USA TODAY

Column: How Wall Street Creates Criminals

By Lynn Stout and Jordan Thomas
September 4, 2012

It is time to admit that Wall Street has lost its moral compass. Each day brings a new story of banks misleading clients, hedge funds' insider trading or investment banks manipulating prices. In one breathtakingly brazen scandal, Barclays and many of the largest banks in the U.S. and the U.K.— including Bank of America, Citigroup, HSBC, JPMorgan Chase and Royal Bank of Scotland— are being investigated for possibly rigging the Libor interbank lending interest rate that determines the interest charged on countless credit cards and bank loans.

The tsunami of scandals cannot be explained away as the work of a few "bad apples." Our financial services industry is in ethical crisis. To assess the depth of the problem, Labaton Sucharow, a law firm where one of us works, commissioned an anonymous survey of 500 financial services professionals in the United States and United Kingdom. The results are alarming.

More than a quarter of respondents reported they had personally observed or had firsthand knowledge of wrongdoing in the workplace. (Given the human tendency to underreport bad behavior, the true figure is likely higher.) Nearly 40% believed their competitors had engaged in illegal or unethical behavior; 24% thought you have to break rules to be successful. An astonishing 16% admitted that they'd engage in illegal insider trading if they would not be caught.

Waiting for a chance

When 16% of people working in financial services readily admit they would commit a crime if they could get away with it, alarm bells should be going off at the Securities and Exchange Commission and other financial regulators. True, Wall Street might attract more than its share of Gordon Gekko-like criminal personalities. But behavioral science suggests more is at work. The financial services industry has become a "criminogenic" environment that tempts otherwise ethical, conscientious people into criminal conduct they would never indulge in outside the workplace. Consider the tragic case of Rajat Gupta, a Goldman Sachs director and noted philanthropist who seemed a pillar of the community until he was recently convicted of insider trading.

How does the financial service industry transform otherwise ethical individuals into criminals? The modern infatuation with "incentives" has played a role — 30% of survey respondents reported that their bonus or compensation plans created pressure to engage in unethical or illegal behavior. (The dirty underbelly of pay for performance, rarely acknowledged by economists or compensation experts, is that it is almost impossible to design a compensation metric that can't be met through illegal behavior.)

Why stay silent?

But a more disturbing part of the story lies in the question of why financial services professionals who observe illegal behavior and don't stand to personally profit from it nevertheless remain silent. Like bank robberies, corporate scandals are rarely one-man jobs, and there are almost always witnesses. It is highly unlikely that more than $1 billion of client funds could disappear at MF Global, or that Libor could be manipulated by Barclays, without many people knowing about it. If more than a quarter of the individuals in the financial industry have firsthand knowledge of illegal or unethical activity, as the survey found, why aren't they reporting this? Where are the whistle-blowers?

Answering this question could be essential to figuring out how to cure the ethical rot that's eating away at many financial services firms. Even in the best of environments, some people will engage in misconduct when the opportunity for personal gain becomes too great to resist. But when a substantial percentage of financial services professionals tolerates misconduct by others, that speaks to a deeper problem. In the language of social science, the financial world is a "social context" that tolerates and encourages illegal or unethical behavior. In lay terms, the problem is Wall Street's culture.

Culture — the mélange of social signals we receive about what our superiors expect, what our peers are doing and how our acts harm or help others in our "in-group" — can be hard to change. But though changing culture is hard, it's by no means impossible. Obvious first steps include giving the SEC and other regulators greater resources; making sure that whistle-blowers are rewarded and protected from retaliation, and that potential whistle-blowers are aware of those rewards and protection; and examining pay-for-performance plans with a skeptical eye to make sure they aren't really pay-for-misconduct schemes.

But as we recently passed the second anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, it's time to recognize that regulation won't work alone. The first step the financial services industry needs to take toward recovery is to admit it has a corporate ethics problem. Otherwise, we should brace ourselves for the next scandal.

Lynn Stout, professor of corporate and business law at Cornell Law School, is the author of Cultivating Conscience: How Good Laws Make Good People. Jordan Thomas, chair of the whistleblower representation practice at Labaton Sucharow LLP, is a former assistant director in the SEC's Enforcement Division.