THE AMERICAN COLLEGE

ETHICS

PERSPECTIVES ON ETHICAL LEADERSHIP IN FINANCIAL SERVICES

Tenth Annual
James A. and Linda R. Mitchell
American College
Forum on Ethical Leadership
2010

FORUM ON ETHICAL LEADERSHIP

The tenth annual James A. and Linda R. Mitchell/American College Forum on Ethical Leadership in Financial Services took place January 16, 2010, in Naples, Florida. The event featured a discussion of several key issues confronting the financial services industry, along with an examination of practical ethical dilemmas encountered by executives during their careers and questions raised by business ethicists from major colleges and universities around the country.

THE EXECUTIVES

Paul Amos, President, Aflac. Chief Operating Officer, Aflac U.S., Columbus, Georgia

Steve Anderson, Senior Executive Vice President, National Sales Manager, Waddell & Reed, Inc., Overland Park, Kansas

Steve Bartlett, President and Chief Operating Officer, The Financial Services Roundtable, Washington, D.C.

John DesPrez, Chief Operating Officer, Manulife Financial Corporation. Chairman and Chief Executive Officer, John Hancock Financial Services, Inc., Boston, Massachusetts

Dennis Johnson, President and Chief Executive Officer, United Heritage Financial Group, United Heritage Insurance Company, Meridian, Idaho

Jim Mitchell, Chairman and Chief Executive Officer (Retired), IDS Life Insurance Company, Longboat Key, Florida (Host)

THE ETHICISTS

Denis Arnold, Associate Professor of Management and Surtman Distinguished Scholar in Business Ethics, Belk College of Business, University of North Carolina, Charlotte, North Carolina

Richard DeGeorge, University Distinguished Professor, Department of Philosophy, University of Kansas, Lawrence, Kansas

Ron Duska, Charles Lamont Post Chair in Ethics and the Professions and Director of the Center for Ethics in Financial Services, The American College, Bryn Mawr, Pennsylvania (Host)

Kevin Gibson, Associate Professor, Department of Philosophy and Director, Center for Ethics Studies, Marquette University, Milwaukee, Wisconsin

Laura Hartman, Professor, Department of Management and Research Director, Institute of Business and Professional Ethics, DePaul University, Chicago, Illinois

Diana Robertson, Professor of Legal Studies and Business Ethics at The Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania

EXECUTIVE SUMMARY

On January 16, 2010 a group of six executives ("practitioners") and six academic ethicists ("philosophers") gathered in Naples, Florida to participate in the tenth annual James A. and Linda R. Mitchell/The American College Forum on Ethical Leadership in Financial Services.

The purpose of this annual event, established in 2001 by Jim and Linda Mitchell, is two-fold:

• To provide executives with an opportunity to reflect on ethical issues they confront on a regular basis with questions posed to them by academics engaged in business ethics education.

• To afford academics the opportunity to engage in discussion about these issues with top-level executives so they can bring that experience back to their classrooms.

EXECUTIVE COMPENSATION: WHO SHOULD DECIDE?

Following the introduction of the participants and discussion of their goals for the day, the conversation turned to ethical issues concerning executive pay. The specific question under discussion was 'who should decide executive compensation?'. The participants agreed that the party who was in the best position to assess the executive's contribution to the value of the company was also in the best position to determine both the appropriate amount of compensation and the form that compensation should take. That party was generally thought to be the Board of Directors.


Jim and Linda Mitchell and Ron and Brenda Duska arrive at the reception.

The participants seriously considered the merits of two different models; a direct and binding shareholder "say on pay" and a non-binding shareholder "say on pay" vote designed to advise the Board of Directors of shareholder attitudes and preferences.

The participants discussed the changing role of corporate boards in recent years. While in the past corporate boards were often viewed as acting solely for the interests of the corporation, most agreed that a "sea-change"

had occurred in the board's perception of its own role and responsibilities in recent years. Most corporate boards now acknowledge they have not only legal obligations to shareholder interests, but also a moral responsibility to be good stewards of the corporate mission. This paradigm shift was accelerated by the recent financial crises, but was originally initiated as a result of increased public scrutiny and regulatory oversight of board activities.

The participants discussed the effect of non-binding "say on pay" initiatives. Some participants believed these initiatives would not significantly impact the manner in which corporate management and boards of directors make their decisions, arguing that issues such as accountability to shareholders and transparency are already on the radar of most corporations. Other participants argued that these initiatives make a difference since they shine a brighter light on the decisions of management and their boards of directors. The majority of the participants agreed that "say on pay" votes should remain non-binding since many shareholders have little knowledge of the day-to-day workings of corporations and lack an interest in the long-term health and viability of the company.

"We're working on a code of ethics for the financial services industry that outlines our responsibilities to the people we serve. As an industry, we have dug ourselves into a hole and now it's a matter of rebuilding trust."

Steve Bartlett

The participants touched briefly on the sense of public moral outrage precipitated by the 2008 financial crisis. Some noted that much of this outrage was driven by the perception that executives of major financial institutions were exploiting the system for their own benefit. Other participants believed this outrage was driven by the impression that the average American, while he or she suffered the losses resulting from a depressed market, had little opportunity to share in the spectacular gains enjoyed by financial services executives. All of the participants agreed that increasing lack of public faith and confidence in the financial services industry was a serious problem and that much work needed to be done by the industry to regain the public trust.

EXECUTIVES' ETHICAL DILEMMAS

In this segment of the Forum, the executives each presented an ethical situation or problem that they had encountered in their careers.

The first dilemma concerned a compensation arrangement in which agents receive a commission when they replace a product in the client's portfolio with a product issued by the company. These "internal replacements" raise the question of whether this system incentivizes an agent to engage in 'churning', a practice of generating unnecessary sales for the purpose of generating additional income. In the specific case, no compliance or regulatory issues had arisen, but the executive was concerned with whether his company had created an incentive structure that would motivate producers to act in the interests of their clients.

A second dilemma considered whether the distribution model for supplemental insurance policies ensured that clients received the product best suited to their needs. The market for this form of insurance is structured so that providers are only able to interact with the client through the medium of their employer. The employer makes the choice as to what products are available to their employees, leaving the insurance provider largely out of the equation. The executive is convinced of the value of every product his company offers, but he is concerned whether his clients are purchasing the most suitable product.

The third dilemma considered the problem faced by a corporate General Counsel who was approached for legal advice by two members of the Board of Directors who insisted the attorney not disclose the meeting to the CEO. To whom in the corporation does the General Counsel owe allegiance—the corporation, the Board of Directors or the CEO who hired him? How should the General Counsel prioritize these obligations when they conflict?

A fourth dilemma looked at what to do if you are in possession of information that may significantly impact the long-term health of a corporation. Should you inform the CEO of what you've heard? This dilemma raised the question of when it is appropriate to intervene in the internal affairs of a company by sharing information, particularly information that may not be correct. This difficult decision is compounded by the question of whether the CEO already knows what you may be planning to share. This dilemma provoked a discussion concerning a "wall of silence" that often surrounds powerful executives and prevents important information from reaching them.

The final dilemma dealt with the decision of a corporation to make its clients whole after an investment recommended by some its agents failed, causing the clients to suffer a loss. This raised questions regarding the ethical responsibility of a corporation when they are not directly at fault or legally liable for the harms suffered by the clients. While it is important not to set a precedent of financial intervention for every bad investment, there is a real concern about the reputation of the company and its perceived trustworthiness on the part of the consumer.

"It can be really hard for the CEO to know the truth about what is going on in the organization. Unless CEOs make it clear that they really want the unvarnished truth, they can be the last people to know."

Jim Mitchell

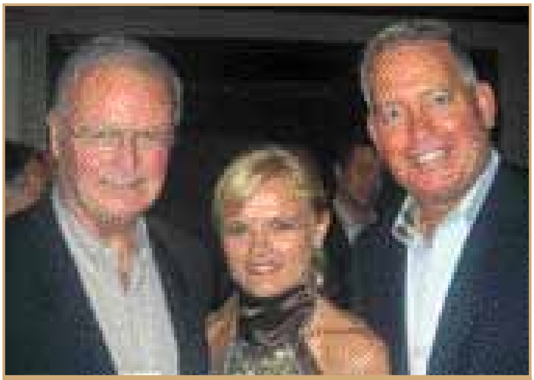
ETHICISTS' QUESTIONS

In this portion of the program, each of the academics posed an issue or raised a question for the group to discuss.

The first question concerned the corporation's obligations to different stakeholders. Does a corporation have a responsibility to its community, particularly during hard times? If so, how should this responsibility be accounted for? This question raises the issue of how corporations should balance their obligations to shareholders with responsibilities of due care to other groups, such as the communities in which the firm operates, who are significantly impacted by the decisions of the corporation.

The second question looked at the case of a pharmaceutical company recently fined a significant amount by the Food and Drug Administration for improper marketing. This was their second violation for the same offense in a relatively short time. This raised the issue of the corporate culture of the company, since the wrongdoers alleged that they were directed to act in ways that clearly violated FDA guidelines. The ethicist wondered how it was possible to both diagnose what was going on in this environment, and more importantly, how to fix it.

