



**Ethics, Professionalism, and the
Public Interest – Wall Street Values**

7th Annual CFE Fraud Seminar

**Dr. Ronald J. Strauss
Montclair State University**

WSJ



<http://online.wsj.com/search/term.html?KEYWORDS=fraud>

Former Olympus executives arrested

By Jonathan Soble and Michiyo Nakamoto in Tokyo



Former chairman Tsuyoshi Kikukawa (above) and two other disgraced Olympus executives, Hisashi Mori and Hideo Yamada, were arrested

Japanese authorities arrested seven people on Thursday in connection with a \$1.7bn [accounting fraud at Olympus](#), including the camera company's former chairman and outside financial advisers suspected of helping executives hide lossmaking investments.

Prosecutors said they believed the former chairman, Tsuyoshi Kikukawa, and the other men had broken Japan's Financial Instruments and Exchange Act by filing false reports to tax officials. The arrests were the first in a four-month-old case that has [shaken corporate Japan](#).

More

[Olympus](#) has admitted that it secretly moved more than Y100bn (\$1.3bn) of securities-related investment losses off its books over the years, then used acquisitions as cover to square the hidden accounts. Including money that the advisers kept in return for their services, roughly Y135bn was "appropriated to maintain the scheme", a civil investigation commissioned by the company concluded in December.

Ex-Credit Suisse traders admit cooking subprime books

By [Grant McCool](#)

NEW YORK | Wed Feb 1, 2012 5:42pm EST

(Reuters) - In a rare criminal prosecution to emerge from the financial crisis, two former Credit Suisse traders admitted on Wednesday to conspiring to manipulate the value of about \$3 billion in subprime mortgage-backed securities in order to hide losses as the U.S. real estate market began to collapse in 2007.



Ethics vs. Self-Interest



- Ethics is characterized by disinterestedness....evaluating whether an action is right or wrong, regardless of personal interest in the outcome.
- Economics seeks to maximize individual and firm welfare

How do we determine if an act or persons are moral? Varieties of Moral Theory



- **Consequentialism-Utilitarianism**
- **Deontological-Kant**
- **Contractarian-Rawls**
- **Virtue Ethics-Aristotle**
- **Religious Based Theories**
- **Gets complicated in international business because social values are not always the same.**

Consequentialism



- Focuses on the consequences of an action in order to determine the morality of that action.
- One determines the morality of an act based on whether the consequences of that act are considered good or bad.
- Best example of a teleological theory is utilitarianism
 - Jeremy Bentham (1748-1832)
 - John Stuart Mill (1806-1873)
 - Must consider the interest of everyone (not just you personally)- can this be done?.

Consequentialism-Utilitarianism



- **Maximize the greatest happiness for the greatest number.**
Everyone, not just you!
- Taken seriously *maximizing* is a very high standard of behavior.
- Obviously can result in injustice for small minority.

Deontology: Immanuel Kant

- *Reason tells us that the highest good is good will. Intention or Motivation, not consequences, makes action good.*
- **Categorical Imperative** (Version 1): Act only on maxims that can be universal laws.
- **Categorical Imperative** (version 2): Always treat people as ends and not as means. People have free will.

John Rawls, *A Theory of Justice*



- Rawls asked how much inequality should there be in a just and fair society.
- To decide this asked that you go behind the “**veil of ignorance**” and assume “**the original position**”
- In other words, you take your existing condition and place in society out of your judgment about justice and inequality.
- Rawls thought such a person would choose some inequality to encourage industriousness but also would not want the worst person in society to be too badly off.

Natural and Human Rights



- Human Rights are moral claims that cross national borders, exist regardless of the constitutional and legislative rights of a particular nation.
See Universal Declaration of Human Rights
- Negative Rights: Others must refrain from violating your right not to be disturbed—e.g. free speech; property.
- Positive Rights: Someone (the government?) must supply you with healthcare, job, education
- Rights are philosophically problematic (how do we know that they exist?) but powerful rallying cries for moral suasion.

Virtue Theory: Aristotle/Confucius



- Not principles that are important but the virtues that lead to right action – moral character of person
- **Honesty, loyalty, sincerity, courage, reliability**
- We are social creatures who derive our identity from community. Integrity of individual and organization are mutually dependent
- What do we admire? Who do we admire? What allows us to succeed? What virtues are admired in a particular company? Codes of Conduct? Corporate Culture?

Relationship Between Law and Ethics



Law and Ethics



- Exactly the same—following the law means acting ethically; and vice versa.
- Separate realms—law is hard and definite; ethics is personal and aspirational.
- In either case, manager has little need to independently assess and think about ethics.

