EDIFICE

WRECKS

CAN THE PSYCHOLOGY OF ETHICS DRIVE THE RISE OR FALL OF INVESTMENT FIRMS?

BY CHRISTOPHER WRIGHT

"There's so much money," says Keith Darcy, "it's intoxicating."

Big money, big temptations. Darcy, calling the investment industry a profession at risk, worries for the soul of the industry. And he knows what he's talking about. After 30 years in banking, he is now executive director of the Ethics & Compliance Officer Association (ECOA) in Waltham, MA. His provocative thesis is: Ethical culture is what drives organizational success.

Psychology professor Thomas Oberlechner of Webster University Vienna has come to a similar conclusion about the power of ethical culture. "Laws and regulations by themselves are inadequate for upholding ethical behavior in the world of finance and investments," Oberlechner observes in *The Psychology of Ethics in the Finance and Investment Industry*, a wide-ranging study published last year by the Research Foundation of CFA Institute. "Culture, in contrast," he adds, "has a significant impact on the ethics-related perceptions and the behavior of finance professionals."

In other words, "culture always wins," says Steve Priest, president of the Ethical Leadership Group, now part of Global Compliance Services in Charlotte, NC. "If there's conflict between culture and a policy, code of conduct, or rule, culture wins."

Yet most organizational leaders are naive about what is required to build and maintain ethical culture, according to Jim Ware, CFA. Ware and his firm, Focus Consulting Group of Long Grove, IL, have been involved in rebuilding ethical culture after scandals at well-known investment firms. In his experience, people who run investment firms are as overconfident of their ability to behave ethically as investors are about the returns they can obtain in the market. They all think they're ethical, Ware says, but "when we ask CEOs of investment firms what integrity means, most of them do not have an answer beyond 'doing the right thing.'"

DOING THE WRONG THING

Companies that experience ethical lapses are typically placing great pressure on employees to show short-term success. "It's that pressure that makes you start to think you need to be successful by any means necessary," says Patricia Harned, president of the Ethics Resource Center (an independent research organization in Arlington, VA), who has been involved with ethics and compliance training at the NYSE. An ERC survey shows that, in fact, 90 percent of people who feel pressured to meet performance goals observe misconduct at work.

A pressure-cooker environment at an investment management firm can result in account churning, an unhealthy focus on commissions, and even "pump-and-dump" schemes. Ware recalls senior executives at one major firm telling him, in effect, "We talk a lot about having the right solutions for the client, but it's not true—we just cram what we need to sell down the client's throat."

Ethical high performers, however, have a long-term view. They are not, according to Harned, simply out for short-term gain.

Another factor, in addition to pressure, that leads firms astray is an outsized sense of entitlement. Recently, Fidelity Investment's Peter Lynch settled a long-running civil case filed by the U.S. SEC alleging that he directed two traders under his supervision to obtain free tickets from clients to major events such as the Ryder Cup golf tournament and a U2 rock concert. Others at Fidelity (and other firms) were involved in the gift-giving scandal, which included sordid tales of illegal drugs, female escorts, and foreign trips on private jets. The most revealing comment about a sense of entitlement in the affair came from a spokesman for Lynch who told the *Wall Street Journal*, "He doesn't deserve to be lumped in with this other crowd. It was *only tickets*; it wasn't expensive cases of Bordeaux or trips on jets like these other cases" [emphasis added].

A financial professional steeped in a fiduciary culture would not be worrying about getting tickets from clients. Fiduciary culture asks not "how much am I going to get?" but "how am I going to serve?" Fiduciary culture is embodied in the CFA Institute Standards of Professional Conduct, which, taken together, exhort professionals to "put the client first." The standards promise fair and equitable treatment of all clients and shield them from conflicts of interest with an investment firm or its employees. Clients may not know much about money management, which is why fiduciary responsibility exists and why financial professionals have jobs.

HABITS OF HIGHLY ETHICAL FIRMS

First, highly ethical firms are self-aware. They have a good sense of what their culture is and they make ethics a priority. Darcy says that they pay attention to culture because they know an ethical culture is what drives their long-term success. He cites Hewlett-Packard as an example. Before the founders did anything else or even knew what business they wanted to be in, they sat down and wrote the HP Principles, which became the backbone of the company. Self-awareness starts with being able to articulate core values. At highly ethical firms, Priest says, the values are organic and suffused throughout the entire organization, not simply pasted on.

Second, these firms imbue the work with a sense of mission and give employees a sense of purpose larger than themselves. The work imparts a sense of meaning; it's not simply a job. Darcy cites the 2000 film *Cast Away*, in which actor Tom Hanks portrays a FedEx employee stranded on an island after a plane crash. When several FedEx packages wash ashore, Hanks' character opens them to find supplies that may help him survive. Yet, apparently motivated by a sense of duty, he leaves one package unopened. He finally gets off the island five years later and personally delivers the package to the proper recipient, with a note attached that says, "This package saved my life."