A third question asked about the role of business schools in causing the financial crisis of 2008. Many have pointed the finger at prestigious graduate programs in business, arguing that they failed to educate their students adequately in either risk management or ethical decision making. The ethicist wondered what business practitioners were looking for from these graduate programs. Did they have any recommendations for changes to the curriculum or overall program? What qualities are they looking for in recent graduates?


Jim Mitchell and Steve and Tracey Anderson at the closing dinner.

The fourth question asked how ethical behavior was rewarded in the practitioners' organizations. Besides the challenge of creating incentives for doing good, it's also important to clarify how organizations actually define what they mean by 'doing good'. This led the ethicist to ask two questions - how to create incentives for decent, standard behavior and how to reward behavior that really goes beyond what is expected.

The final ethicist asked about the industry's response to the tremendous amount of criticism it has received, rightly or wrongly, since the onset of the financial crisis. Are financial institutions prepared to come out with a series of statements that say, "This is what we, as an industry, contribute to society. These are our commitments to society and this is how we haven't lived up to our commitments. We are accountable for living up to these principles and you can judge in the future whether we do so or not". Has the industry tried to do this?

INTRODUCTION AND GOALS FOR THE DAY

The tenth annual James A. and Linda R. Mitchell Forum on Ethical Leadership in Financial Services began by Jim Mitchell asking the participants two questions: What does ethics mean to you in your organization? How do you hope to benefit from today's discussion?

Jim Mitchell began by noting that his experience at American Express taught him that a highly ethical culture could be highly profitable, as well. In his view, good ethics and profits are not mutually exclusive things. "An effective, ethical organization can create a win-win situation and do a great job for its customers, its employers and its community, as well as its owners. That's what I observed, not just what I think."

He noted that the Forum is designed to provide some time for industry leaders to reflect on ethical issues. "You guys are so busy that it's hard sometimes to step back and reflect on how you might be a better, more ethical leader, and how your organization might behave in a more effective way." He hoped that the academic participants would also benefit from the session. "Academics don't often have the opportunity to rub minds like this with industry practitioners. We hope that you will not just help us think, but that you will come away with some new ideas that are useful to you."

Ron Duska noted that he was honored to hold The American College chair of business ethics, which was the first chair of business ethics in the country. "For those of you who don't know The American College, it was founded by a group of insurance salesmen with the express intent of turning insurance salesmen into professionals. So the college was founded on an ethical mission." He added that while he always enjoys these sessions, he is "...serious

"I think there is a contract between the community and your corporation. They're providing for you and you ought to give something back."

Dennis Johnson

about the importance of a dialogue between practitioners and academics. I look forward to the opportunity to talk to you frankly, and I'm sure I'll come away having had a wonderful day of talking to executives and my colleagues."

Steve Anderson said his experience in the marketplace reinforced his belief in the importance of ethics. "Positioning ourselves as a trusted advisor is critically important in our organization right now. We spend a lot of time talking about ethics and making sure our advisors understand the client comes first. It has to be a win-win situation: the enterprise has to win, the advisor has to win, and the client has to win." He added that he was looking forward to "tapping into some real hard experience that a lot of you have had."

Richard DeGeorge noted that he had just finished writing the seventh edition of his book on business ethics and that the hardest chapter to write was the one on finance. During the research process he discovered many complaints about the financial services industry. He hoped that the discussion would, "broaden my vision and help me put out the word of what's good about the financial services industry and not just what's bad."

Kathy Johnson and Denis Arnold talk about the day's events.

Laura Hartman noted that some of her recent research focused on partnerships developed with those living in poverty that are intent on making a profit. The guiding idea behind these partnerships is that "there needs to be a profit motive in order to be successful in a sustained way." She added that this notion could inform a discussion about executive compensation. "I think that there are some challenges, and so part of what I would like to explore today is how to resolve some of those challenges."

Paul Amos believes in the principle that transparency is necessary for ethical behavior. "If you can't be transparent, you're not going to be ethical. Ultimately, opening up the door and letting everybody see all the things you're doing, leads you to make the right decisions." He is committed to seeing his company grow ethically and believes that one of the best ways to do that is to learn from other people and organizations. "It's important that I leverage the experience of others, so I can know the types of situations that I'm going to encounter, and be prepared for them when they do come about."

Dennis Johnson noted that the financial services industry, and the life insurance industry in particular, is in the business of making promises. "When it comes to the question of ethics, it's a matter of making promises and keeping promises. If we can't keep the promises we make, then our entire business model falls apart. Nobody will trust us and there's no long-term value in our business." He added that he has tremendous faith in the contribution academics can make to the development of best practices. "I've always believed in having an academic, typically a business professor, on a corporate board. We do that, and I think the interplay is very helpful."

Steve Bartlett thought that there are three types of ethical lapses the financial services industry needs to cure. The first lapse is taking long-term risks for short-term gain, and compensation policies that reinforce that behavior. The second is a failure to focus on the customer. "The companies that do well start with the premise of fairness to the customer. Those that fell off the boat were the ones that weren't fair to the customer." Finally, the industry needs to restore transparency, "that is, plain English as a way of saying what you mean and saying it in a way that everyone can understand it." He was here to continue his work of rehabilitating the industry. "I'm called upon, along with others, of course, to try to figure out ways to reconstruct the industry in an ethical way that works and then communicate that as we get it together."


Diana Robertson makes a point during the discussion.

Diana Robertson spent her career, "trying to understand what kind of organizational factors influence ethical or unethical employee behavior." She does not think that academics and practitioners come together enough and when they do, it is not always profitable. "I've been at academic conferences where I have seen business people rather perplexed by what it is that we're doing as academics. They believe that what we're doing doesn't relate to what you as practitioners are doing." She welcomed the opportunity to participate in the Forum.

John DesPrez observed that the case on executive compensation, which will be discussed initially, gets to the heart of what is happening in the industry. He thinks that trust is the foundation of the financial services industry,

and it is important to continue to earn that trust. “People have to believe that you’re going to live up to the promises that you make. Absent that, you’re out of business in a hurry.”

Denis Arnold noted that because most of his students are working professionals at the early stages of their careers, “they bring a wealth of everyday experience and let me know right away if what I’m saying doesn’t make sense in the context of their workplace.” He added that he was looking forward to bringing the insights he discovers during this discussion back to the classroom. Talking with executives and business people, “really informs my teaching in a substantial way and helps me to provide a variety of perspectives to my students. ”

Kevin Gibson said that his basic approach in the classroom is to show that “the purpose of business is to serve people, and if you forget that, there’s nothing else there.” He tells people that he teaches ‘values’ rather than teaching ‘ethics’. “What I try to do is say: ‘Look, you’ve been at business school, you’ve been out in the world and folks are saying you’ve got to add value. But what does that notion of value actually mean? What are your values? How are you going to transmit those values?’” He noted that there seemed to be a disconnect between what people believed was going on in the financial services industry and what is actually occurring. “I want to find out from the CEOs what the reality is. If I come away with that, I’ll be thrilled.”

“As people, we get intrinsic value from aligning our actions with what we believe to be our inner set of standards.”

Steve Anderson

Julie Ragatz shared that her experiences of working with executives leads her, “to believe there is a general level of commitment among most practitioners to being an ethical leader.” She was eager to learn from the practitioners why, in their opinion, the financial crisis and turmoil in the market occurred. “I am looking forward to all I can learn from you today.”

CASE STUDY: WHO SHOULD DECIDE ON EXECUTIVE COMPENSATION?

A CASE STUDY

Jack Heilmann is the Chairman and CEO of Global Financial, a large New York-based firm with banking and insurance interests. He is scheduled to appear tonight on the "Charlie Lily Show" to discuss executive compensation. He agreed to participate, despite the objections of his Public Relations department, because he believes Charlie Lily provides his audience with a fair and balanced discussion of important issues.

But he was determined not to participate in a discussion which excoriated executives for the level of compensation they receive. He thinks these discussions distracted people from the truly important issue – who should have the right to determine executive compensation. Some people were advocating that it should be a company's shareholders in the form of a direct vote; others thought the federal government could do the job better. Jack believes the company's Board of Directors continue to be in the best position to make decisions on executive compensation. It was well-established in the law that the Board has a fiduciary duty to look after the interests of the shareholders. Moreover, boards of directors could, and in Jack's opinion should, focus on creating value for their long-term investors, rather than pandering to short-term speculators. Jack is concerned that the Board's historic role was under threat, which is why he accepted Charlie's invitation to participate.

George Sanchez, a shareholder advocate with the consortium Empower Shares Now, is delighted to appear on the Charlie Lily Show. George is not as well-known as the other participants, but he believes Empower Shares Now had earned a seat at the table. George began his career working for the public employee pension fund of a large Western state and had formed Empower Shares Now a few years ago to encourage corporate accountability. His organization, a membership consisting of mostly large public and private employee pension funds, is convinced the time is ripe for substantial change in corporate governance. Their strategy is to use public anger over executive compensation to push for allowing shareholders to make decisions—including on executive compensation— through a direct vote.