Law-Ethics Relationship



- In certain important respects they need to be kept separate
 - **Ethics sometimes less important matters**
 - **Law changes—clever lawyers and activist judges**
 - **Exemplary conduct**
 - ✦ **J&J Tylenol**
 - **Sometimes Law Wrong**
 - ✦ **Segregation Laws**

Law-Ethics Relationship

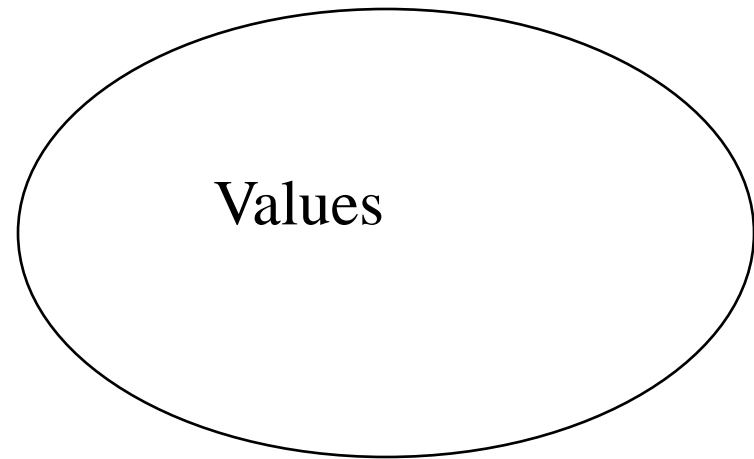
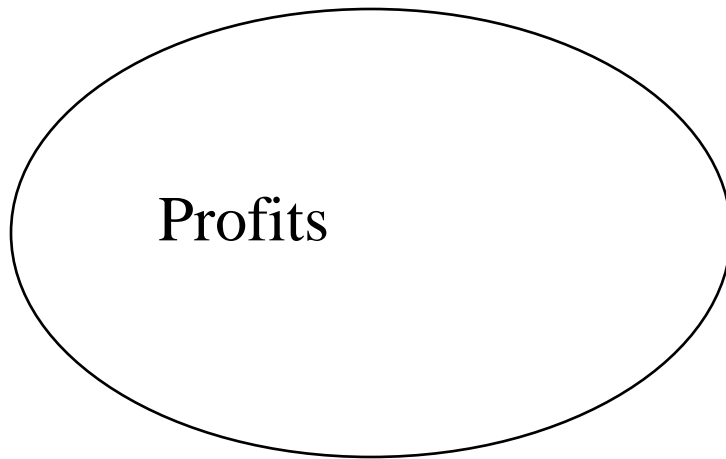


- There is also a significant correspondence between law and ethics.
- Deception, promise breaking, theft, torts are illegal because society disapproves of them
- The law is a mechanism for reinforcing and enforcing through the coercive power of the state those moral obligations regarded as critical to social life. Applies especially to business ethics.



Does Ethics Pay? Business Ethics and Financial Performance

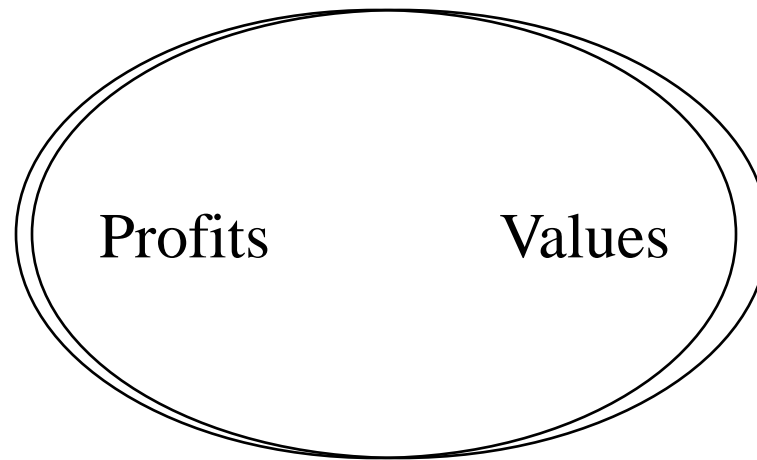
Relationship Between Values and Profits: Traditional View



“What do you mean they want safety? ... We cannot carry the load of inflation and safety...without breaking our back.”