"Metaphorically, work gave him meaning," says Darcy. "It kept him alive." In other words, if money itself is what makes you tick, you're already in trouble.

Third, a strong ethical stance emanates from the top. "Tone at the top" has become a cliché, but it's nonetheless true. Ethics were front and center for Vanguard founder John Bogle. He was a clear ethical beacon for the people around him when he ran that firm. Like Bogle, Ware points out, people at the top must show in words and deeds that integrity is important and that they "will choose to do the right thing over the profitable thing."

But where is the top? Steve Priest consulted with a senior leader at a 150,000-person corporation who was conducting employee focus groups in a conscious attempt to "set the tone at the top." On one occasion, the senior leader was speaking with pride about the CEO's commitment to ethics when a young employee said that, although such grand commitments might be well and good, what really mattered to him was dealing with an immediate problem he had with his own direct manager.

Respondents to ERC surveys tend to define "the top" as the managers closest to them. So, an ethical tone must emanate from all layers of management, down to the immediate-supervisor level. "When supervisors display a commitment to ethics (talking about ethics, modeling ethical conduct, etc.)," says Harned, "misconduct around them is reduced by 32 percent." (This finding is from the ERC 2007 "National Business Ethics Survey," which is available free at www.ethics.org.)

Finally, highly ethical firms measure their integrity. "Integrity management," like financial management, involves auditing and monitoring various indicators and then representing the status of those indicators in metrics and charts, Priest explains. For line supervisors, typical metrics include (1) the number and severity of ethical or compliance incidents in their department; (2) the percentage of subordinates who know the company's policies and code of conduct; (3) the percentage of employees trained to recognize the key risk factors that could result in malfeasance in the department (e.g., front running, insider trading); (4) the degree to which formal monitoring, detection, auditing, and compliance (e.g., as related to personal trading) are practiced; (5) the degree to which informal detection mechanisms are working (e.g., messages from employees to errant peers indicating that, in effect, "you're putting me at risk, and I'm going to have to tell someone if you don't stop"); and (6) remedial steps taken and progress made in addressing ethical deficits identified in previous audits.

NUTS AND BOLTS

Ethical culture is not some diaphanous construct that exists only in the ether. There are manifestations you can see and touch in the real world, such as a statement of core values and (increasingly important to investment firms) compliance programs.

Recruitment and Hiring

You can fool some of the people some of the time. According to Priest, one premier Wall Street institution has prospective new hires interview with 8–20 people in the firm because candidates are likely to show their true colors at some point during this extended process.

When the same firm was expanding in Russia, applicants were asked how they would handle the following hypothetical scenario: The firm is in competition for a big contract, one worth millions. Someone outside the firm instrumental to the contract award has made it known that the firm could seal the deal if the "small gift" of a BMW were forthcoming. The recruiter in Russia was surprised at how many candidates said they would give some type of gift—a flat-screen TV if not a BMW. This interview question was an easy way to eliminate potential bad apples.

At Southwest Airlines, new hires go into training for several months and their continued employment depends on how they do. Darcy says he knows of at least one instance when the top performer in a training cohort was not given a permanent position because the person was not deemed to be a team player—that is, did not *live* the values of the organization.

Code of Ethics

Having a written code of ethics is a good beginning. The best ethical codes, in Darcy's view, are short and focus on values. Of course, employees have to be informed at some point about

applicable laws and regulations, but an unwieldy code can be overwhelming. One Fortune 10 company Darcy advised had a 45-page code of ethics that laid out every applicable law and regulation in mind-numbing detail. Aside from its length, the code was deficient because it stopped at trying to instill a *compliance* culture. Compliance is a component of ethical culture, but compliance is not enough. Darcy says, "Research tells us that mere compliance programs become 'check the box' programs in the second year."

Compliance is externally directed, but ethical conduct is more internally directed—people choosing of their own volition to do the right thing. As Oberlechner discusses in *Psychology of Ethics*, as people progress through stages of ethical maturity, they become motivated less by external factors (e.g., fear of punishment) and more by internal considerations (such as empathy for others, justice for all, self-actualization).

U.S. Federal Sentencing Guidelines enshrine the distinction between ethical culture and compliance culture. After passage of the Sarbanes–Oxley Act of 2002, culpability scoring for organizational defendants was changed to go beyond the company's compliance program (to prevent and detect criminal misconduct) to the measures needed to "promote an organizational culture that encourages ethical conduct." In other words, U.S. authorities are now looking for an investment in ethical culture over and above compliance. Rules and regulations are considered minimum standards.