Liz Warrant, an economics professor from a prestigious Midwestern university, was recently appointed to oversee the use of TARP funds by the firms that received them. The more she immersed herself in the job as "TARP Czar", the more she realized that the executives of these firms faced some tough choices. It was not an enviable position, particularly for the companies who were 'encouraged' to accept government monies they did not want. Nonetheless, Liz is convinced that the politics of the executive compensation issue are incendiary. The public is upset at what they saw as greedy executives making off with millions after running companies like AIG and Lehman into the ground. Until the government could neutralize the issue, it would be impossible to make any progress on the issues of improving financial services industry oversight. Liz was coming to believe that the only solution was the imposition of industry-wide salary caps on executive pay, which would level the 'playing field' and perhaps go some way to soothing public discontent.

"Good evening, I'm Charlie Lily and thanks for joining us. I'm here tonight with three distinguished panelists. Jack Heilmann is Chairman and CEO of Global Financial. Liz Warrant is Professor of Economics at the University of Cleveland and recently appointed head of the President's Special Economic Council, the so-called 'TARP Czar.' Finally, we are joined by George Sanchez, the Founder and Director of Empower Shares Now, a group which urges direct shareholder participation in corporate decision making. The topic for discussion tonight is 'Executive Compensation: Who Should Decide?'

"George," Charlie began, "your organization argues that executive compensation should be determined by a direct vote by the shareholders. How is this different from the system which is in place now?"

"Currently, compensation packages are proposed by outside consultants," George noted. "These consultants are hired to make recommendations regarding the compensation packages of senior executives. After the recommendation has been made, the Board of Directors votes on the proposed compensation package. My organization, along with others, is advocating a direct 'say on pay' for shareholders. We want to give shareholders an independent voice."

"Liz," Charlie turned to his attention across the table, "isn't the Board of Directors supposed to be the 'voice' of the shareholders?"

"In theory, the shareholders are supposed to have control over the composition of the Board of Directors," Liz agreed, "but in practice most boards operate relatively independently of shareholders, and have been accused of being seriously 'out of touch' with the concerns of the shareholders."

"So, do you agree with George's solution of a direct 'say on pay'?"

"I think that in the future something like George's proposal could work," Liz conceded. "Many shareholders have lost confidence in the ability and willingness of corporate boards to look out for their interests. But, Charlie, we're in a crisis situation. I think we need a more radical solution."

"You're proposing federally imposed salary caps for a certain percentage of the top executives in the financial services industry, is that right?"

"The government's intervention in the financial markets was unprecedented in scope," Liz argued. "The public is furious that executives are walking away with millions while average Americans have lost their jobs and their retirements. On the other hand, the companies that received TARP funds believe that they have been placed at a significant disadvantage on account of the salary restrictions which were a condition of the TARP loans. We believe that a government-imposed salary cap would both relieve the pressure these companies face and go a long way toward assuring the public that there are consequences for failure in the market."

"Well, Jack," Charlie continued, "now that we've heard Liz and George, what do you think is the best approach to determining executive compensation? Do you think that a direct 'say on pay' is a good idea?"

"Charlie," Jack began, "I first want to say that George's characterization of the role of executive compensation consultants is outdated by 20 or 30 years. Today, compensation committees are composed entirely of directors independent from management, and the outside consultants work for the committee. The degree of independence from management is as high for the compensation committee today as it has traditionally been for the audit committee."

"I also want to disagree with Liz's statement that most boards are 'out of touch' with the interests of shareholders," he continued. "The market gives feedback to the board as well as management every day in the form of the company's stock price. A board that does not look after the interests of shareholders will find their company does not remain independent for long. I can understand the frustration of people like George and Liz, but I worry that, if implemented, their proposals would be downright dangerous for the American economy."

"Jack, I think that our viewers still need to be convinced. Many believe that the distorted incentives created by the current compensation models prevalent on Wall Street were major causes of the crisis. And those schemes were all approved by corporate boards. How do you respond to that?"

"Charlie," Jack responded, "we've got to be very clear that there are two different issues here. The first one, the one we are talking about tonight, is which institution or group should determine executive compensation. The second issue, which deserves an entire show itself, is what model of executive compensation is the most likely to create shareholder value over the long term. And in terms of who actually makes the decision, I think that if you allow a direct and binding 'say on pay', you run the risk of decision making being hijacked by special interest groups who do not look out for the interests of the shareholders."

"What do you mean by 'special interests'?"

"A direct 'say on pay' sounds like a great idea, in theory." Jack began. "Let's just institute a model where all of the owners have a voice in important decisions. But we're not talking about 'Mom and Pop' shareholders here. If this idea became reality, companies would be forced to fend off a range of special interests with deep pockets. Union pension funds will promote their political agendas and activist shareholders will try to take over the company on the cheap. That is not much of a democracy."

"George," Charlie asked, "how do you respond to this?"

"Jack's right that some shareholder activists, like my group, represent labor unions and similar organizations. What I disagree with is the implication that activist groups only promote their own special, narrow interests while corporate boards will look towards the interests of all of the shareholders. The average shareholder today holds an investment for just one year, but the members of my organization are long-term investors, and we want the company to be successful. We think companies need to hear our voices directly."

"George," Charlie asked, "there's been a suggestion that broadening corporate decision making will not only lead to a kind of decision-making paralysis, but may hurt the company by empowering individuals who lack the knowledge and experience to make sound business decisions. How do you respond to that?"

"I'm not sure how much experience it takes to look at a financial statement and see that these guys have lost me, and all of the shareholders, a lot of money. One of the reasons these management teams made the decisions that led to such catastrophic losses in shareholder value was that their compensation package incentivized them to take huge risks with the company's money—with my money. I think I should have the right to say 'no' to compensation schemes that put my money at risk. If they want to bring in some consultant to make recommendations, that's fine by me, but it's not right to say that the matter is too complicated for the average shareholders to understand. It's not."

"Charlie," Liz interrupted, "I'd like to respond to this as well, if I may."

"Absolutely."

"George is talking about precisely the sort of frustration among shareholders that I referenced in my earlier remarks. It's not just wealthy people who lost in the financial crisis, but middle-class Americans who saw their retirement accounts diminish in a matter of months. They deserve to know that some sort of system is going to be in place to ensure this doesn't happen again."

"And a government-imposed salary scheme can do that?"

"I think that it does two things: the first is that it shows the world that if the government is required to intervene as a lender of last resort, there will be consequences. The second point is that it takes some of the pressure off the companies who accepted government aid by imposing a blanket compensation requirement."

"Jack," Charlie began, "there's a lot on the table here. What do you think?"

"Well, in regards to George's proposal," Jack responded, "I just don't see how this could possibly work. Logistically, it would be incredibly complicated and would be prohibitively expensive for many companies."

"With respect, Jack," George interrupted, "it doesn't need to be that complicated. What we're suggesting is more of a referendum in which all of the owners can vote on the compensation scheme and other key issues recommended by the board. We're not proposing that every single shareholder drags a chair into the conference room at Global Financial and starts shouting. And as I've mentioned, you don't need a degree in finance to know that if someone has lost tremendous sums of money, they don't get a raise. If executives are asked to resign because they've cost the company tremendous amounts of money—they don't get 'golden parachutes'. . ."

"George," Jack replied quickly, "I agree with you. I don't want a raise if the company loses money! And if I or anyone else resigns after hurting the company, they should not be rewarded with extravagant benefits! But the issue is complicated. We want to create executive compensation programs that will reward executives for driving a company's strategy and objectives and creating shareholder value. We want that system to be consistent with an acceptable risk profile and to encourage legal and ethical behavior. That is a complex set of objectives, and only the Board of Directors is in a position to know the company and its business well enough to achieve them."

"Now, I'm going to interrupt you both," Liz interjected. "Jack, I agree with you that it is a complex task. But it is clear to most Americans that the boards of the Wall Street investment banks were not up to the task. That's why the Federal government needs to step in and do the job for them. Since I've had my current position, I have heard from virtually all of the CEOs of companies that accepted the TARP funds, complaining bitterly about their inability to keep their high-performing 'superstars' who are being wooed by companies not subject to the salary caps. I am aware that AIG has already lost half of its top 25 highest paid executives to competitors."

"I know, Liz." Jack responded. "We hired two of their insurance people. We were able to hire them because we never even considered taking any of the TARP funds. We are not an investment banking firm and we were never part of Wall Street's meltdown. But under your proposal, our executive compensation would be determined by the government, even though we aren't a Wall Street firm and weren't part of the problem. Global Financial can do our part in pulling this economy out of recession, but not if you put those kinds of handcuffs on us. If the government limits the compensation we can pay, we will lose our key executives to hedge funds and foreign-owned financial firms that don't have to comply with restrictions imposed by the US government on public companies. Once again, government intervention would lead to adverse unintended consequences."

