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Corporate Integrity at a Crossroads

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday August 6, 2012

Editor's Note: The following post comes to us from Jordan A. Thomas, partner at Labaton Sucharow LLP and former assistant director at the Securities and Exchange Commission. This post is based on a Labaton Sucharow report, available here.

Executive Summary

We are mindful that, as we share the results of this groundbreaking survey of financial services professionals in two of the world's key financial markets, we approach the fourth anniversary of the collapse of Lehman Brothers, the harbinger of the global financial crisis.

In the wake of that crisis, numerous countries have examined–and some have adopted–laws and regulations aimed at creating greater stability in the financial markets. In the UK, June 2010 marked the establishment of the Independent Commission on Banking. One month later, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most sweeping financial reform effort since the Great Depression. Recognizing that financial regulators and law enforcement authorities cannot effectively and efficiently police the marketplace without the assistance of private individuals, one of Dodd-Frank's key provisions required the Securities and Exchange Commission (SEC) to establish a whistleblower program that offered anonymous reporting, employment protections and monetary awards to individuals who report violations of the federal securities laws.

Nevertheless, behind these important legislative efforts and other international initiatives was a nagging truth: Companies went out of business, millions of employees lost their jobs and countless investors lost their life savings. What prompted the scandals that played a central role in the downfall of so many institutions? Call it greed. Call it slack compliance. Call it conflicts of interests. The fact is, too many organizations–both central to the crisis and in its periphery–have lacked a strong culture of integrity. In the end, one of the most significant lessons to emerge from the global economic crisis is that corporate ethics matter.

The question is, can governments effectively strengthen corporate ethics? Have these important investor protection efforts trickled down into the hallways, offices and conference rooms of financial services organizations? Is corporate integrity any better today than it was four years ago?

We surveyed 500 professionals–evenly split across the United States and the United Kingdom–working in various segments of the financial services industry. We asked about personal ethics, corporate culture and possible misconduct. We asked about competitors. We asked about the regulators and law enforcement authorities that oversee the financial services industry.

The results were both alarming and, in some cases, encouraging. Among our key findings:

- Misconduct is still widespread in the financial services industry; 26% of respondents indicated that they had observed or had firsthand knowledge of wrongdoing in the workplace.
- Nearly one-fourth of respondents believed that financial services professionals may need to engage in unethical or illegal conduct in order to be successful.
- An alarming number of financial services professionals, 16% of respondents, would commit a crime–insider trading–if they could get away with it.
- Nearly one-third of all financial services professionals reported feeling pressured by bonus or compensation plans to violate the law or engage in unethical conduct. Nearly one-quarter of the respondents felt similar pressure from other sources.
- While enforcement actions are on the rise and new reforms have strengthened financial regulators and law enforcement authorities, only one in four financial services professionals believe these watchdogs are effective.
- Despite the encouraging 94% of financial services professionals who indicated a willingness to report wrongdoing given the protections and incentives such as those offered by the SEC Whistleblower Program, less than half of the industry is aware of the SEC's new program.

With more than five decades of experience prosecuting high-profile and high-stakes corporate wrongdoing, securing historic financial recoveries for prominent institutional investors around the world and compelling landmark corporate reforms, we at Labaton Sucharow are certain of one thing: We are at a crossroads. The best way to ensure that the financial marketplace operates with greater transparency, fairness and accountability is to recognize the powerful troika–regulators, corporations and individuals–that has the ability to establish and strengthen a culture of integrity that will create lasting change in the financial markets.

Who Engages in Misconduct?

Do you need to break the rules to be a success?

Given the difficult financial times we live in, when jobs are scarce and bonuses hang in the balance, we asked respondents whether financial services professionals have to engage in unethical or illegal activity in order to be successful. The results were disheartening:

- 24% of those surveyed believed that the rules may have to be broken in order to be successful.
- 25% of UK respondents believed financial services professionals may need to engage in unethical or illegal activity to get ahead; US respondents were only slightly less inclined to engage in wrongdoing at 22%.

Recognizing that it is often easier to acknowledge wrongdoing perpetrated by others, we asked respondents to tell us about the likelihood that staff in their company have engaged in illegal or unethical activity to be successful.

- Doubt about ethical conduct pervades financial services organizations. Only 41% of respondents reported that staff within their own organization had “definitely not” engaged in unethical or illegal conduct to be successful. 39% of UK respondents believed that others in their company have definitely not engaged in such misconduct to get ahead. 43% of US respondents had a similar view.
- 12% of total respondents believed that it was *likely* that staff in their company have engaged in unethical or illegal activity in order to be successful.

