Corporate Finance and Original Sin

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Abstract: The unique characteristics of the financial services industry present practitioners with challenging ethical demands. Of these, the potential for extraordinary monetary gain and the moral anesthesia resulting from the inward-looking nature of the profession conspire to hamstring effective regulation by industry insiders. Effective control of the industry must come from outside the industry. The choice is between regulation by a private entity and regulation by a governmental body.

"If men were angels, no government would be necessary."— James Madison, Federalist Papers, No. 51

MY LATE FATHER was possessed of a preternatural ability to distract store clerks in such a way that they returned too much change, which he always gave back. The resultant look of surprise on the clerk's face provided him the cue for his signature bon mot, which varied only with the amount involved: "For 50 cents, I can be an honest man." These miniature morality plays (produced, I suspect, for my benefit) contained three separate lessons—first, that the exercise of honesty is in itself pleasurable; second, that it always comes at a price; and third, by implication, that the price of moral self-satisfaction occasionally comes quite dear.

I open with this small story because it goes to the heart of the treatment of the profession's recent ethical travails in two important articles in these pages—one by Marianne Jennings (2005) and one by John Dobson (2005). Jennings' piece laid out the history of the high-profile corporate scandals of the past few decades, categorized them as to type—soft dollars, the analyst-underwriter conflict, the analyst as cheerleader, and so forth—and then argued that no amount of government enforcement can substitute for a strong set of ethics intrinsic to the financial profession. She pointed out that outright avoidance is preferable to case-by-case analysis: For example, a company that restricts its operations to either investment banking or research does not have to worry about a conflict of interest between the two.

The Benefits and Costs of the Warm Glow

Dobson's piece came to the same conclusion from a different direction. Citing recent research from the fields of sociology, primate biology, and cognitive neuroscience, he dispelled the notion that human beings are amoral "wealth-maximizing opportunists." He argued that ethical behavior both endows its producer with a pleasurable sensation of virtue and, in most cases, also provides an economic benefit.

But one does not need to be a "neo-Darwinist" (to borrow from Dobson's title) to grasp this idea. Paleo-Darwinism works just fine, thank you. Societies that cherish and observe such guidelines as the Ten Commandments and the Golden Rule run more smoothly than societies that do not. In other words, the pleasure provided by ethical behavior probably serves the same evolutionary purpose as does the pleasure elicited by eating, by social contact, by sexual activity, and by the mere presence of small children.

Dobson began with a parable in which one finds Adam Smith's proverbial butcher collapsed on his shop floor. He pointed out that most people (even finance professionals!) would assist the butcher rather than choose the most economically efficient option—that is, proceeding immediately to another butcher shop. This story is nearly identical to my father's story: In both cases, the economic price of the warm moral glow is low. But what if the store clerk inadvertently hands back several thousand dollars? What if the cost of aiding the butcher is measured in the millions?

The Original Sin of finance is simply the presence of so much illicit potential; the price of the warm glow is just too high. Furthermore, we are solidly in Willie Sutton territory, for the sheer baldness of the temptations alone attracts large numbers of bad actors.[1]

The Inevitability of Moral Anæsthesia

Worse, ethical sense decays with time and repetition.[2] As put by Adam Smith in *The Theory of Moral Sentiments* (1984):

> "So partial are the views of mankind with regard to the propriety of their own conduct, both at the time of action and after it; and so difficult is it for them to view it in the light in which any indifferent spectator would consider it. . . . If we saw ourselves in the light in which others see us, or in which they would see us if they knew all, a reformation would generally be unavoidable. We could not otherwise endure the sight." (pp. 158-159)

Simply put, given enough time, human nature usually rationalizes behavior regarded by most others as odious. Just as most of us believe that we are better than average at driving, investing, and pleasing others, so too do we believe that our moral character exceeds that which nature and nurture have allotted others.

Such moral overconfidence manifests itself in spades in the hothouse atmosphere of most professions: The view from the outside is very different from the view from inside. Ask physicians in the United States what is wrong with U.S. medicine and they will not tell you about the crises most obvious to lay people: a wasteful system that costs almost twice the percentage of GDP spent by other developed nations while producing inferior outcomes, that leaves 45 million citizens, including millions of children, uninsured, and that is the nation's most common cause of bankruptcy, even among those with good medical insurance. Rather, they will rail against the corrosive effects of tort lawyers, the mendacity of the insurance companies, an increasingly demanding patient population, and their burgeoning work loads.[3] At the extreme, interviews with Nazi death camp personnel revealed that not only did most feel that they were doing honorable work but, like junior

1. Notorious bank robber Willie Sutton is famous for this apocryphal quotation: When asked why he robbed banks, he supposedly replied, "Because that's where the money is."

2. The major exceptions to this rule are famous convicted political and white-collar felons, who regularly experience miraculous religious and moral revelation.

associates at top-flight firms, treated the carrying out of their odious missions as a competition (Rees 2005).[4]

Obviously, the erosion of moral sense produced by social conditioning takes time—concentration camp guards are made, not born. Smithian rationalization and the mutual validation of the work environment inevitably lead to the sort of "moral creep" so well described by Jennings.

If given to mathematical pedantry, one might summarize the decay of moral impulse resulting from temptation, repetition, and social reinforcement as follows:

$$P = f(x, t, n),$$

where P is the probability of an ethical outcome, x is the amount of money involved, t is number of years the person has been engaged in the profession (or the length of a bull market), and n is the number of coworkers engaged in the same activity. Does anyone doubt that the slope of this function is continuously negative in all three variables?