"The fact is that we now have two tracks in the financial services industry, one for companies who accepted government assistance and one for companies who did not or did and returned the funds," Liz explained. "The latter group is obviously going to be able to out-pay the former group by a large margin given the government's restrictions on executive compensation. We're already seeing companies returning the TARP funds in order to free themselves from what they see as an untenable situation. The fear is real. Jack is right about that. Top performers are leaving to go to other companies whose compensation schemes are not subject to limitations."

"Why shouldn't the government simply lift the restrictions on executive compensation that come with accepted government assistance?" Charlie asked. "Wouldn't that solve the problem?"

"I don't think so," Liz said carefully. "Again, it is not necessarily about the size of the compensation package, but about whether it is designed to incentivize the right behaviors. Corporate boards have failed, in many cases, to make sure that compensation schemes protected the shareholders from taking undue risk while increasing payouts to management. And as long as one board is willing to offer these extravagant and inappropriate packages, the rest of the companies will have to follow suit. Only the government can ensure that compensation schemes are designed to incentivize the right types of risk-taking and protect the shareholders across the board. Like George, I think that the old model has failed and we need a new approach.

"George," Charlie asked, "what's your opinion on this?"

"The mission of my organization is the empowerment of the shareholder and forcing corporations to be accountable." George shook his head. "The irony here is that we seem to be the only participant in this debate who remembers that shareholders are not uninformed interlopers. We are the owners of the company."

"I can understand George's objection," Liz responded, "but he's got a collective action problem. Unless he can get the shareholders of an entire industry to act in unison, the ones who change their compensation plan in response to shareholder direction will be tremendously disadvantaged. The role of

the government, historically, is to step in and resolve collective action problems."

"Jack," Charlie turned and asked, "what do you think?"

"Well, Charlie," Jack looked at Liz and George thoughtfully. "I think that both Liz and George have made excellent points tonight. George is right, the shareholders are the owners of the company and their interests should be of the utmost concern to both the executive and the Board. I'm impressed with Liz's grasp on the unique and troubling situation facing the companies who accepted TARP funds; it must be especially hard for those companies who were made an offer they 'couldn't refuse'. But I am unconvinced by their arguments. First, the government has demonstrated in the past that it is not capable of determining compensation levels in an effective way. This sort of government intervention in executive compensation will result in significant distortions which will undermine our economic system. Second, there were some boards who failed their shareholders by being asleep at the switch, but to sanction the entire financial services industry through an overthrow of the current model isn't fair to those companies and boards who were and are doing the right thing. Finally, there are ways we can improve the current system without these sorts of wholesale changes, and that is where we need to begin."

"Unfortunately," Charlie said, turning to the camera, "we're out of time. I think that what we have seen tonight is that executive compensation in the financial services industry is a contentious issue which may be with us for a long time. Thanks for joining us. Good night."

QUESTIONS

1. The Conference Board Task Force on Executive Compensation, in its 2009 report says, "Compensation programs should be designed to drive a company's business strategy and objectives and create shareholder value, consistent with an acceptable risk profile and through legal and ethical means."[1] To what extent do you agree with this statement? Whose job is it to oversee the development and implementation of such compensation programs? The company's Board of Directors? Shareholders directly? Government? Someone else?

2. Pearl Meyer, an executive compensation consultant, said the following: "Unfortunately, institutional investors, corporate governance activists and even SEC regulations have led many corporations to define performance simply as stock performance—to disregard a corporation's vision and . . . its value system. This structure stimulates extreme emotions—exuberant greed when things are

going well, demoralization when the market falls and everyone's options are under water."[2] What role has each of these groups played in equating corporate value with stock value? How should we understand the conception of "corporate value"?

3. "Institutional investors now own approximately 60% of U.S. equities (using other people's money). Some observers say, while there are some long-term value holders, many of these investors are driven by the goals of short-term performance in their portfolios, so they engage in relatively short-term trading strategies and have little interest in the creation of long-term economic value of the corporations whose securities they own and trade."[3] William Allen, Director of the Center for Law and Business at NYU, says that the average stockholder today holds a stock for one year. If the typical institutional investor has a one-year time horizon, how do you believe that a "say on pay" would affect the executive compensation structures of companies?

4. "Effective corporate governance requires that decision-making authority be vested in a small, discrete central agency rather than in a large, diffuse electorate."[4] Many commentators argue that allowing shareholders a direct vote on compensation plans (or other important business decisions) will create serious problems for both owners and management. One problem could be described as procedural, namely, a large and unwieldy group of shareholders will find it difficult to focus their discussions and make decisions. Second, critics argue that the average shareholder lacks both the business acumen and the interest to make decisions which are in the long-term interest of the company. A third problem is that activist institutional investors are likely to be union and public employee pension funds, whose interests may differ substantially from those of average investors. Union pension funds are perceived to be attempting to use their voting power to obtain benefits they could not through bargaining. Public employee pension funds are perceived to have their own political agendas. In this situation, it is possible that shareholders will make decisions on the basis of less-than-optimal information and/or be swayed by issues that will not promote shareholder value. Are you persuaded by these three arguments? Do you believe that significant harm could result if shareholders are given a direct and binding (vs. advisory) "say on pay"?

5. Anne Sheehan, the Director of Corporate Governance for CalSTRS (California State Teachers' Retirement System) believes executive pay has become a moral issue. "I think that the matter of pay has moral connotations, when you consider that regular working people have lost half of their 401(k)s, and many have lost their jobs, only to see over-the-top bonuses paid out to those responsible for the mess. The moral outrage needs to be acknowledged, and if companies don't respond to the issue, the government will." [5] Do you believe that the current levels of executive compensation constitute a moral outrage? One of the arguments in favor of allowing compensation to be determined directly by the shareholders is that corporate Boards of Directors are "out-of-touch" with what average Americans (and shareholders) believe is morally appropriate or fair. Do you think that this is a good reason to support a direct "say on pay"? Do you think it is a good reason to support government intervention in executive compensation?

6. Advocates of government intervention in executive compensation argue that corporations operate within the context of a social contract with society. The contract stipulates the limits and the benefits of the relationship between the corporation and society. An important assumption of this argument is that particular corporations do not have an inherent right to exist. When corporations violate provisions of the social contract or the existence of the contract is proven to be harmful to society, society has an obligation to intervene and revise the terms of the contract. Arthur Levitt poses the following question, "Is corporate America bending the social contract that business has with the American public?"[6] Levitt answers this question in the affirmative. Do you agree with Levitt? Do you think that the government has the right or the obligation to be involved with executive compensation? If so, how should it be involved?

7. "There's strong evidence that far from being too much, many CEOs are paid too little. Not only do the top managers of multibillion-dollar corporations earn less than basketball players. . .they are outpaced in compensation by financial impresarios at hedge funds, private equity firms, and investment banks. Should we care? Yes. If other positions pay far more, then the best and the brightest minds will be drawn away from running major businesses to pursuits that may not be as socially useful—if not to the basketball court, then to money management."[7] Some argue that if executive pay is capped or unduly regulated by the government or shareholders, talented individuals will be unwilling to work as corporate executives. Instead, they will head for more lucrative positions with

hedge funds and private equity firms or with foreign employers not bound by such regulation. At these firms, they can make more money while avoiding the negative publicity recently attached to executive paychecks. Do you think that this is a reasonable concern? Should it influence our thinking on who decides executive pay?

8. Jeffrey Immelt, CEO of General Electric has said, "I can't run this company if I have to worry about asking for shareholder approval to determine how the guy who is running, say, the energy business is paid. We won't be able to compete with the Chinese, the Japanese, and others who will have more freedom to make decisions about talent and leadership."[8] Do you agree with Mr. Immelt? Does government or shareholder interference in executive compensation pose a danger to the growth of American corporations and the soundness of the American economy?

9. Some argue that legislative interference in executive compensation in the early 1990s led to the current crisis. "In 1992, the government thought that managers were too risk-adverse. Stock options were seen as the magic bullet for making managers act more aggressively in the shareholders' interest. Today, many in Congress are blaming executives for causing the financial crisis precisely by engaging in 'excessive' risk-taking. What they fail to mention is that it was Congress's own tinkering with the tax code that led to the very compensation packages that incentivized risk-taking."[9] Do you think it is possible, or even likely, that government intervention may do more harm than good in this situation?

10. Michael McConnell argued that the establishment of the "pay czar" was unconstitutional and represented an abuse of power by the Obama administration. "The power to set compensation at large American businesses is especially subject to political abuse, favoritism, arbitrariness or political manipulation. . . .Because he is not an appointed officer of the United States, Mr. Feinberg's executive compensation decisions were unconstitutional."[10] Do you agree with Mr. McConnell's assessment? Does Mr. Feinberg's appointment represent a dangerous precedent?

"It's interesting to see that you're grappling with ethical issues and you don't know all of the answers, either. In a way that's heartening since it means we're grappling with these issues together."

