Testimony of

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What about Business Ethics?

Outline:
1. Why markets need ethics
2. Where the law ends
3. The failure of current approaches
4. Recent changes that have challenged corporate integrity
5. What government and business should be doing.

1. Why markets need ethics:
More than 200 years ago, Adam Smith, the father of capitalism and himself a professor of moral philosophy, made a point echoed recently by the Nobel Prize winner in Economics, Amartya Sen: namely, markets won=t succeed unless they are supported by the ethical cooperation of their participants. Even capitalism, the best of all economic systems, remarkable for its capacity to direct the inevitable self interest of people towards the common good (the Ainvisible hand@), will fail unless it operates against a critical backdrop of moral integrity. In the United States, this very integrity today stands in the balance.
In ethics and economics, not all nations are created equal. A nation can hold key competitive advantages stemming simply from elements of its ethical behavior in the market. Some nations build Acompetitive advantages@ not only by dint of hard work and abundant resources, but by attention to trust, fairness, and integrity. These are part of a nation=s Asocial capital.@ For decades, US stocks have been a haven to foreign investors because of our business community=s reputation for transparency and integrity. That valuable reputation, too, today stands in the balance.
Many analyses of past global events help show why ethical attributes or their absence impact economic success. The broad and continuing failure of markets in former Soviet Union over the last decade has been linked to patterns of widespread bribery and corruption. Crony capitalism and the lack of transparency were rightly implicated in the Asian melt down of 1997-1998. Without transparency and reliable numbers about the economic health of Asian companies, investors were stymied from responding rationally to the crisis. They were unable to dump their investments in poorer companies and hold their investments in better companiesCbecause they simply couldn=t trust the numbers. In the ensuing crisis, they dumped everythingCwith pernicious consequences. Today, we appear to be experiencing a Atransparency discount@ in the American equity markets. Investors pay less because they believe that they know less.
Nations have held the integrity of US financial markets in aweCuntil recently. Our accounting standards, our principles of corporate governance, and our corporate ethics programs, were blueprints for the reform of institutions abroad. But the recent exposures of greed, dishonesty, and sophisticated theft in the US have damaged our national reputation. That reputation took decades to build. It can be rebuilt, but clearly not overnight.

Nowadays one hears often about the staggering cost of corporate crime, and about transparency failures in corporate bookkeeping and how such failures raise the cost of capital, thus harming society. But these are only two of the symptoms of ethical issues that flow in the lifeblood of business and society. Our problem is bigger than the cost of raising capital.

Consider the basic issue of fairness. When people perceive that a game is fundamentally unfair, they won=t play as hard. As the economist, Amartya Sen, has noted, how a cake is to be divided can influence the size of the cake. An employee=s incentive is less if she believes that the reward system at her corporation is rigged and unfair. The ordinary employees of Enron, who lost the bulk of their savings watching the elite executives at the top walk away rich, are today dispirited and unmotivated. Throughout our country, millions of employees are beginning to doubt the very fairness of their corporate system, and are beginning to distrust the ethics of their corporate leaders. Countless Americans are asking this hard question, Aeven if I strain every nerve and muscle, working the hardest I can for my corporation, can I receive my fair share?@

Economic efficiency also demands that we accept the duties of economic citizenship. A list of the duties of economic citizenship important for a market system include:

1. Respect for intellectual property
2. Engaging in fair competition and avoiding monopolies
3. Avoiding nepotism and Acrony capitalism.@
4. Not abusing government relationships
5. Providing non-deceptive information to the market (including transparency of relevant information)
6. Avoiding bribery
7. Respecting environmental integrity
8. Duties to honor contracts, promises, and other commitments

Recent scandals have turned heavily on #5, i.e., providing non-deceptive information to the market. The importance of accurate information in fueling efficient economic activity is well substantiated. Rational choice demands accurate information. When companies fail to provide investors with accurate information, investors make worse decisions and markets, in turn, become less efficient. Indeed, one of the three "principal objectives" asserted at the end of 1998 by the head of World Bank, James Wolfensohn, in the wake of the financial turmoil at Asia was Aimproving the quality and transparency of key government institutions, including addressing issues of corruption and accountability.@ The IMF, too, has emphasized financial accountability as a key financial pillar for recipient nations.

2. Where the law ends:

One characteristic winds its way throughout these success criteria, and it has implications for how Congress should address the currently boiling problems of corporate misbehavior. For markets to function well, the values discussed above must be accorded "intrinsic worth@ by market participants. Put simply, we need at least a threshold number of executives and employees who often will act simply because Ait is the right thing to do,@ and not because they believe they will make more money or help them escape legal penalties.