A Paragon Goes Bad

Jennings cited the sorry stories of "the usual suspects" that by now have become household names—Frank Quattrone, Andrew Fastow, Jack Grubman, and Bernie Ebbers. But a less well known tragedy demonstrates just how irresistible is the siren song of Wall Street.

When he began his career in finance, no one would have picked out Michael Smirlock as a future felon. Brought up in a household presided over by, in the words of one of his friends, a "classic Jewish intellectual" father, Michael excelled academically and acquired a PhD in finance. Six years later, he was awarded a tenured chair at the Wharton School at the University of Pennsylvania, where he mentored a large number of future practitioners and academics. Drawn by the lure of bigger money, he found himself in 1990 at Goldman Sachs; by 1992, he had made partner. The very next year, he garnered a $50,000 fine and a three-month suspension by the U.S. sec for suspicious late-trade allocations and was forced to resign. He then set up a real estate investment trust and a series of hedge funds. On 24 May 2002, Judge Gerald E. Lynch of the Federal District Court for the Southern District of New York sentenced him to four years incarceration and fined him $12.6 million for fraudulently concealing losses from his investors (Lux 1998; SEC 2002).

True, Smirlock's peers at Goldman Sachs presumably avoided temptation, and a few even had the rectitude and courage to bring him to justice. But if this highly respected academic, who should not have had any problem with the legal and ethical concepts involved, could not keep his hands out of the cookie jar, what chance does the average broker or B-school grad have?

To summarize:

- Finance provides extraordinary temptation. This circumstance not only turns people into scoundrels but also attracts to the profession those already scoundrels. Although most people derive noneconomic satisfaction from ethical behavior, in finance, the warm

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3. Personal communication to me from numerous colleagues throughout my medical career. I admit to the personal expression of similar sentiments on numerous occasions.

4. Interestingly, the same is not true of Soviet and Japanese camp personnel, who were driven to their odious tasks mainly by fear (see Rees).

moral glow simply costs too much.

- Over time, the atmosphere of internal validation that characterizes and binds together most professions inevitably blinds a large number of finance and corporate practitioners to their unethical behavior.

The Road Back

Because outsiders can more clearly discern the conflicts of interest than insiders numbed by moral anesthesia, reform must be directed from outside the industry. Anyone who doubts this proposition should ask himself why cheerleading analysts' recommendations and Richard Grasso's pay package at the NYSE provoked so little outrage within the industry before New York Attorney General Eliot Spitzer brought them to public attention.

Real reform should contain at least three elements. First, fiduciary standards should be raised across the board. Nowhere in the industry is the need more crying than in retail brokerage, where the nearly complete absence of fiduciary responsibility encourages a moral rot that extends far beyond the broker-client ambit. Furthermore, the level of financial training and expertise among retail brokers is abysmal. Let us be honest: In some states, getting a manicurist's license is more difficult than passing the National Association of Securities Dealers' (N ASD) Series 7 exam. An incompetent or mendacious broker can savage a client's wealth with far greater dispatch than can an inept or dishonest accountant; it thus makes little sense that whereas "CPA" is essentially a graduate-level designation, sitting for the Series 7 does not require even a high school diploma. Portfolios consisting of a tiny and constantly changing list of individual securities should no longer pass regulatory muster; performance, overt fees, and transactional costs should be reported in a clear and compelling manner. The moral swamp that is retail brokerage corrodes the rest of the financial industry, and much of corporate America along with it. A corps of well-trained brokers, fully cognizant of and guided by the precepts of modern finance, would go a long way toward tamping down dishonesty in the other arenas of finance and in the business community as well.

Second, the hermetically sealed moral environments of the corporate and financial worlds should be regularly challenged in the only way possible—from the outside. There are many possible ways to skin this cat, the most obvious being regular and mandatory participation in ethics symposia—staffed by outsiders and backed up with vigorous enforcement—for all brokers, advisors, analysts, and corporate executives and board members.

Finally, as Jennings hinted, the most egregious conflicts of interest should be prohibited by statute. These conflicts include, to name but a few, soft dollars, the coexistence of research and investment banking within the same corporate ownership structure, resistance to expensing options, and lack of a precise definition of excessive compensation.

Just who should these outside watchdogs be? Most practitioners in the industry would prefer to avoid the clumsy, dead hand of government. As an alternative, some suggest a nongovernmental oversight organization. How would such an approach work? Probably the best functioning model of nongovernmental professional oversight is the regulation of attorneys by state bar associations. But although nominally private organizations, the bar associations are, in practice, closely supervised by the state supreme courts. Similarly, accountants and physicians, generally considered to be effectively regulated, are overseen and disciplined by state institutions.

Private securities regulatory bodies, however—the NASD and NYSE board of directors—have not of late inspired confidence in their policing of, respectively, standards in the brokerage industry and CEO compensation. The central problem with private regulatory bodies, apparently, is that they tend to be staffed by industry insiders, precisely those most susceptible to moral anesthesia.

Governmental bodies, on the other hand, have a good track record in overseeing other aspects of the security industry. It may not be a coincidence that the U.S. securities markets are both the world's most strictly regulated and the most transparent and vibrant. Empirical study, in fact, confirms that the cost of capital in a country is inversely proportional to the vigor of the country's securities law enforcement (Hail and Leuz 2004; La Porta, Lopez de-Silanes, Shleifer, and Vishny 2002).

Whether the ethical direction so sorely needed in U.S. finance comes from the government or private organizations, it clearly must be directed by outsiders not numbed by the industry's high compensation and internal validation. The long and sorry history of ethics in U.S. corporate finance and money management is at least a century past the point where anyone can argue that functioning moral underpinnings can be entirely, or even substantially, sustained from within. It is high time that the farmer replaced the fox at the henhouse door.

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