Richard DeGeorge

THE DISCUSSION

Jim Mitchell reminded the group of the main question posed by the case, "The question we're asking is 'Who are the right people to decide about executive compensation?' Not whether it is too high or too low, but who ought to decide. Maybe we could paraphrase it as 'Who's most likely to help improve the compensation structure so that we're incentivizing people to do the right things and rewarding them appropriately when they do'?"

Steve Anderson suggested that whatever group was in the best position to assess the executive's contribution to shareholder value should decide on the compensation. "Isn't it whose perspective is the most informed? Because ultimately the reason we get paid is to drive shareholder value. Who has the best vantage point to make the best decision about compensation versus return?"

John DesPrez said his thinking has changed in the last couple of years, "Five years ago, I would have told you that since shareholders own the company, they should get to decide. This is classic corporate theory. The Boards of Directors are simply the representatives of the shareholders. But shareholder democracy is an illusion. They can vote with their feet and that's how they vote, not at a shareholder meeting. Most institutional shareholders aren't interested in the long-term growth of the company."

Laura Hartman listens as Paul Amos comments on a dilemma.

A MORAL RESPONSIBILITY TO STEWARDSHIP

Richard DeGeorge raised an intriguing point. "I've been bothered by an assumption that seems to be floating around that paying executives large amounts is unethical. Is this really an ethical issue? Is it wrong to pay people a million dollars, $8 million, $20 million? Where do we draw the line? Certainly paying executives is not wrong."

Ron Duska was sympathetic to DeGeorge's point, but believed there was more to the issue. "There is just something unseemly about the level of pay in the financial services industry, not so much in the commercial banking area and insurance, but in the investment banking and derivatives markets. I think it's kind of an intuitive notion that the amount of money hedge fund operators and the people on Wall Street are making is just outrageous. It's outrageous somebody can make $20 billion by simply trading and not doing any kind of real work."

Paul Amos offered an explanation for the feeling of moral outrage. "If you look at the market as a whole throughout history, the average investor was betting long. The problem with hedge funds is that they are not only contributing to the volatility, but profiting from the volatility. So the average investor does not see the long-term gain, and so they don't feel that they're profiting from the market. What they're seeing instead is that hedge funds are able to drive up volatility so quickly, and they're making profits from

Kevin Gibson pays attention to Denis Arnold's case.

that, yet the market as a whole is not yielding profits for the average American. I think this inherently makes people feel that the hedge funds are getting something that the average person doesn't have access to. In the past, most people saw the market as being accessible to everyone if you had the financial means to invest in it."

Diana Robertson thought the moral outrage might also be fueled by the belief that executives are not using their money to benefit society. "I think another part of the moral outrage is the notion that executives should be stewards of the money. We don't tend to worry about how the ballplayers and the movie stars use their money, but we worry about executives who make so much money and are not taking their stewardship responsibility seriously."


Steve Bartlett makes a point.

Laura Hartman wondered where questions about the moral responsibility of stewardship fit into a capitalist society. "We live in a society that purports to be capitalistic, and certainly we claim to be an open market, but we all accept, as business people, that there are restraints on that open market. Maybe our expectations are, 'we'll let you make as much as you can, but you're not supposed to harm people while doing it.' So you do have a responsibility not to take advantage of others, and perhaps to try to help. I think that we as a group think there is a positive responsibility, but we have not articulated it yet."

Steve Bartlett picked up on Hartman's point. "I think people expect a system where the compensation someone makes is directly and transparently related to the value they're adding for their shareholders. And in that sense, 'say on pay' is not designed to set the pay. It's designed to put a spotlight on pay. It can't be 'make all you can', it's make all you can for your shareholders legally and ethically and then get paid commensurate with that."

THE ROLE OF THE CORPORATE BOARD

Julie Ragatz noted that the public seems suspicious of the independence of corporate boards. "People who don't get to talk to you and hear this information first hand think that the corporate boards, those 'incestuous, chummy' boards, are designing compensation in a way that creates inappropriate incentives. Therefore, boards should not have the right to determine compensation."

DesPrez responded that, "the inside deal with the Board is over, with a vengeance. If anything, the pendulum has shifted too far the other way. In some companies it is almost a war between the management and the Board."

Denis Arnold took a historical perspective on the issue. "If we look over the last 20 years, this is not a new problem. There was an article in *Fortune* about this five or ten years back entitled, "Pigs at the Trough". I think that we've been evolving in terms of best practices, to better tie pay to performance, but I'll ask one question: How many annual reports provide full disclosure in plain language of executive compensation packages, including a cash value for all benefits provided?"

Bartlett responded, "All the proxies provide that information now. But three years ago, they didn't. The 'pigs at the trough' was, in too many cases, true. It was the 'good ol' boy' network on the boards and the compensation committees. That was the sad fact, but it's gone now."

Dennis Johnson added that part of the 'pigs at the trough' mentality might be exacerbated by the structure of executive compensation that places a heavy weight on the annual bonus. "If you have a compensation system where salaries are only about 10% of the package, it could be that you need that bonus to make your mortgage payment. I think you have a personal responsibility not to leverage yourself so much that you have to go begging for a bonus in a year in which you don't deserve it. You're a 'pig at the trough' if you've structured your personal life in such a way that you're asking for things you shouldn't be asking for."

"When you're a leader, sometimes you have to walk people through the process, step by step, even if it was a normal and everyday occurrence for you. If you don't, they won't know what you expect of them."

Laura Hartman

WHAT KIND OF INCENTIVES?

Kevin Gibson noted that in reading the case he noticed the following underlying assumption: "If you pay people lots, they will work hard, and the more you pay, the harder they will work." But he thought there is something else going on in terms of what really motivates employees. Pay is not the only incentive. "I think we have to distinguish between incentives and compensation. And what I would like to hear from the executives is whether you can incentivize people to do the right thing."

DesPrez answered that it's important to understand that the incentive is not designed to influence only the behavior of the person receiving it. "You're not just incentivizing the person you're paying, you're incentivizing an organization and a whole pyramid of people below the person you're paying who are willing to work for 20 years and have the opportunity to be the guy that's getting the big check."

Paul Amos believed you can motivate people to work harder and do the right thing with money, but he added that, "I think it would be negligent of all of us to think that money is the only reward that motivates people. We need to consider those incentives that are outside of what is on the payroll, and you have to understand what motivates an individual to work. If I give everyone the same package, I'm only going to satisfy one person."

"One of the benefits of a Chief Ethics Officer is that there's someone outside of the executive suite who has the responsibility for managing the organizational integrity issues."

Denis Arnold

THE EFFECT OF "SAY ON PAY"

DesPrez noted that most of the larger companies in Canada adopted "say on pay" in 2009, but he didn't think it had an impact on how management ran the company. "It probably compels the Board to pay more attention to these issues, which they're doing anyway. The problem is that it's an illusion that most shareholders are engaged and that they bring a greater level of expertise than the directors. You need a series of checks and balances. The Board is supposed to provide a check on management and shareholders are supposed to provide a check on the Board."

DeGeorge wondered whether American firms would agree to legislation mandating "say on pay". "Would any of you object to legislating 'say on pay'?"

Bartlett answered, "We think it ought to be legislated if it's structured correctly. There should be a non-binding initiative. In effect, 'say on pay' should provide a data point for the Board, but we're still letting the Board decide."

Mitchell wondered whether a "say on pay" initiative would make a difference. "Will boards do anything different from what they would have done anyway?"

Bartlett responded that a "say on pay" initiative would make a difference. "They'll know there's this big spotlight, on them. Boards are going to say, 'Wait a minute. We need to think about what this is going to do to our reputation.' So it will improve behavior."

THE PRACTITIONERS' ETHICAL DILEMMAS

At this point, each of the practitioners was asked to present an ethical dilemma that he has faced in business.

ISSUE #1: WHETHER TO PAY FOR "INTERNAL REPLACEMENTS"

My dilemma deals with the consequences when agents repurpose a client from one financial product to another, and earn a commission on both transactions. In a particular case, they redeem their client's mutual funds and then purchase a variable product. These trades, on their face, are good trades. We have a comprehensive compliance program and we look through all of our transactions very carefully. Five years ago, we didn't compensate our agents for any internal replacement, and the amount of these transactions dropped to almost zero. Some of our top producers argued that there is real work involved in orchestrating these replacements and that, in most cases, they are in the best interest of the customer. We decided to pay commissions on these transactions, but we tried to structure the thing so it protected the customer. For example, like most organizations, we have a holding period. You need to hold a product for a period of time before we'll allow any replacement transaction.

Richard DeGeorge and Steve Anderson listen to the discussion.

The question on the table for us is whether we should continue this practice. There are two issues here. The first is that repurposing transactions make up 35% of my total volume in VA sales. I am not naïve, and I know that some of the deals may not be in the best interest of client. The second is that the organization grows through bringing in and serving new clients, not just moving money around with our current customers. Thus, it may not be in the long-term interests of the company to pay our salespeople for these replacements. Obviously, the financial ramifications of not paying on these transactions would not be good for the company in the short term, but we view ourselves as a caretaker for the customer, so this is a real concern for us.

