PERSONAL ETHICS and BUILDING A NEW CULTURE

RICHARD KETCHUM

Former CEO and Chairman of the

Financial Regulatory Authority (FINRA)

I. Introduction

I want to first congratulate professor Enderle on his thoughtful and incisive report. That report effectively frames the issue for this working session. My discussion paper does not question any of the conclusions of Professor Enderle's paper, but rather tries to supplement it by discussing the practical challenges that regulators and the Industry face in their efforts to effectively implement conscious shift away from a sole focus on profit maximization to a strategy that is based on balancing the multiple interests of its shareholders, clients and citizens at large.

I would start by positing that we should accept the fact that, while driving one's business based on the consistent application of ethical decision making appears straight forward, in large global corporation it is in fact, quite difficult. In making this general point, I will speak solely about the financial industry with which I am most familiar.

While the financial industry is critical to the health and wellbeing of both developed and emerging economics, it also has contributed some of the most egregious ethical failures over a wide range of years. These failures, arguably, reached a crescendo in the events during the Credit Crisis of 2007-2008 that was a direct cause of the great global recession beginning in 2009.

What I believe is most interesting about the recent history of financial industry conduct has been the conscious effort by many financial industry leaders and regulators to shift from a short term shareholder wealth maximization focus without noticeable behavior impact. For example, after a range of missteps at the turn of the century, ranging from the financial industry's participation in Enron's fraudulent transactions and financial misstatements [1] and the failure to manage investment banking conflicts throughout the NASDAQ bubble period [2] virtually every large financial firm in the United States declared their intent to increase efforts to ensure that their clients' interests were always placed first. [3]

On the other side of the market collapse arising from the Credit Crisis of 2007-2008, those firms reaffirmed their commitment to placing their clients first and acknowledged, as well, their responsibility to manage their regulatory and operational risks to avoid creating systemic risks that place the global financial system at risk.

While much good work has occurred during that time to increase large financial firms' compliance and risk management capabilities, we have continued to see serious ethical lapses both in markets and the firms' businesses with retail investors. In sum, I believe it is important for us to attempt to answer the question of "why good corporations and good individuals make harmful and unethical decision?" Accordingly, I would like to explore two issues. First, what have been the common misconceptions that have contributed, time and again, to otherwise well-meaning members of the financial industry harming their clients and the financial markets. Second, what steps can financial firms proactively take to more effectively create a culture that drives ethical decision making throughout their organization?

II. How Good Firms Go Bad?

1. “Our Clients and The Firms Interests Are Aligned”

Any thoughtful financial industry company has included in its mission statement for years that the firm succeeds only if their client’s interests are placed first. While this message can never be delivered too often, it does risk the dangerous by-product of firms becoming overconfident that the firm has its conflicts under control. As Professor Enderle properly notes, while a firm that embraces a balanced ethical approach which focuses beyond the goal of short term shareholder maximization can reduce, it cannot eliminate, all conflicts in its business.

For example, much effort has been made by members of the financial industry to shift customers from accounts driven by commissions to advisory accounts where fees, based on the amount of assets, are applied annually. Moreover, where commissions continue to be charged to clients, many firms are moving to more “neutral grids” where an adviser generally receives the same compensation whatever product is sold. Yet even these steps, admirable as they are, cannot eliminate all conflicts attending the retail client’s account. In fact, in many cases, advisers and the firm will make more money from a “fee only account” then if the customer was charged a commission. In particular, where clients are making very few trades a year, the shift to “fee only accounts” can be substantially harmful to the client. Ironically, firms must guard against the conflict of moving customers to advisory accounts even though those accounts generally are viewed as less conflicted.

The basic conclusion derived from the above example and many other instances of the firms’ compliance failures is that the effort to manage conflicts must be ongoing.

A simple discipline that all firms should regularly do is conduct a thorough review to identify new conflicts that have developed in its business and carry out a ground zero review of how successfully the firm has managed its conflicts and where it has slipped up.

"Follow the money" is always the right place to start any firm's risk analysis of its ethical exposures but, in itself, it is not sufficient. While monetary inducements are often the cause of "good people making bad decisions", there are a wide number of other factors that historically have often contributed. Firms ignore those more subtle influences at their peril. Set forth below are a few of the common accepted "truths" which have sent firms and individuals in the financial industry down catastrophically wrong paths.

