?

A securities exchange sets up transactions according to certain rules (Jajuga & Jajuga 1994). The very conformance to the rules brings in a certain order to the securities market, and the existence of universally observed rules is sometimes considered to be a sufficient condition for ensuring order in the market. Hayek claims that business people discover rules for proper business conduct and follow them because they find them useful (Hayek 1962). This concept bears a resemblance to the idea of the utilitarian nature of rules, albeit to a certain degree, since it cannot be considered totally universalist — Hayek believes the nature of competition to be the uncovering of information by competitors. This view presupposes that the information that is the basis for decision-making is not freely available, and that competition consists not only in processing information, but also in gaining access to hidden data.

Depending on the commodity traded, markets differ markedly in the information gap between buyers and sellers. Buyers may know a lot about certain goods, e.g. food. Thus they only need to supplement this knowledge with information provided by suppliers prompted by the primary obligation
not to do harm. By contrast, securities, particularly shares, are a mysterious commodity. Both buyers and sellers often lack adequate knowledge, and the relevant information may be hidden or hard to obtain. Commenting upon this fact, Keynes compared the stock market to a casino. Both function according to certain predefined rules, but they lack a rational basis and the participants’ profits reflect their luck (Keynes 1936). A securities market operating in this way would pass the risk from the issuers of shares to their buyers, a feature that caused a moral condemnation of lenders, who passed risk to borrowers. Such a judgement can be made from both consequentialist and deontological points of view. If the stock market functioned like a casino, confidence in the market would drop, the trade volume would slump, the flow of capital to the companies would subside, stock issues would flop, and funds would be allocated in an inefficient way. These adverse consequences would affect not only the stock market players, but would also spread into other sectors in the form of reduced confidence in public companies. From the deontological point of view, a stock market where access to information is not symmetric is a market where the issuers treat the buyers instrumentally. If this principle was generalised, business would become very risky and unpredictable. Therefore, the rules of the stock market should prevent it from turning into a casino. The question now arises of what are the beneficial functions of the stock market that such rules should foster. At least two answers can be given: the economist’s and the moralist’s.

Economists claim that the stock market helps to allocate scarce financial resources. This allocation may be more or less efficient, depending on the amount of information processed by the market players and reflected in share prices (Jajuga & Jajuga 1994).

A market is fully efficient if all essential information about the market, shares, and public companies is freely available and instantly converted into decisions to buy and sell, which in turn affect share prices. This essential information includes:

1) historical information on the prices of a company’s stock and relative prices of shares of different companies measured using a set of relative ratios such as price-earnings (P/E) or price-book value (P/BV),

2) information on the past and present economic situation of companies, their plans and their risk rating,

3) information on the economic situation of the country and of different industries,

4) information on the current and future economic policy of the government.

It can be easily seen that some of this material information cannot be made public, since it either concerns a concealed future or constitutes a secret of
some players in the market. Consequently, if there is a consensus that the stock market should be as efficient as possible, rules for disclosure of material information are established. This creates a moral problem of using material non-public information. We will illustrate this with two examples.

Case 1: a Frankfurt stockbroker received an order to buy 200 shares of a certain company at DM 1,950 per share. Five minutes before the order was filled, he purchased these shares at DM 1,900 in the name of his daughter and went on to sell them to the customer, clearing DM 10,000 without taking any risk („Rzeczpospolita” 1995, 28-29 October). Such operations are called front running.

The deontological moral judgement of this situation is simple: to further his goals, the broker took advantage of information that was not his property. Thus we have a conflict of interests situation. The broker's duty is to represent the customer in stock exchange transactions, so he acts in the capacity of an agent. The transaction between him and his customer is based on an agent-principal relationship with the action concealed. The principal trusts that the broker will not use the information supplied by the Principal to further their own interests. Therefore, taking unauthorised advantage of material non-public information is an instance of embezzlement. One might wonder why information about stock exchange orders is kept confidential, while, for example, the participants of a tendering procedure know one another's plans. The only possible answer is that there is a consensus among the participants regarding the rules governing different types of exchange. If such rules were not generally accepted, then some types of markets would disappear and others would blossom. Thus, if stock exchange players agree that some material information should remain private property, then its use by others, so-called insider trading, is immoral.

A consequentialist analysis of Case 1 would be different, but would lead to the same conclusions. Such an analysis would have to take into account the consequences of front running, and in particular the damages, their scope, tendency to spread, etc. The customer's loss does not offset the broker's benefit, since the broker did fill his customer's order. However, if there was a price limit on the buy order, then five minutes earlier the shares cost less and so the customer lost an opportunity to buy the shares cheaper. If front-running becomes more widespread, confidence in the given stock exchange will be undermined, which spells losses to investors and brokers alike. It should be noted that front-running has been illegal in Germany since 1st August 1994. The management of the Frankfurt Stock Exchange has announced the speedy introduction of an electronic stock exchange, which would make brokers redundant.