Laura Hartman suggested that this was a matter of balancing the competing interests. "I think we have to ask, keeping the best interest of the customer in mind, what's the appropriate percentage of transactions like this? You don't want your agents refusing to do a transaction the customer needs since it is not worth his time but, on the other hand, you don't want agents pushing an inappropriate trade on the customer to make some quick money."

Steve Bartlett noted that it was important not to emphasize the new sales too much. "Just because it's new money doesn't make it the right product for the customer. My point is that whether it's new money or an existing account, you've got to have some kind of second look at the transaction from someone besides the salesperson."

Diane Robertson observed that despite regulatory and compliance assurances, management still appeared less than comfortable with the current arrangement. "The question is how you can put in place a structure to change what's going on if there are individuals who are taking advantage of the situation. This is about trust, which is what we keep talking about."

Kevin Gibson suggested that it is important to articulate the principles that inform decisions about compensation structures. "The prime directive here, as I understand it, is that you're working on behalf of the customer. And that will govern every other decision that is made about compensation. Also, the agents are working for the company, and they've got to bear in mind what is in the best interest of the company. If I were an agent, I would like to hear how these principles justify the difference in compensation."

Richard DeGeorge added that the best we could hope for was a range that would be acceptable. "Your principles won't give you a definite number. They won't say you have to have 17% for this and 65% for that. We shouldn't expect ethical considerations to give you a fixed number, but they can help determine the range."

ISSUE #2: THE INFLUENCE OF DISTRIBUTION CHANNELS

In the supplemental or voluntary worksite benefits business, we sell 95% of all of our insurance through the workplace. Up until recently, we sold 100% individual insurance. These policies are individually written and owned by the individual. They're fully portable and consumers can take them with them wherever they want to go at the same rate. This is an ideal consumer situation because they own the policy. They're empowered and we've never really had a rate increase. There have been some small adjustments, but that is on a state-by-state, or class-by-class basis. There is none of this annual re-rate thing.

The recent trend is the group platform becoming more popular, especially with larger businesses. In a group platform, the policy is owned by the company and there are certificates issued to each individual, which may or may not be a portable product. In my opinion, the value of this insurance product is not as high as the individual policy, although they are both excellent products. My dilemma arises when brokers and institutions want the group platform since it maximizes their enrollment, as well as their capability to re-rate the insurance. My question is what duty do I have to try and push something that I believe is better for the customer, yet is less demanded by the intermediaries?

Denis Arnold noted that almost every corporate value statement claims that one of the primary concerns of the corporation is the well being of its customers. "It's pretty clear to me that what I would want, and what I would want for my employees, is a choice. I think that's important. In an ideal world, employees would have a choice and they would be given a piece of paper where the descriptions of the plans were provided, along with a list of the pros and cons of each plan."

Dennis Johnson saw structural constraints at play in this situation. "Isn't the reality that no matter what you think is the better policy for the customer, if you can't sell it to the companies, it's not going to be offered to the consumer. The companies are really the funnels that determine what product gets offered to the group in the first place. And if this is true, this dilemma is a dilemma for all insurance providers of this sort in the marketplace."

Kevin Gibson with Angela and John DesPrez at the reception.

Jim Mitchell believed that if these are both good products, then consumers are better off by having either one. "If they get the group product when they wouldn't have had access to the individual product, they're better off. If they got the individual product, when they wouldn't have the group product, they're better off. So let the marketplace decide. It's a situation of right versus right."

ISSUE #3: DUTY TO WHOM?

This dilemma concerns a hypothetical situation in which an attorney was hired by the CEO to act as General Counsel. As General Counsel, the attorney acts as the corporate secretary and as the corporate lawyer for the organization. He reports directly to the CEO who hired him. At a Board meeting, the attorney is approached by two directors, the lead director and the vice chairman, who ask for a private meeting with the General Counsel. During this meeting, the board members state that they are speaking on behalf of the entire Board and are looking to remove the CEO.

Elizabeth Lentini and Dennis Johnson at the final dinner.

There are obviously important questions regarding client confidentiality here, since the two directors expect their conference will be kept in confidence. Does the attorney have an obligation to tell the CEO what's going on? If so, would this override his obligation of confidentiality? How does this information affect the attorney's ongoing relationship with the CEO? Should he be loyal to the CEO, the person who hired him?

Steve Anderson wondered who was the attorney's client. "Doesn't the General Counsel work for the corporation? Isn't his primary duty to the corporation?"

Dennis Johnson agreed that this was the key issue. "That's the question that ought to be answered. Who does the attorney work for?"

John DesPrez thought the tricky issue is whether the attorney had any obligation to the CEO if he knew the Board was planning to take action. "That's the really hard question. Do you have an obligation to tell the CEO? Under the code of ethics, they expect that there will be absolute confidentiality for any conversation they have with you."

Laura Hartman distinguished between the corporation and its advisors. "The client is the corporation and the fiduciary duty is to the corporation, not to its officers. You do whatever is in the best interest of the corporation. If someone comes in and says, 'I have to tell you something, and I need to know that you're not going to share this with anyone else' then perhaps the right response is to say, 'You know, I can't promise you that. Maybe you shouldn't tell me.'"

Steve Bartlett believed it was incumbent on the attorney to tell the board members to talk to the CEO. "I think you have an obligation to advise these two directors to talk with the CEO, unless they suspect him of some kind of malfeasance. If you're going to depose the guy, it's not like he's not going to notice. So be an adult, go and talk to him."

ISSUE #4: TO PIERCE THE "WALL OF SILENCE"?

I became aware of some information regarding the soundness of a mortgage subsidiary of a large corporation. I didn't know absolutely, but I had a suspicion that their practices were unethical. There were a couple of clues. I was hearing things from my contacts in the industry and they weren't good. But I was not certain, and I wasn't sure it was my place to call up this CEO and say, 'Hey, the word is that your subsidiary is not running a great operation.' After the problems had come to light, he called and asked if I had known what was going on. He was convinced that I should have come to him and told him my concerns, and as I look back on it, I believe he was right

Richard DeGeorge wanted to know how he was privy to this information. "How is it that you were able to find out what was going on when the CEO didn't even know what his own people were doing?"

Jim Mitchell didn't think this was all that surprising. "It's more common that you might think. It can be really hard for the CEO to know the truth about what is going on in the organization. Unless CEOs make it clear that they really want the unvarnished truth, they can be the last people to know. Subordinates want to fix the problem; they don't want to bring it to the CEO. And if they can't get it fixed and the whole situation escalates, then they may be afraid to tell the CEO."

Dennis Johnson agreed and added, "Sometimes CEOs compound this problem by how they've handled bad news in the past. If every time someone brings me bad news, I shoot the messenger, people are not going to want to bring me the bad news anymore."

Steve Bartlett said the problem arose because corporations got away from transparency and a focus on the mission of serving customers. "If you start with, 'Is this fair?' in plain English, you can smoke a lot of bad stuff out. But at the CEO level, they were starting with 'what are the metrics, what are the earnings, what are the margins, what's the market share?' The corporate

"Part of the history of the corporation is its stories and its heroes, and it's really important that these are spread throughout the organization."

Kevin Gibson

officers and the CEOs may not have known what it was taking to get that market share and all the rest, they just knew it was working."

ISSUE #5: MAKING CLIENTS "WHOLE"

Like other financial services institutions, we have a variety of distribution operations that sell our products, but from time to time we sell or provide referrals to other people's products. In one case, we referred some of our clients to a limited partnership opportunity. In total, we referred about $800 million, which was about 40% of the total offering. The partnership went along fine for a year or two, but when the regulators requested an audit report it turned out that there were some problems. The bottom line was that some of the money appeared to be missing and overnight the partnership interests lost half their value. At this point, no one knew what the actual facts were. All we knew was that some of the money was probably not there. The losses generated negative press and our name was all over the story. It was not a good PR situation. Although we didn't have any legal obligation in this situation, we decided to effectively repurchase our clients' interest for what they paid for it. In the end, the amount of positive coverage and customer support was tremendous and our losses on the partnership investments did not turn out to be significant.

Steve and Gail Bartlett arrive at dinner.

Laura Hartman was concerned about the precedent that was set. "I would be wondering if we were prepared to do this every time an anomaly comes up. We might get more customers, but they'll be convinced that if they put their money with us, we'll make them whole if something happens. I am concerned about that."

Steve Bartlett took the opposite view. "I think it is a positive precedent. I think of Chubb immediately after 9/11. The property and casualty insurance world was in a free fall because all of the companies were reporting that this was an uncovered event, because it was an act of war. So the CEO of Chubb walked in front of the cameras and said 'we'll pay every claim with every asset we have,

Paul Amos listens to Laura Hartman.

including my office furniture.' After he did that, everything settled down."

Dennis Johnson believed that this was the right decision, "The brand of the entire institution may be at stake and that's worth a whole lot more than you stand to lose. And the longer it takes to make the decision, the more it's going to cost you."