2. <u>"This Time is Different"</u>

Mankind is constantly in search of new paradigms. When combined with the monetary incentives of completing a deal or recommending an investment in securities, such thinking can provide the basis for terrible misjudgments. For example, the internet bubble at the turn of the century, resulted from the confusion of the truly transformative power of the internet with the mistaken perception that any company with a new website or sales idea would succeed, notwithstanding a lack of funding or the potential for new competitors. Similarly, the simplistic view, that home real estate prices "never go down", combined with the disintermediation of mortgages through securitization, encouraged the grossly negligent design and sales of mortgage backed securities which became a primary cause of the credit crisis in 2007.

3. <u>"Our Competitors Are Doing It"</u>

It is tempting to believe that we can affect a sufficient cultural shift by focusing on removing the monetary conflicts that drive bad decision making in the financial industry. It is important to remember, however, that employees in the financial industry are exceedingly competitive. Accordingly, bad decisions are often driven by their frustration over the relative success of competing financial firms and the belief that those firms are playing under a looser set of rules. Moreover, "our competitors are doing it" has often been effective in persuading supervisors and compliance personnel to interpret a rule more liberally (even when, in fact, it should not be).

4. "This is a Key Firm Initiative"

That same competitive spirit drives another fundamental reality of financial firms. When the senior leadership identifies a major initiative, everyone should move out of the way because employees will blow out walls and break down doors to meet the goal.

The Wells Fargo cross selling scandal is the most striking recent example of this phenomena. Responding to management's increasingly strident demands for the cross selling of banking products, over 5,000 employees spread across the country opened, without customer consent, over two million checking and credit card accounts [4]. Needless to say, this incident also involved numerous inappropriate uses of financial incentives, performance goals and threats of termination. But the fact that such widespread fraudulent activity could occur without the company identifying it and quickly responding to it, demonstrates how widespread the momentum can be from firm driven initiatives.

5. "The Law Does Not Prohibit It"

In the short time that I moved away from being a regulator and was on the legal staff of a major financial corporation, it became very clear to me that, among the riskiest employees were those senior product managers who immersed themselves in understanding in detail each specific legal requirement applying to their area. Invariably, the purpose of this effort was not to appreciate the underlying policy concerns that led to the creation of the rule but instead to arm the person to push into the "grey areas" and argue that no specific rule prohibited the design or sale of a particular product. Yet such a narrow focus consistently ignores the fundamental weapons that regulators possess with respect to prohibitions against fraud and misleading disclosure. The reality is, if a firm or employee takes actions that seriously harm their clients or markets, regulators will find the ability to bring a disciplinary action. Even more significantly, the reputational harm that a company will receive from being a part of such actions will vastly exceed any monetary gain.

6. "Our Segment of The Company Has its Own Set of Principles Derived from our Knowledge of the Business"

Financial companies have been consistently bedeviled over recent history with the development of damaging cultural "principles" in individual segments of their business. Whether it be the breathtaking assumptions of what was "normal business practice" of certain trading desks in manipulating LIBOR index levels, [5] the breakdown of research analysts independence in an effort to support "the greater good" of investment bankers capturing deals and maintaining issuer relationships during the NASDAQ bubble, [6] or the discrete ethical precepts that drove equity market makers to engage in anti-competitive price collaboration in the 1990's, [7] the inability of financial companies to identify and control discrete sub-cultures has consistently had disastrous results.

III. <u>The Art and Science of Creating Culture</u>

The purpose of my foregoing discussion is not intended to be encyclopedic, it is only to recognize that there are a wide variety of incentives and subtle influences that can impact decision making and defeat even thoughtful efforts to shift away from a culture focused solely on rule compliance and short term shareholder maximization. Accordingly, I believe that is important for our discussion to consider what steps a CEO and her board can take to both create and defend a successful corporate culture.

It has become almost trite to discuss the importance of “tone from the top” but frankly it can never be repeated enough. Even if financial CEO’s state their belief in a culture fundamentally focused on the interests of their clients and recognize the firm’s responsibility to not put at risk the global financial economy, it will mean little if it is not continually emphasized and the CEO does not allocate substantial time to participate in corporate cultural efforts. Moreover, even an activist CEO’s efforts will be for naught, if employees observe that corporate decision-making, goals and initiatives and actions are not continually analyzed and explained as to why they are consistent (or not) with corporate goals.

Second, it won’t matter how articulate or inspiring the CEO may be, if the messages coming from the rest of her team or the vast range of middle managers are inconsistent and focused solely on profitability goals.