Not surprisingly, when assessing their competitors’ integrity, respondents reported a much stronger causal connection between unethical or illegal activity and success.

- 39% of total respondents believed it was likely that their competitors have engaged in illegal or unethical activity in order to be successful. 36% of UK respondents believed that their competitors have likely engaged in such misconduct to get ahead. 40% of US respondents had a similar view.
- There was an eight-point spread in the UK based on gender, with 38% of men and 30% of women believing their competitors likely have engaged in illegal or unethical activity to be successful.

Given that one in four respondents reported that misconduct may be a necessary factor for success, we were curious to what extent ‘getting caught’ factored into financial professionals’ decision-making. Accordingly, we asked financial services professionals across the US and UK how likely they were to engage in insider trading in order to make $10 million.

- 16% of total respondents were at least fairly likely to engage in insider trading if they could get away with it. Perhaps more troubling, only 55% of all respondents could say definitively that they would not engage in insider trading if they could make $10 million with no risk of getting arrested.
- Gender played an important role in how financial professionals answered this survey question:
    - Among all respondents, there was a 9-point spread between the genders; 19% of male financial services professionals reported a willingness to engage in insider trading compared to 10% of female financial services professionals.
    - In the UK, 20% of male financial services professionals reported that they were at least fairly likely to engage in insider trading under these circumstances compared to 9% of female financial services professionals.
    - In the US, similar to the UK, 18% of male financial services professionals reported that they were at least fairly likely to engage in insider trading under these circumstances compared to 10% of female financial services professionals.

The Regulatory Landscape

Following the financial crisis of 2008, the primary regulators of the financial services industry—the SEC and Financial Industry Regulatory Authority (FINRA) in the US and the Serious Fraud Office (SFO) and Financial Services Authority (FSA) in the UK—have all made significant overhauls to their structure and strategic focus. And the fact is, the number of enforcement actions and monetary sanctions secured by these organizations is on the rise. Nevertheless–and surprisingly–the financial services professionals we surveyed did not report a high level of confidence in their financial regulators.

Specifically, we asked if these financial regulators are effective at deterring, investigating and prosecuting securities violations. The majority of respondents didn't think so.

- Only 30% of all respondents felt that the SEC/SFO effectively deters, investigates and prosecutes securities violations.
    - In both the UK and US, women had more confidence in the effectiveness of the SEC/SFO with 40% of female respondents having a favorable opinion compared with 27% of male respondents.

    - In the UK, 34% of financial services professionals felt that the SFO is effective. Notably, female financial services professionals in the UK were 15% more confident in the effectiveness of the SFO with 46% of female respondents having a favorable opinion compared with 31% of male respondents.
    - In the US, only 26% of financial services professionals felt the SEC is effective. Interestingly, we again noted a 15-point spread in responses based on gender with 36% of female respondents having a favorable opinion compared with 21% of male respondents.
- With respect to FINRA and the FSA, only 29% of all respondents felt these agencies effectively deter, investigate and prosecute securities violations.
    - In both the UK and US, women had more confidence in the effectiveness of FINRA/FSA with 40% of female respondents having a favorable opinion compared with 25% of male respondents.
    - In the UK, 32% of financial services professionals felt that the FSA is effective. Notably, female financial services professionals in the UK were significantly more confident in the effectiveness of the FSA with 43% of female respondents having a favorable opinion compared with 29% of male respondents.
    - In the US, 27% of financial services professionals felt FINRA is effective. Interestingly, we again noted a significant spread in responses based on gender with 38% of female respondents having a favorable opinion compared with 21% of male respondents.

Ethical Culture

In March of this year, corporate integrity was thrust into the international spotlight with the public resignation, through an Op-Ed in *The New York Times*, of a Vice President at Goldman Sachs. One of the primary drivers of the resignation, and a much debated fact in its aftermath, was his claim that Goldman Sachs didn't really value its clients, but instead, put the bank's pecuniary opportunities ahead of its clients' best interests.

Recognizing that the degree to which organizations value clients is a strong indicator of ethical culture, we asked respondents if their employers put the interests of clients first. Although the vast majority of respondents signaled a client-oriented culture, the significant percentage of respondents who believed that their organizations did not put clients' interests first is an area of concern.

In both the UK and US, 86% of financial services professionals reported that their employers put the interests of clients first.

Consistent with this finding and underscoring our belief that valuing clients is a natural outgrowth of a strong ethical culture, when asked to rank their organizations' ethical values, 84% of professionals surveyed felt their employers had fairly to very strong ethical values.