Paul Amos agreed with Johnson. "You can't build a brand overnight. But you can make a decision to pay those claims if you're Chubb, or take your client's place in this transaction. If I were in their shoes, I would have tried to pay it. Your brand and the trust of your customers are the most important things you have."

"It was important for me to hear all of you [business people] using these words we [academics] use all of the time. Somehow I didn't realize that you were talking about transparency and trust and values and community involvement."

Diana Robertson

THE PHILOSOPHERS' QUESTIONS

QUESTION #1: GIBSON

Stakeholder Theory has its origins in the idea that a company is responsible to everyone who has an interest or a stake in the company. It creates an alternative to the theory of management which argues that the only responsibility of management is to look out for the interests of investors. Linked to Stakeholder Theory is the concept of Corporate Social Responsibility (CSR), which is the idea that corporations should give back to their communities. There are two different approaches to CSR.The first is strategic and justifies giving on the belief that helping the community is in the long-term best interest of the firm. Another approach suggests corporations are obliged to care for stakeholders even if there is never a payoff; it's just the right thing to do. Research on the top 500 companies shows that CSR is not empty rhetoric. Companies actually put a lot of money into these sorts of community initiatives, even when it's not clear they're earning a financial return on their efforts. My question is does a company have a responsibility to its community, particularly during hard times, and how should this responsibility be accounted for?

John DesPrez listens to Denis Arnold.

Dennis Johnson thought community responsibility should go beyond giving money. "People are apt to accuse corporations of being cynical when they donate corporate, rather than personal resources. But if I am digging into my own pocketbook, that can make a difference. But more than that, I ask my employees not only to donate money, but also to donate time. It's a multi-faceted approach: donating corporate resources, contributing your own money and time and showing that you're genuinely willing to do that. I think there is a contract between the community and your corporation. They're providing for you and you ought to give something back."

Laura Hartman wasn't convinced. "Why? It's fine if you give time on your own and you do it because you think you should and it's important, but I don't see why a company has an obligation. I think once you go that route it becomes difficult to say where the responsibility ends."

Steve Bartlett believed that social responsibility does not just have an impact on the bottom line, but can benefit companies in other ways. "I was looking at the data on the financial services organizations we represent, and it was something like 100 different companies did 40,000 community service projects which touched the lives of over 3 million people. Sure, it's good for their reputation, but when I talk to executives they say it's really good for their corporate culture. It helps when their management and employees engage collectively in public service."

Steve Anderson agreed that community service had both individual and collective benefits. "As people, we get intrinsic value from aligning our actions with what we believe to be our inner set of standards. I'm not sure if it's my company's responsibility to do all the things we've done, but as long as I'm a thought leader in that organization, I will insist that it is our responsibility to try to give someone else the same opportunities we've received."

Diane Robertson wasn't certain it was necessary to determine whether the motivations for community service were altruistic or self-interested. "Sometimes I challenge my graduate students to give an example of a decision which was made solely because it was the right thing to do and, for the most part, that's very challenging. Most of the examples we teach in business ethics reflect 'enlightened self-interest' where companies strive to align the needs of the business with the needs of others."


Julie Ragatz, Kevin Gibson and Dennis Johnson enjoy the reception.

QUESTION #2: ARNOLD

Recently, a large pharmaceutical company settled with the Department of Justice and the FDA for off-label marketing. Off-label marketing occurs when pharmaceutical representatives are directed to market a drug to physicians for a disease for which it has not received FDA approval. They were fined $2.3 billion, which was the largest criminal settlement with a company in the United States ever. In this case, six different pharmaceutical representatives from all over the country blew the whistle on the company. These representatives claimed they were being directed to market the products to physicians for off-label uses. My question *is what's going on in the culture of this organization?*

John DesPrez didn't think it was difficult to see how something like this could happen. "Sales representatives are under enormous pressure to get their numbers up, and there was evidently no organizational penalty to them for off-label marketing. If management is on them in terms of making their numbers, I can just see the head of Sales saying, 'since you haven't provided us with a good enough product to reach our sales goals, we'll have to move outside of the parameters you've provided.'"

Steve Bartlett agreed with DesPrez that the sales representatives were motivated by material conditions, but he thought something else was involved as well. "I suspect that senior management never articulated that off-label marketing was a real problem. They likely never made a big deal of it as a value proposition. They probably focused on it as a compliance issue. But they didn't make it a core value."

Jim noted that the problem might be in the sales goals. "Goals need to be perceived as challenging, but achievable. If you put people out there with goals they don't think they can make, you encourage them to cut corners."

Paul Amos emphasized the importance of swift consequences for infractions, especially in cases like this one. "Really getting to understand the values and why this behavior is wrong is great, but they also have to understand the penalty. We run our business on three principles of risk management: don't risk a lot for a little; consider the odds; and don't risk more than you can afford to lose. If management were to have consistently said those three things, I don't believe this practice would've happened."

Ron Duska wondered if the sales representatives' behavior could be explained by the difference between the culture of the field and the home office. "When I see field people engaging with home office people, it seems as though they live in two totally different worlds. How do you handle that duality between the field and your home office?"

Amos noted that his field background helped him achieve a level of credibility with his field force that he may not have had otherwise. "I find that headquarters people can't think like our field people. I have to translate things all of the time. It's such a different mentality because the salespeople are looking at how to win and the headquarters people are looking how to abide by the rules and those are two different philosophies. Many times they align, but a lot of times they don't. And so it is very difficult."

QUESTION #3: ROBERTSON

Recently, some have raised the question of whether business schools should be held responsible for the financial crisis because they've failed to prepare students for the ethical challenges they will face in business. My question is what would you like to see us do differently? What skills would you like us to build in our students? One of the questions we're asking is what mix of students we should have. But we are also considering what kind of culture we should be building and what skills we should be emphasizing. Do you have any suggestions?

Steve Bartlett offered two suggestions for improving the education of MBA students. "The first is to integrate values as a core component of every course and the second is to develop case studies based on events in entry-level jobs. You can't give entry-level students a case study involving a senior management decision. You need to focus on the situations they'll face in their first five years on the job."

Jim Mitchell agreed with the importance of building values into the curriculum. "Some Wall Street firms have done a lousy job of managing risks, but that's because the upside reward seemed to be greater than the downside risk. It was in no one's interest to point out they were doing a poor job in managing risk. You can teach the quantitative skills of risk management, but the real answer lies in clarifying and reinforcing people's individual values."

Paul Amos identified two qualities he would like to see from recent MBA graduates. "Number one is a better sense of what's going to happen over the next 10 years in terms of their career track. Some believe that by just showing up for work and doing their job description, they deserve a promotion. The expectation should be to come in, work hard, be willing to be accountable and work your way up through the company. The second quality is leadership capability, not in an academic sense, but the capacity to manage different levels of people all throughout the organization."

Richard DeGeorge wondered whether the importance of ethics education is communicated to Human Resources. "We have CEOs telling us that they

"People have to believe that you're going to live up to the promises that you make. Absent that, you're out of business in a hurry."

John DesPrez

want ethical people, but what about the people who are doing the hiring? Do they look at a transcript and ask whether ethical issues were discussed in their college courses? Are the HR people asking 'what is the ethical character of this person?' Are people committed to asking these questions, getting the answers and making decisions based on that answer?"

Mitchell believed an ethical reputation made a difference. "You would be amazed at the number of people who self-selected out of our hiring process because they didn't particularly want to work hard at living the values that were such an important part of our culture. But a lot of people with our values found us to be the employer of choice."

QUESTION #4: HARTMAN

I'm wondering how you reward ethical behavior in your organizations. This is a sort of age-old question for academics, and we still haven't found the right answer. Besides the challenge of creating incentives for doing good, it's also important to determine how we describe "doing good". So I have two questions. First, how do you create incentives for really decent, standard behavior, and second, how do you reward behavior that really goes beyond what is expected?

Paul Amos said an effective incentive system is a multi-level process. "In our organization, every person is evaluated on ethics. It is built into the evaluation process. If my direct reports don't get a perfect score on the ethics component of the evaluation, they're off my team. There is also a direct tie between our evaluation process and the bonus you receive as well as the possibility of promotion. In addition, for every organization in the company, we have what we call a 'spot-award budget'. Managers are given access to a fund that they can

Paul Amos listens to Dennis Johnson.

use at their discretion to reward people for going above and beyond, for making the right decision. On several occasions, I've personally rewarded people for making a decision that was the right decision, even though it may have cost the company money."

Denis Arnold suggested that some executives find it helpful to appoint a dedicated ethics officer. "One of the benefits of a Chief Ethics Officer is that there's someone outside of the executive suite who has the responsibility for managing the organizational integrity issues within the organization. Basically, the Chief Ethics Officer is responsible for articulating corporate values and ensuring that values are embraced by managers throughout the organization"

John DesPrez wasn't convinced. "Isn't all of this management's role? This seems like a complete abdication of management's responsibility. One of the realities of corporate culture is that when you set up a specialized function to deal with something, everyone else believes that it is no longer their responsibility."