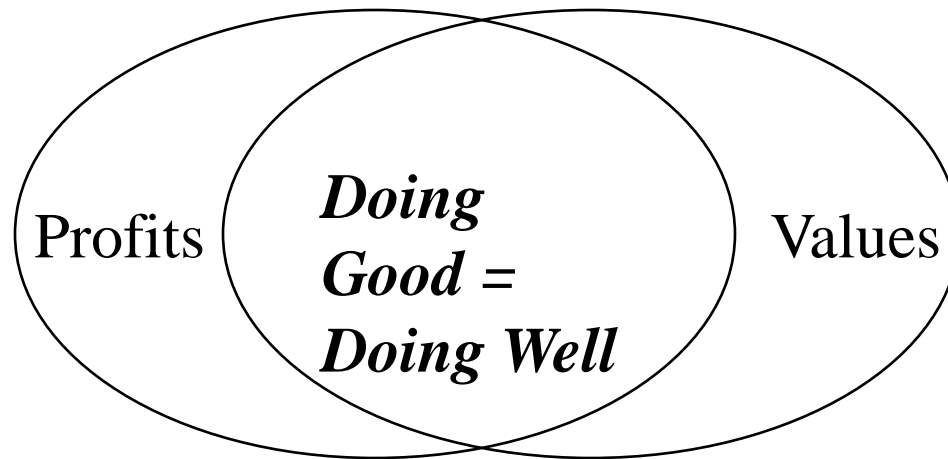
Lee Iacocca, President, Ford Motor Company, 1971

Optimistic View of Relationship Between Values and Profits



Depending on issues presented, a survey found that 14 to 47% of executives were willing to misreport financial statements to maintain the appearance of stronger profitability. (Brief, et al. 1996)

More Realistic View of Relationship Between Profits and Values



There are some activities that are ethically problematic but financially profitable, e.g. misleading a lender about financial condition of company to get lower interest rate. Conversely, there are ethically attractive options that are financially costly, e.g. failing to pay a bribe.

Factors Affecting Profits Value Relationship



- Time Frame
- Business Environment
- **What Kind of Values?**

The Ethics Environment

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- Understanding the Ethics Environment, drivers of change & expectations for ethical behavior
- Understanding Good Ethics & Governance
 - Why are they so important?
 - How do they work?
 - What constitutes good ethics and good governance?
 - How can they be instituted?
- Understanding key scandals - the Subprime Lending & World Com - world changing ethics events

The Ethics Environment

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Growing Awareness ...

- Environmental change
- Pollution
- Oil spills – Exxon Valdez, BP
- Equity for women: pay, fair
- Fair treatment of minorities
- Oppressive regimes
- Child labour
- Harmful practices & products
- Scandals



- Corporations can make a difference

Frauds & Fraudsters

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- **Insider trading/market manipulation –**
- **Savings & Loan Crisis**
 - Michael Milken
- **Earnings management**
 - Enron – Lay, Fastow, Skilling
 - HealthSouth
- **Corporate looting**
 - WorldCom
 - Tyco – Denis Kozlowski
- **Personal piggy bank**
 - Adelphia – John Rigas
- **Insider trading**
 - Martha Stewart
- **Ponzi scheme**
 - Bernie Madoff
- **Subprime Lending Crisis**
 - Various

Lessons

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- Public pressure can help change corporate behavior
- Stakeholders support is essential
- Reputations are at stake
- Ethical behavior is essential
- Good governance is based on good ethics
- Good ethics & governance don't just happen on their own – **ethical leadership is essential**

Stakeholder Accountability is:

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- **To stakeholders, not just shareholders:**
 - Capital markets...
 - Consumers...also Nike...supplier codes
 - Employees...
 - Environmentalists...
- **Global, immediate info flow**
- **Lingering liability**
- **Increasing sensitivity, morality**



BREAKING THIS MORNING

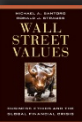
CNN HD

LEHMAN BROTHERS BANKRUPT

7:01 AET

LEGENDARY INVESTMENT BANK TO FILE FOR CH. 11 AMERICAN MORNING

A DISPATCHER TRIED TO WARN THE ENGINEER THAT HE WAS ABOUT TO COLLIDE WITH



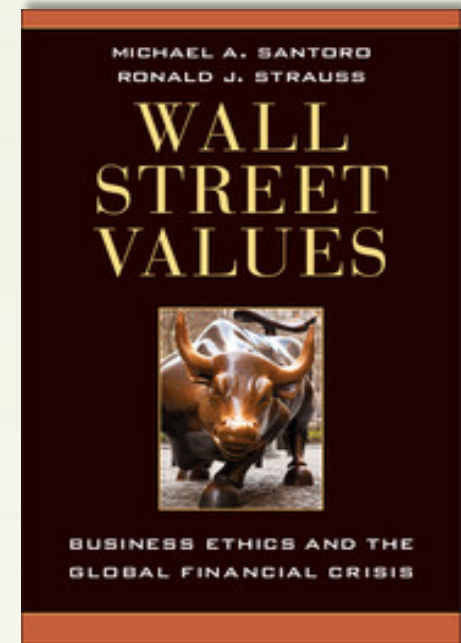
Business Ethics and the Global Financial Crisis