Not always is the moral judgement of insider trading that simple. Consider Case 2: the President of Berthold AG purchased 300 shares of his own
company at DM 200 per share. A year later he sold them at DM 650, just before the company's poor financial performance was announced and the share price plummeted (Dusza 1992). The president took advantage of material non-public information, so he embezzled it. A deontological judgement of this act is definitely negative. Firstly, the president used information that was not his property to further his interests. This information was entrusted to him by the company's shareholders, so he defaulted on his fiduciary responsibility. Secondly, the investors did not have equal access to the information, which undermines the confidence put in the stock market, since a stock market allowing insider trading forces the participants to observe the caveat emptor principle. A market like that would not even be a casino.

This is the way insider trading is evaluated by the public, and the above arguments contributed to its illegalisation. The first laws on insider trading were passed in the USA in 1934 (Securities Exchange Act), and in 1988 insider trading was made a criminal offence. Before that happened there was a heated debate in the press on the moral aspects of insider trading. The leading arguments were consequentialist and they will be presented as they relate to Case 2. The immediate benefits are the president's, in the amount of DM 135,000. The president bought and sold the shares at the current prices, which he had not rigged. The buyers of the shares bought them of their own will, and were guided in their decision by the price which had not been influenced by the president. It can be argued, then, that they did not suffer a loss, as they should have known that the seller had an information advantage. Moreover, Kay claims that the sale of shares in this case suggested that the company was loosing its foothold (Kay 1988). What is more, taking advantage of non-public information did not cause a loss to the company. Thus, the participants in the debate agreed that insider trading did not harm the parties to the transaction and might be beneficial to the stock market. With insider trading becoming widespread and starting to affect share prices, the stock market becomes more efficient, which is beneficial to all players. Seligman claims that insider trading is very common and does not deter investors from the stock market (Seligman 1983). It was also pointed out that the managers and the Board of Directors of a company may own and trade in the company's shares. Having, by virtue of their capacity, access to insider information, they are not likely to be prevented from using it for their own goals.

The above arguments for insider trading illustrate consequentialism narrowly understood. This was pointed out during the USA debate where some universal consequences were provided. Firstly, the people who bought shares from the president incurred losses, as the president's offer might have influenced their decision to purchase. It is certain that had those people gained access to insider information, they would have declined the president's offer.
It follows that the president's benefit, in the amount of DM 135,000 is equivalent to the other parties' losses. The transaction in question was judged accordingly, and the president was made to compensate the losses.

Secondly, an expansion of insider trading would mean that investors have to incur the costs of purchasing information, which would partly change the stock market into an information market. The gap between the buying and selling price would widen, which would be not only unfavourable for the players, but would also mean a social loss (King and Roell 1988).

Thirdly, people who have access to insider information can manipulate such information or the time of its disclosure to gain personal advantage. This might cause losses to the company as well as harm to society (Sen 1993).

Fourthly, the market is not just an anonymous mechanism that distributes gains and losses depending on who can discover more information. The functioning of any market, including the stock market, is based on trust between the partners in the exchange. Maintaining this trust in the stock market grows more important as this market becomes more crucial in the development of the economy. De George claims that it is the trust that people put in the market, and not market efficiency, that is decisive in the analysis of the consequences of insider trading (De George 1995).

Ultimately, an extended consequential analysis yields the same conclusion as does the deontological one — using material non-public information is immoral. Such was also the public verdict in the United States and in Germany. This proves that these societies value the right to equal access to information and commercial integrity higher than the increased efficiency of the stock market due to the use of insider information. Since by selling privileged information its owners make the stock market more efficient, the market could be even more efficient if this information were placed at the disposal of all its players. Accepting the existence of company secrets that are morally justified means that the market will not be optimally efficient. This choice is the first best morally, but only the second best economically.

The above moral analysis of insider trading is not limited to the stock market: insider trading can also occur in commodity exchanges, real estate markets, etc. This phenomenon was already described by the famous Polish writer W. Reymont in his 1899 novel *Ziemia obiecana* (*Promised Land*).

On stock exchanges, where transactions are arranged through intermediaries, the temptation to use insider information is very strong. The circles of brokers and financial advisers are closely scrutinised by the public, who set high standards of their professional excellence. A prospective broker of the Warsaw stock exchange founded in 1817 was obliged to 'enjoy a good, impeccable name'. Today, the Warsaw stock exchange brokers are required to observe the ethical standards that safeguard them against allegations of abuse.
of trust. However, in the 1994 debate over their professional code of conduct, the Polish brokers rejected proposals barring them from holding investment accounts, which, if adopted, would have significantly increased their credibility. The use of insider information is forbidden by the law on public trade in securities, but insider trading is hard to control, among other reasons owing to bank secrecy. The proliferation of front-running on German exchanges was made possible by opening accounts with Swiss banks. An universalist analysis of the consequences of insider trading should therefore include the functioning of international financial markets.

5. CONCLUSIONS

The knowledge about ethical issues of the financial markets and about the great importance of public good created by these markets in Poland is extending. The most important: banking sector and Warsaw Stock Exchange are regulated very seriously and their functioning is right. Unfortunately, the primary markets of such securities, as stocks of national investment funds are the “wild” markets.

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