We ought not to be surprised by the key role played by intrinsic values in economic activity. In daily life we rightly prefer doing business with people who show independent concern for values. Think of integrity. If we believe that our lawyer or banker is constantly lying in wait, looking for the moment he can abandon integrity, and that he is routinely seeking the hidden moment when acting unscrupulously will fatten his advantage and decrease oursCwhile escaping legal penalties--then we suppose it is time to hire a new lawyer or banker. Most of us prefer

doing business with a lawyer or banker who places intrinsic value on integrity.
The need for placing a value on integrity itself and for Adoing the right thing because it=s the right thing@ has implications for the limits of law in correcting abuses. For example, the limits of law and regulation to cope with corporate ethics became obvious in the twentieth century when consumers saw that regulation inevitably lags behind knowledge inside an industry. Governments were powerless to regulate successfully the use of asbestos because knowledge about its carcinogenic effects was known not by regulators, but by employees inside the industry. By the time the law caught up, it was too late. In the recent scandals, it was often a clever and complex financial arrangement, such as the ARaptor@ entities of Enron, that bedazzled and cheated investors. MBAs and financial experts are trained to develop clever ways to make money. Some are ethical, some are not. But the law alone cannot be expected to anticipate each new creative financial design. Rather, society must rely, at least to some extent, on companies to use their creativity in a responsible way, and to act right because it is the right thing to do.
None of this is to say that we do not need new and tougher laws. As I will explain later, I think we do. But it is to clarify the contours of a broad solution to our current problems..
This brings us to the issue of how best to insure corporate integrity
3. The failure of current approaches:
. Unfortunately, many of the most popular recent corporate approaches to ethics are either failures or lukewarm successes. Corporate ethics programs were like hummingbirds in the 1950s. You didn't see one often and when you did it seemed too delicate to survive. Now, these curiosities have proved their sturdiness, flourishing and migrating steadily from their historical home in Europe and the US to Asia, Africa and Latin America. Most of the 500 largest corporations in the US now boast a code of ethics, and the proportion among a broader collection of US companies has risen to 80 per cent. Similarly, a recent study of FTSE 350 companies and non-quoted companies of equivalent size showed that 78 per cent of the responding companies had a code of conduct, compared with 57 per cent three years ago.
In 1991, US Federal Sentencing Guidelines offered companies a dramatic incentive to develop formal schemes in the US. The guidelines promise reduced penalties for companies found guilty of criminal conduct as long as they meet requirements for compliance and ethics programs. In turn, compliance-oriented ethics programs, usually with designated ethics officers, have boomed. Both the Ethics Officers Association and the Defense Industry Ethics Initiative have hundreds of members and share best practice for establishing ethics offices, hot lines, code design, web pages and training programs. Most of the largest 200 companies in the US belong to one or both of these groups.
Unfortunately, no persuasive data exist establishing a correlation between having an ethics code, or even an ethics program, and lessoned pressure on executives to commit unethical acts or better ethical behavior. In fact, some studies show an upside-down correlation: that is, companies with codes and programs do worse, not better! I do not think this is because codes and ethics/compliance programs are worthless. In fact, when designed well, they play a critical role. The absence of a correlation, or the presence of even an upside-down correlation, is probably like the phenomenon of Awhere you have more doctors, you have more disease.@ Doctors do not cause the disease, rather they follow the disease. Similarly, when corporations have ethical troubles, their first response is usually to call in their lawyers and develop codes and compliance mechanisms. But their underlying habits of bad ethics may well persist.
Yet, this makes one thing clear. Codes and compliance programs are at best only first steps in successfully managing corporate ethics. We do well to remember the dazzling creativity of

corporate slime. In the recent spate of Enron and WorldCom tragedies, every time it has been a new scam. If sleaze were less flexible; if corporate offenders tried the same scam again and again, then we could better design internal rules and external laws to cope with the problem. But smart people are too often smart enough to invent new ways to evade old rules.

Enron, for example, has all the bells and whistles of a modern corporate ethics and compliance program. Employees could repeat the phrase, ARICE,@ (Respect, Integrity, Communication, and Excellence). They had wallet cards listing the company=s published values and received a thick list of ethics rules (which managers signed each year.) I have a copy of a letter signed by Kenneth Lay in November of 2001 sent to the head of a large New York life insurance company. It says, in effect, we stand for the highest of ethical principles, and if you happen to see any unethical behavior, please contact our designated compliance officer. None of these ethics and compliance mechanisms came close to preventing the Enron implosion. Nor are such mechanisms relevant for most of the recent scandals.