WALL STREET VALUES

**Business Ethics and the
Global Financial Crisis**

www.wallstreetvalues.org



- Michael A. Santoro
- Ronald J. Strauss

Wall Street's Dual Role



Wall Street is a vital cog performing crucial social functions at the epicenter of capitalism and free markets—capital allocation, valuation, connecting buyers and sellers.

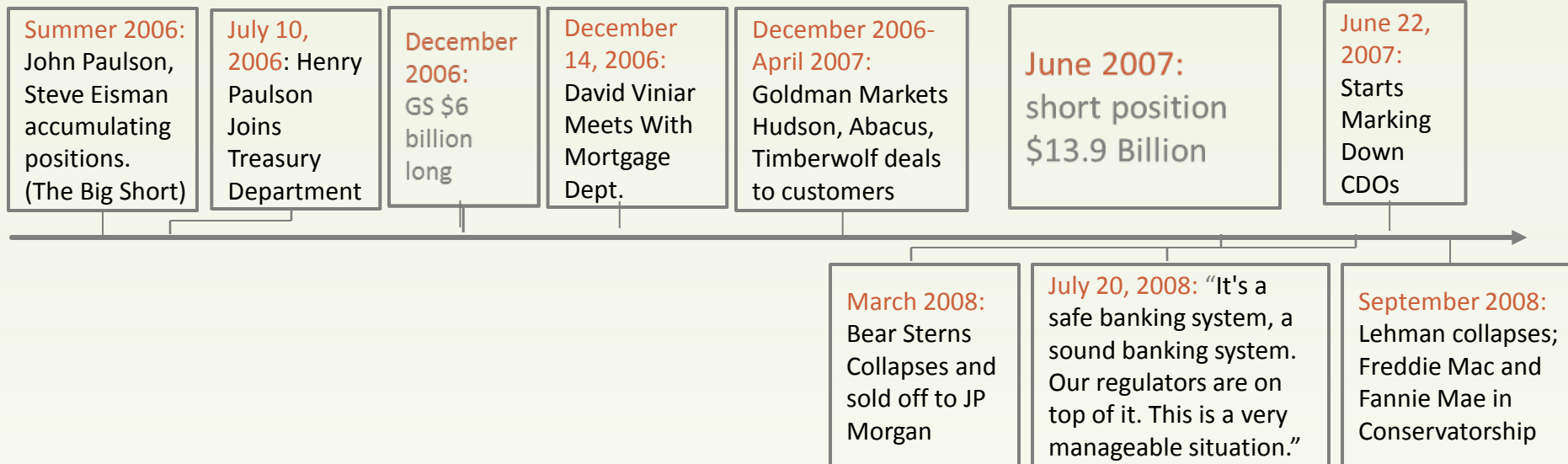
And an industry where firms seek to maximize profits.

Wall Street Undermines Market Information



- **At the moment when customers and the public were all in need of clear and accurate information about the subprime market, Goldman Sachs was actively going about deceiving and misleading counterparties (who used to known as clients) and the market.**

Financial Crisis Timeline





Economics and Morality

What are the economic and moral connections between Wall Street and the overall economy?



Wall Street and the Free Markets

How did we arrive at this point in history where our most powerful financial institutions and the putative engine room of capitalism thwart rather than promote our free markets, our prosperity, and even our social cohesion?

Goldman Sachs: In the 1990s

Goldman Sachs revenues by business segment 1996-1998 (in \$millions)

	1996	1997	1998
Trading and principal investments	2,693	2,926	2,379
Total revenues	6,129	7,447	8,520
Percent of Total revenues from Trading and principal investments	43%	39%	28%

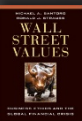
Source: Goldman Sachs 1998 Annual Report

Goldman Sachs: In the 2000s

Goldman Sachs revenues operating results by business segment 2005-2007(in \$million)

Business segment		2005	2006	2007
Trading and principle investments	Revenues	16,818	25,562	31,226
	Pretax earnings	6,218	10,600	13,288
Total	Revenues	25,238	37,665	45,987
	Pretax earnings	8,273	14,560	17,604
Percent Pretax earnings From trading and principal investments		75%	72%	75%

Source: Goldman Sachs 1998 Annual Report



Wall Street Transformation: From Customer to Counterparty

Beginning roughly in the last two decades of the 20th Century and culminating in the 2008 financial crisis, the dominant Wall Street's business model transformed from a mostly "client" orientation with a minor proprietary trading component to one where trading operations with "counterparties" came to dominate.