Ethical Compromise: Do Financial Services Professionals Feel Pressure to Engage in Misconduct?

In the business community, where success is too often defined in quantitative terms, we wondered if professionals in the financial services industry felt that their compensation, bonus plan or other factors created pressure to compromise ethical standards or violate the law.

- 30% of all financial services professionals reported feeling pressure to compromise ethical standards or violate the law as a result of their compensation or bonus plan. There was a slight differential between the UK and US, with 32% of UK respondents and 28% of US respondents believing that their compensation or bonus plan created pressure to compromise ethical standards or violate the law.
- In assessing other pressures that may lead to unethical or illegal conduct, 23% of all respondents also reported feeling other pressures to compromise ethical standards or violate the law. In the UK, this figure jumped to 26%, while only 19% of US financial services professionals reported this problem.
- In the UK, we found a significant gender spread among financial services professionals regarding other pressures to compromise ethical standards or violate the law with 29% of male respondents acknowledging the problem compared with only 17% of female respondents.

Misconduct at Work

With trillions of dollars under management, investors and citizens must have confidence in the integrity of the financial services community. *Any* degree of misconduct in the industry is a serious matter.

- Our findings sound the alarm: more than one in four financial services professionals has observed or has firsthand knowledge of wrongdoing in the workplace.
- 30% of UK financial services professionals observed or had firsthand knowledge of misconduct compared with 22% of their US counterparts.

Is Retaliation a Concern?

Yes. And the numbers are compelling. While 14% of all respondents believed that their employers were likely to retaliate if faced with a report of wrongdoing in the workplace, we noted hedging in the responses. In fact, of all financial services professionals surveyed, only 35% felt certain that their employer would "definitely not" retaliate.

In the US, there was a 10-point gender differential among financial services professionals with 22% of female respondents believing that they would be retaliated against if they reported wrongdoing in the workplace compared with 12% of male respondents.

Consistent with these findings, fear of retaliation may play a major role in the reluctance to speak out against misconduct. One in five of professionals we surveyed was not sure of, or had serious doubts about, how their employers would handle a report of wrongdoing.

Are Whistleblowers the Answer? Encouraging Signs from the Financial Services Industry

As noted above, in 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. Included in the Act was the charge to the SEC to establish a whistleblower program that would serve to detect and deter misconduct. The SEC Whistleblower Program, finalized and implemented in August 2011, has broad extraterritorial reach. And, other jurisdictions around the globe are considering and implementing similar programs to encourage individuals to break their silence and report possible violations of the law.

Are these programs reaching the grassroots?

We turned our attention to the financial services sector, the primary target of regulatory reform. We asked industry professionals if they would report misconduct in the workplace if it could be done with the factors present in the SEC Whistleblower Program—anonymity, employment protections and a monetary award. A startling 94% of all financial services professionals would do so. Equally encouraging, 90% of all respondents would encourage a spouse or loved one to report misconduct.

However, only 44% of financial services professionals were aware of the SEC Whistleblower Program. Not surprisingly, there was a 10-point differential between US and UK financial services professionals; only 39% of UK respondents were familiar with the SEC Whistleblower Program compared to 49% of US respondents.

In the short term, these staggering figures will undermine the tremendous potential of the SEC Whistleblower Program.

To establish a broader context, in 2011, we probed the American public's awareness of the SEC Whistleblower Program in our *Ethics & Action Survey*. We were dismayed to find that only 32% of respondents were aware of this critical investor protection initiative. Here, in the instant research, we are concerned to note a relatively insignificant difference in awareness between the general public and the financial services sector. Two years after Dodd-Frank established historic reforms to the financial services sector, industry professionals should be more 'in the know.'

Education is the answer. We must do a better job of bridging the gap between the regulators and industry. And we must turn our focus from compliance to the ethical culture within our organizations. Until we begin a robust dialogue about corporate integrity—the extent to which it doesn't exist and the extent to which it must–we cannot create significant and lasting change within the financial services industry.

Methodology

Populus conducted 250 online interviews in the UK and 250 in the US with senior individuals within the financial sector, including, but not limited to, Fund Managers, Bankers, Analysts and Asset managers. Respondents were screened to ensure that only senior individuals qualified and that interviews were spread across a variety of different roles within financial markets. The sample was drawn from online panels and the screening criteria created a regional distribution towards the major financial cities of London and New York City. Populus is a founding member of the British Polling Council and abides by its rules. Further information can be found at www.populus.co.uk.