The Corporate Criminal Sentencing Guidelines have backfired in many respects. They have resulted in a lessoned tendency to impose substantial fines on the corporate entity, and have lessoned the willingness of the government even to embark on litigation. My colleague, William Laufer at the Wharton School often talks of the phenomenon of Areverse whistle blowing.@ In the context of the Corporate Criminal Sentencing Guidelines, the government has often arranged to spare the corporate entity litigation in return for information that will implicate white collar criminals inside the organization. Hence, during the past six year the government has convicted more, not fewer, white collar criminals. But notably, these white collar offenders have usually been Amiddle-class@ managers, not managers at the top of the hierarchy who often deserve punishment even more. So the systems we have now, both inside corporations and in the government, aim down the corporate hierarchy, not up. Yet the current scandals have their locus far up that hierarchy. In corporate America, it=s often more toxically joyful at the top.

This reflects what I call the Ateflon top.@ As we have seen in the recent scandals, executives at the top can insulate themselves from blame by delegating responsibility to others and hence adopting a deniability posture, even as they put enormous pressure on executives to Ahit the numbers@ or Amanage the numbers@ in a way that encourages corporate crime.

The more important determinates of ethical behavior in a corporation are:

1. Reward systems,
2. Corporate culture,
3. Leadership example,
4. Institutional systems outside the corporation (including legal and regulatory systems).

It is a mistake to think our current problems are simply the product of a Afew bad apples.@ Corporate Watergates typically involve scores and sometimes hundreds of people inside the corporation, and all too often, scores of people outside the corporation, i.e., in institutions such as accounting firms, investment banks, and law firms. The plain truth is that many of these thousands of people are not slime balls or bad apples but ordinary people under extraordinary pressures.

4. Recent changes that have challenged corporate integrity:

I believe the single most important change fueling the recent corporate scandals is the transformation of the compensation system for upper level executives that occurred during the last decade. We have moved quickly from a cash-based compensation system to a stock-based one. Good reasons exist for the change and for aligning executive pay better with corporate

performance; but we must now pause and recognize that the game of executive motivation has forever changed. The temptations at the top are fixtures in a new and different world.
Over the past two decades I have talked with hundreds of corporate executives behind closed doors listening as they described their ethical challenges. During the past six years the tone of those conversations has shifted sharply. Increasingly, short-term stock price pressures have assumed significance as the salient goal, and increasingly these executives= ethical pressures center on either the demands they must make, or the demands they must fulfill, to bolster short-term stock price. Studies reveal that the number one pressure on the ethics of corporate managers is the demand to hit numbers, and more broadly, to, make their company look good to the investment community. As we have seen recently, this pressure has overloaded manyCwith catastrophic consequences.
Once again, it is not a matter of a few bad apples or even a few bad companies. To be sure, the Enrons and WorldComs are gross exceptions, companies that lie on the outer periphery of ethical behavior. But commentators who say that 99% of corporations are honest and only 1% dishonest make a fundamental mistake. Their picture is too simple. Virtually all large, publicly traded corporations in the US today are confronted with temptations that are unprecedented in American corporate history. And many have made at least modest accommodations in the direction those temptations.
5. What government and business should be doing.

Without question, we should change the cost-benefit equation that fuels temptations in the executive suite. For this reason I support the Corporate and Criminal Fraud Accountability Act Ethics passed by this committee, which would create a new federal securities-fraud felony and give prosecutors better tools to pursue corporate executives. I also support measures being discussed elsewhere to place limits on the exercise of stock options that would align executive benefits more with long-term rather than short term equity values. And I support measures to strengthen the role and integrity of audit committees of corporate boards, especially ones that would tighten the connection between the CFO and the audit committee and, in turn, loosen it between the CFO and the CEO.
But when it comes to laws, even more important than new laws is doing a better job of enforcing ones we already have. This means giving more resources to the Justice Department, the FBI, the SEC, and other institutions charged with the duty of legal enforcement. We must also look once again at the prospect of holding entire corporations, and not merely individuals, accountable and financially liable.
Lastly, we must educate Americans, and especially current and future executives, about the importance of ethics. Part of this duty falls to elected representatives such as you. But much of it falls upon me and my colleagues, that is, professors in our nation=s schools of business. These schools, the training grounds for tomorrow=s executives, have the unavoidable duty of taking ethics seriously wherever it arises: in accounting, in marketing, in management, and in finance. Ethics is now nominally required as a part of the curriculum in accredited US schools of business, but too many schools take their responsibility lightly, relegating it to a Amention@ or Aadd-on@ and refusing to support the serious research without which business ethics simply becomes pleasant discussion.