Third, no cultural initiative will succeed if it is not subject to continuous audit and review. The financial industry has come a long way in developing a structured process of identifying key financial and operational risks and developing a measureable matrix of steps to remediate and manage those risks. The same process needs to occur with respect to key cultural risks. Specifically, firms need to regularly go through a process of identifying the monetary and other conflicts that impact corporate and employee decision making and set up a structure where mitigation steps are identified and tracked. This process should begin with the articulated goal that, wherever possible, these conflicts should be eliminated, not simply disclosed away. Where a high level, thoughtful conclusion is reached that a conflict cannot be fully eliminated, than a careful plan must be laid out to ensure that the client or counterparty clearly understands the conflict and ongoing monitoring must occur to evaluate whether any harmful effects result from the actual transactions entered into.

Fourth, the firm must recognize that the most significant “influencers” are not always Senior Management or the supervisors identified in the business organization structure. Moreover, while legal, compliance and risk functions are key culture carriers, there is a natural separation between those control functions and the business lines that limits their impact. As discussed above, many corporations have seen subcultures evolve, whether because of the isolation of the group or as a natural result of substantial acquisition activity. Trying to impact the messages delivered in these “subcultures” becomes a great challenge. Some financial firms, in their retail advisory businesses, have taken steps to identify successful employees who demonstrate strong commitment to the firms desired culture and specifically made a part of their work responsibilities being available to their business line colleagues to present insights and provide training on a range of compliance and ethical culture issues. Other firms have consciously tried to identify these influencers through surveys or steps such as “skip level” manager meetings. Today there are interesting analytic tools that, through evaluation of concentrations in email and messaging activity, without inappropriate invasions of employee privacy, can be quite effective at identifying these informal “influences.”

Fifth, there must be visible accountability for actions clearly inconsistent with the firm’s desired culture. This must go beyond responding to rule violations to addressing all ethical violations of the firm’s policies. It is equally important that a firm resist hiring persons, no matter how valuable, who have a history of significant client complaints or who have otherwise demonstrated a lack of judgement in how they treat their colleagues or how they have managed significant risk issues at their prior firm. In addition, violation of firm's ethical policies, whether they relate to training, employee conduct or other ethical standards should always be taken into account in determining an employee's incentive compensation and, in most cases, act as a block to further promotion. Finally, the CEO and her Senior Managers must be held accountable for firm failures that reflect on the effectiveness of the firm's cultures. It is not enough that these persons did not contribute directly to widespread harmful actions; they must also be reviewed as to whether these actions demonstrate failures in the firm's culture itself.

Finally, the corporation's board is absolutely critical in this effort. There must be conscious efforts to ensure that the Chairman or Lead Director's messages are fully supportive of the CEO's cultural messages. Additionally, Boards should regularly participate in the evaluation of how effective the cultural initiatives have been. In recent years, boards of financial companies have taken an active role in reviewing the effective management of key financial and operational risks. That same process must be expanded to include active monitoring of the firm's key conflict risks and how effective Senior Management has been achieving the desired shift in culture.

This is in no way to suggest that the Board can effectively micromanage culture. I do conclude, however, that continuous Board attention underlines the importance of ethical cultural change and contributes to effectively, identifying measures of progress attained.

Can any of these actions ensure that individuals in a large and complex global corporation will make no mistakes, of course not, but it can substantially increase the likelihood that actions inconsistent with the desired culture are more quickly identified, held up to transparent conversation and evaluation and much less likely to spread widely across the company. We can realistically hope for little more.

Notes

1. Vaughn K. Reynolds, The Citigroup and JP Morgan Chase Enron Settlements: *The Impact of the Financial Industry*, N.C. Banking Inst. 247

2. Global Research Analyst Settlement: Lit. SEC Rel. No. 18438/ October 31, 2003 – SEC.gov

3. See for Example, Floyd Norris *"A Warning Shot To Banks on Role in Others' Fraud, "* NY Times, July 29, 2003 at C.

4. Wells Fargo and the Slippery Slope of Sales Incentives; Harvard Business Review, 2016/09

5. See for Example, Rose, Clayton S., and Aldo Sesia. *"Barclays and the LIBOR Scandal*, Harvard Business School Case 313-675 January 2013 (Revised October 2014)

6. See N. 2

7. See, for example, Peter Truell, *"Deal Reached in Civil Suit Over Collusion on NASDAQ"* NY Times, July 18, 1996