Training

A lot of emphasis has been placed on ethics training in recent years, but training in and of itself does not reduce misconduct. "You're teaching your employees what they need to know," says the ERC's Patricia Harned, "but it's the culture of the organization that actually stops misconduct from happening.

Training does build awareness of how ethical principles apply in situations that may not be obvious. It also helps employees recognize misconduct and leaves them better equipped to deal with ethical issues. The most effective training, in Harned's view, is based on scenarios that come right out of the actual work of the employees. This approach is a variant of the case-study method in which the employees themselves supply the hypothetical situations.

Using Harned's preferred method, managers sit down and talk with the people who report directly to them. All the pressures and temptations to cut ethical corners during the daily grind are laid out on the table. Managers are clear about how they want employees to handle the problematic situations that most frequently arise in the department, such as churning or personal trading or whatever else may arise. Role playing can be useful but only if it relates directly to the work at hand. Unrelated scenarios are not helpful.

Harned advocates a cascade approach to this method: The CEO meets with people reporting to her or him, and they then sit down with their own direct reports, and so on down through the organization.

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PATRICIA HARNED
President, Ethics Resource Center

E-learning has its uses. It can reinforce the firm's view that ethics are important and helps people remember the rules. But because of the temptation to open other screens and multitask while supposedly reading the message, the best e-learning tools come with quizzes.

Compensation

"Amazingly," Priest says with tongue in cheek, "people do what you pay them to do." Because people respond to financial incentives, pay and promotion need to be aligned with the behaviors the firm wishes to elicit. If building assets under management is what gets rewarded, employees will be tempted to sell unsuitable products and resort to other questionable means to bring money in the door.

Short-term performance metrics are a recipe for disaster, in Keith Darcy's opinion. Compensation formulas should be adjusted to focus on long-term performance. Problems may arise also if compensation is based solely on delivering financial numbers. For this reason, some firms add an ethical component to performance reviews by tying some nontrivial portion of overall compensation to faithful observance of the stated values of the firm.

A list of desired behaviors provides rigor to the measurement. One approach is for team members to score each other on their ethical performance and provide those scores to the team's managers. High marks are rewarded. Priest goes a step further and advises clients to include input not only from the team but also from people one level above and below the employee being scored.

Steve Priest and Jim Ware both advocate using a stick along with the carrot. Bad ethics should reduce awards, and the potential reduction should be enough to provide a significant deterrant in an industry in which bonuses often account for a substantial amount of total compensation. Managers who turn a blind eye or fail to see obvious signs of malfeasance should have their bonuses slashed or taken away. Moreover, Priest says, "whether by viral [word of mouth] or explicit means, other people in the organization have to know that this happened."

Reporting Mechanisms

According to the most recent ERC National Business Ethics Survey of the United Sates, 43 percent of respondents who

observe misconduct take their concerns to their immediate supervisor, 34 percent report it to upper management, 13 percent go to the chief ethics officer or designated ombudsperson, and 3 percent use an anonymous hotline. Because employees clearly prefer to report misconduct to someone they know, managers should be trained in how to handle such reports and send them up the chain. Otherwise, problems are unlikely to be resolved.

Ware advocates using some formal mechanism for anonymous complaints and thinks a hotline is a great thing to have in place. A safe neutral place to give feedback is important, Ware explains, because if the problem is at the top, it's too scary to challenge the behavior to the person's face. (Such hotlines are usually run by an outside company that takes calls for many clients and passes along complaints to designated recipients.) But Ware has seen this approach used only once in the investment world.

Patricia Harned agrees that "it's necessary to have that mechanism in place; it's an important resource. There are certain types of misconduct that employees are a little more likely to report through an anonymous 'helpline', primarily if their own supervisor is the person they're having to report." However, after the Enron Corporation/WorldCom round of scandals, the number of companies establishing hotlines rose but the number of employees using them did not, according to Harned.

A HOUSE THAT WILL NOT FALL

Early in the 20th century, Arthur Andersen was upset at the ethics of the accounting profession. Under the motto "Think straight, talk straight," he started his own reform-minded firm in 1913. Ironically, at the close of the 20th century, the firm bearing his name collapsed as a result of its connection with fraudulent accounting practices in the Enron case.

Cultures, observed Oswald Spengler in *The Decline of the West*, are like organisms: They grow, they decline, they die. Accordingly, one may reasonably ask whether ethical culture is sustainable over the long haul and, if so, what maintaining such a culture requires.

Harned believes that ethical culture is sustainable. But, she cautions, "it's something that has to be worked on, tended to, and maintained constantly. If you ignore the culture, it will start to break down." The danger is in assuming that if your ethical culture is strong today, it will be strong tomorrow. Even a robust culture can be weakened through neglect. And times of great change—transition in leadership, merger with another firm, restructuring—can also put the culture at risk.