Dennis Johnson thought that the CEO should function as the Chief Ethics Officer. "I think that the CEO needs to ensure ethical standards are met by everyone in the organization."

Tomand Diana Robertson and Richard and Fern DeGeorge on the final night.

QUESTION #5: DEGEORGE

Financial institutions have come in for an enormous amount of criticism, right or wrong, since the onset of the financial crisis. What I've been looking for from financial services organizations is a statement that says, 'This is what we, as an industry, contribute to society. These are our commitments to society and this is how we haven't lived up to our commitments. We are accountable for living up to these principles and you can judge in the future whether we do so or not.' Are financial institutions prepared to come out with a series of statements like this?

Steve Bartlett agreed that these are good ideas. "We're working on a code of ethics for the financial services industry that outlines our responsibilities to the people we serve. As an industry, we have dug ourselves into a hole and finally, I believe we've stopped digging that hole. Now it's a matter of rebuilding that trust, which is the purpose of a code of ethics."

John DesPrez didn't believe the cause of the financial crisis is as simple as it has been made out to be. "I think there's a myth that a bunch of people did a bunch of bad things. But that's not right. A bunch of people took a lot of risk in a calculated way. It's not that the risk people didn't know what could happen; it's that they believed the risks were so remote they were willing to take the chance. There was no penalty built into the system. The risk was priced incorrectly."

Dennis Johnson added that there is also a failure to distinguish different aspects of the financial services industry. "One of the problems is lumping all of the companies together and not differentiating between the investment banks and the insurance companies. You have to look at the specific problems with individual companies rather than thinking they were all bad apples."

Jim Mitchell noted that executives who speak up on behalf of the industry often take a risk. "I've heard this time and time again from CEOs; they're concerned that if they stick their heads up, they become a target for the press, a target for legislators and a target for their regulators. But Steve's leadership at the Financial Services Roundtable is beginning to make it easier for executives to speak out."

CREATING AN ETHICAL CULTURE

Jim Mitchell shifted the conversation to the importance of creating an ethical culture. He asked several questions. "How do you create an ethical culture? What are the obstacles, and how do you overcome them? How do we go about creating and sustaining an organization that behaves in an ethical way?"

Kevin Gibson said that he believed that at the core of any ethical culture is the corporate narrative. "Part of the history of the corporation is its stories and its heroes, and it's really important that these are spread throughout the organization."

Laura Hartman noted that the details of the decision-making process described in a story can be just as important as the outcome. "When you're a leader, sometimes you have to walk people through the process, step by step, even if it was a normal and everyday occurrence for you. You have to show others how you arrived at your outcome. If you don't, they won't know what you expect of them."

Dennis Johnson said that he believed creating an ethical culture went beyond what people did at the office. "It's also how you deal with people when you're in the grocery store or in traffic or at home. People are watching all of the time and it's not just about your words but about your entire affect. It's how all of that comes together when you interact with other people. Do you really care about other people? I think that this is the corporate culture you want to create."

Steve Anderson shared an important practice that occurs in his organization, "We all carry the same business card. I think this focuses our shared identity and creates an environment in which all of our employees are invested in the integrity and reputation of the company."

"In our organization, every person is evaluated on ethics. It is built into the evaluation process."

Paul Amos

CONCLUDING THOUGHTS

Jim Mitchell asked the group to share their thoughts on two questions: "What did you get out of your participation today?" and "What will you reflect on tomorrow?"

Paul Amos said it was helpful to hear from other executives about the challenges that he may have to deal with in the future. He added he would reflect on, "how better to teach ethics to my organization. I need to do a better job of getting out into my organization and telling the story of this company. I make decisions all of the time, and I don't tell people necessarily why I did what I did. I may think they understand, but I need to be a better teacher and better coach when it comes to that."

Dennis Johnson noted that it was humbling to remember that there were a lot of things he didn't know. "It's helpful for me to be in a room with academics and other executives and realize how much there is to learn." He added that it was heartening to see and hear how many companies are trying to align their actions with ethical principles. "We're trying to battle the negative press caused by the few companies who have done the wrong thing. But we're also trying to work together as an industry to really do the right thing."

Steve Bartlett was struck by the diversity of views of both the academics and the practitioners. It was clear that each participant had been paying attention to what happened in the financial services industry and had suggestions how the industry could rebuild its trust with the public. "What I'll think about tomorrow is what I thought about today, and that is how we can get people to recognize that most companies are trying to be both honest and ethical."

Diane Robertson said that it was enlightening to see that the academics and practitioners have a shared language. "It was important for me to hear all of you using these words we use all of the time. Somehow I didn't realize that you were talking about transparency and trust and values and community involvement." She added that she would reflect on how to bring these lessons into the classroom. "My students don't always believe that some of these issues are real, but when I come back with industry examples it is tremendously helpful."

John DesPrez said that there is a disconnect between the perception of the financial services industry and the realities. "Essentially everybody I know in this business is very honest and trying hard to do the right thing. So this perception that the entire industry is a bunch of crooks is completely at odds with the reality I experience every day." He added that it was interesting to witness the academic disagreement over possible solutions to the current problems. "I'm reassured that there is no unanimity of opinion in the academic world, since business people always disagree on everything. You guys don't have it figured out either."

Jim Mitchell and Julie Ragatz are intent participants in the day's events.

Denis Arnold noted the importance of spending time with industry practitioners. "This sort of firsthand interchange really informs my ability to connect and communicate with students. In my teaching and my scholarship, I like to emphasize best practices and to be in a room of best practitioners is a terrific privilege."

Kevin Gibson was leaving the meeting with a feeling of optimism. "What I've heard repeatedly today is that we're not just selling a product, but trying to help people in a meaningful way. I said at the beginning that business is service. In order to have that point of view, you've got to believe that you're serving people and adding value in a serious way, and that you're enhancing people's lives." He noted that it was incumbent on academics to try and tell the story of the positive aspects of business. "When you look at the canon of business ethics literature, it's very negative. We need to build up this narrative of people doing good and doing well so that it becomes a part of the accepted literature."

Laura Hartman observed that the executives in the room in the future will be " all our former students". She noted that you should approach the question of ethics education by asking, "What do you wish you would have learned back then?" She believed it was important to bridge the chasm between academics and practitioners. "This is our 'real world' too, since we're teaching students who are working full time and bringing their ethical questions into our classrooms."

Richard DeGeorge was impressed at how readily the executives admitted that they didn't have all of the answers. "It's interesting to see that you're grappling with ethical issues and you don't know all of the answers, either. In a way that's heartening since it means we're grappling with these issues together."

Steve Anderson said that he expected to have a corporate culture where people challenge each other. " I was pleasantly surprised to see that everyone here was really willing to challenge each other's thinking. I think that one of the problems of corporate America is that a lot of people really don't want to give their opinion because it may be not the one held by the person who signs their paychecks."

Julie Ragatz noted that, like the other academics, she was eager to take these insights back into the classroom. "It's an enormous advantage to be able to go back to my students and share what I've learned here today and for that, I thank you all very much."

Ron Duska took pleasure from the fact that his optimism toward the financial services businesses returned during the course of the conversation. "I am sincerely worried about where the country is going, but the day's discussion convinced me that the world of financial services is largely filled with executives of integrity."

Jim Mitchell agreed with Ron about being re-energized after the day's discussion, "I am excited about how we can rebuild that trust we have lost with the public, and I'm committed to try and do that." He added that he

"The American College, was founded on an ethical mission, turning insurance agents into ethical professionals."

Ron Duska

believed it was imperative to create a business environment where it is easier for people to do the right thing. "I believe that every decision made by every person in the organization is an ethical decision since each decision involves a trade-off among the different stakeholders and a balance between short- and long- term consequences. If this is the case, we have to create structures that make it easier—almost reflexive—for people to do the right thing."

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The James A. and Linda R. Mitchell/ The American College Forum on Ethical Leadership in Financial Services

The American College Center for Ethics in Financial Services is the only ethics center focused on the financial services industry. The Center bridges the gap between sound theory and effective practice in a way that most ethics centers do not. Under the leadership of Director Ron Duska, PhD, the Center's mission is to raise the level of ethical behavior in the financial resources industry. We promote ethical behavior by offering educational programs that go beyond the "rules" of market conduct, help executives and producers be more sensitive to ethical issues and influence decision making.

The Mitchell Forum is a groundbreaking, one-of-a-kind event that underscores the Center's emphasis on collaboration and conversation among academics and practitioners. Jim Mitchell was recognized in 2008 for his dedication to business ethics and was included in the "100 Most Influential People in Business Ethics" by *Ethisphere*, a global publication dedicated to examining the important correlation between ethics and profit. The list recognizes individuals for their inspiring contributions to business ethics during the past year.

The Forum is the cornerstone of the Center's activities highlighting how to bring industry leaders, accomplished producers, and prominent business ethicists together to reinforce the need to connect values and good business practices.

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