Moreover, maintaining a culture is hard if you don't know what it is or where the special challenges lie. Harned recommends cultural assessments (i.e., using survey instruments available from the ERC and others to gauge employee perceptions about the ethics of the organization). Analogous to an annual physical by a doctor, such surveys measure the strength of ethical culture by using a set of concrete indicators, such as whether employees feel they can give their managers bad news. As with financial data, analyses of trends over time and comparisons with other firms on the basis of the assessment can be enlightening.

Darcy considers employee comments (or "verbatims") the most valuable part of employee surveys. The rank and file will tell management where the problems are. Management's assignment is to listen. Part of keeping an ethical culture fresh and alive is maintaining or increasing communication. Firms should deal with their problems openly. "It's an age of transparency," Darcy says. "Nothing will undermine cultural efforts quicker than 'spin.'"

The importance of telling the company's glorious history, if it is glorious, should not be ignored. "Tell me some facts and I might remember them," goes an old Native American saying, "but tell me a story and it will live in my heart forever." Similarly, company lore can help renew culture for succeeding generations. Stories about the company's founders and other heroic figures can undergird ethical culture. "We learn best through stories," says Darcy.

Promoting from within is another way to preserve institutional ethical memory. According to Ware, people who grew up professionally inside a culture are more likely to keep it intact.

Ware also prescribes an "ethical fitness program," an exercise regimen to keep ethical culture in shape that consists of personal integrity checks at the beginning or end of every workday and weekly or monthly role playing or use of some other methods designed to help people practice thinking through difficult situations. In the absence of such a program, employees may become "ethically flabby," and because their ethical muscles have atrophied, they may not make it through the next ethical challenge.

Darcy focuses also on the need for what he calls "moments of Sabbath," when people and organizations pause to reflect on what is essential in organizational life. Houses of worship have a sermon every week for a reason—because learning the rules once is not enough; people need to be constantly reminded about them. Screws get loose and need to be tightened.

Whether all cultures are doomed to decline and fall is unknown, but this repetitive cycle is readily observable. The history of business ethics shows, as Priest points out, that memories are short. A scandal brings a lot of attention from regulators, reporters, and clients. Reforms are instituted. But when the scandal starts to recede from memory, ethical behavior starts to drift. Then another scandal in the firm or industry produces a new wave of revitalization and reform (like market run-ups and bubbles that burst every generation or so).

"Unfortunately, I think that's destined to be the case," Priest says. "We'll see some improvement; then companies will forget." To avoid such situations, senior managers must strive to build strong institutions and bulwarks to support and defend ethical culture. Inspirational leadership is never

enough and can't be expected to show up on cue every few years to renew the culture.

GOOD ETHICS = GOOD BUSINESS?

The business case for a strong ethical culture rests in part on the notion that "flight to integrity" will occur in the wake of every scandal. Mutual fund companies implicated in the market-timing scandal a few years ago lost some US$900 billion in client assets to other firms, and many surveys show that trust is the number one thing people look for in a financial advisor. Thus, Keith Darcy concludes, "reputation risk today is as great as if not greater than strategic, operating, and financial risk." Even a hint of ethical impropriety directly affects the value of a firm and can put the entire franchise at risk.

Patricia Harned believes a strong ethical culture is also key to attracting and retaining the best talent.

In addition, firms with good reputations draw less scrutiny from regulators and enforcement officials when questions do arise. Under the Sentencing Guidelines mentioned previously, a strong ethics program can save an organizational defendant substantial sums of money in fines. Such a program may result in criminal charges being settled in lieu of prosecution. In 2006, Mellon Bank, N.A. (later acquired by the Bank of New York) won a nonprosecution agreement after it strengthened its compliance and ethics programs. Mellon had falsely reported to the Internal Revenue Service that thousands of tax returns had been processed per the terms of a contract when, in fact, Mellon had destroyed them. Mellon paid more than US$34 million and agreed to the imposition of an independent outside monitor in settling the government's criminal, civil, and administrative claims, but the firm successfully avoided criminal prosecution.

Although some may want to debate whether good ethics, at least in the short run, is always good for business, bad ethics is indisputably bad for business. Eventually, notes Ware, dishonesty catches up with you. Just ask Société Générale, which established a team of 100 people (including external fraud-control experts)—at a cost of approximately €50 million—to implement remediation measures in the aftermath of the record-breaking rogue trader scandal at the firm earlier this year. Financial firms that have serious ethical lapses tend not to survive or remain independent (as demonstrated by the cases of Barings Bank and Kidder, Peabody & Co.). For those who seek to prosper, ethical culture appears to be a business necessity.

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