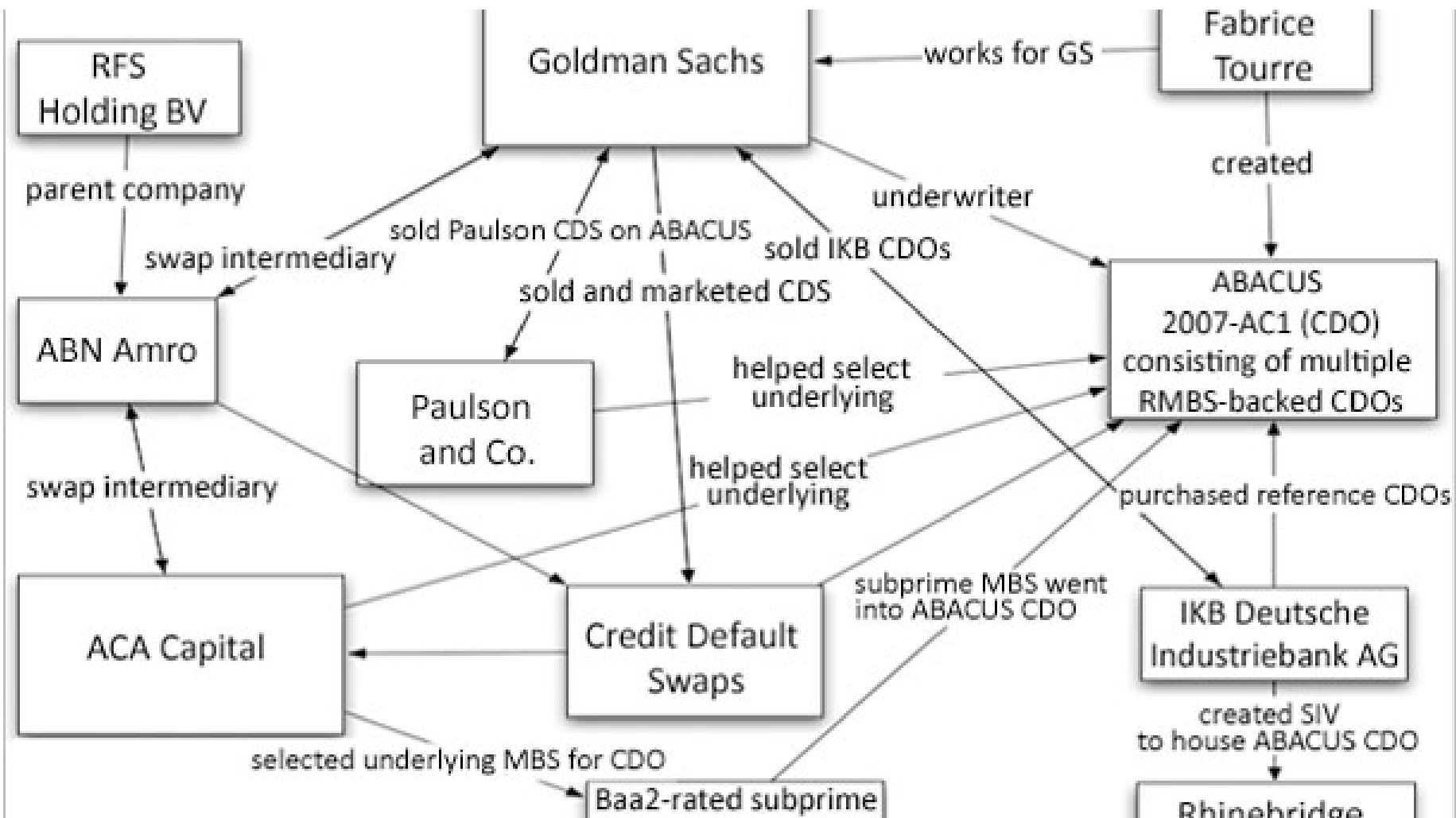
The rise of proprietary trading occurred not coincidentally just as the financial industry was also experiencing enormous growth in scale. In the two decades preceding the financial crisis every major Wall Street firm went from being a privately funded partnership to a publicly held company.



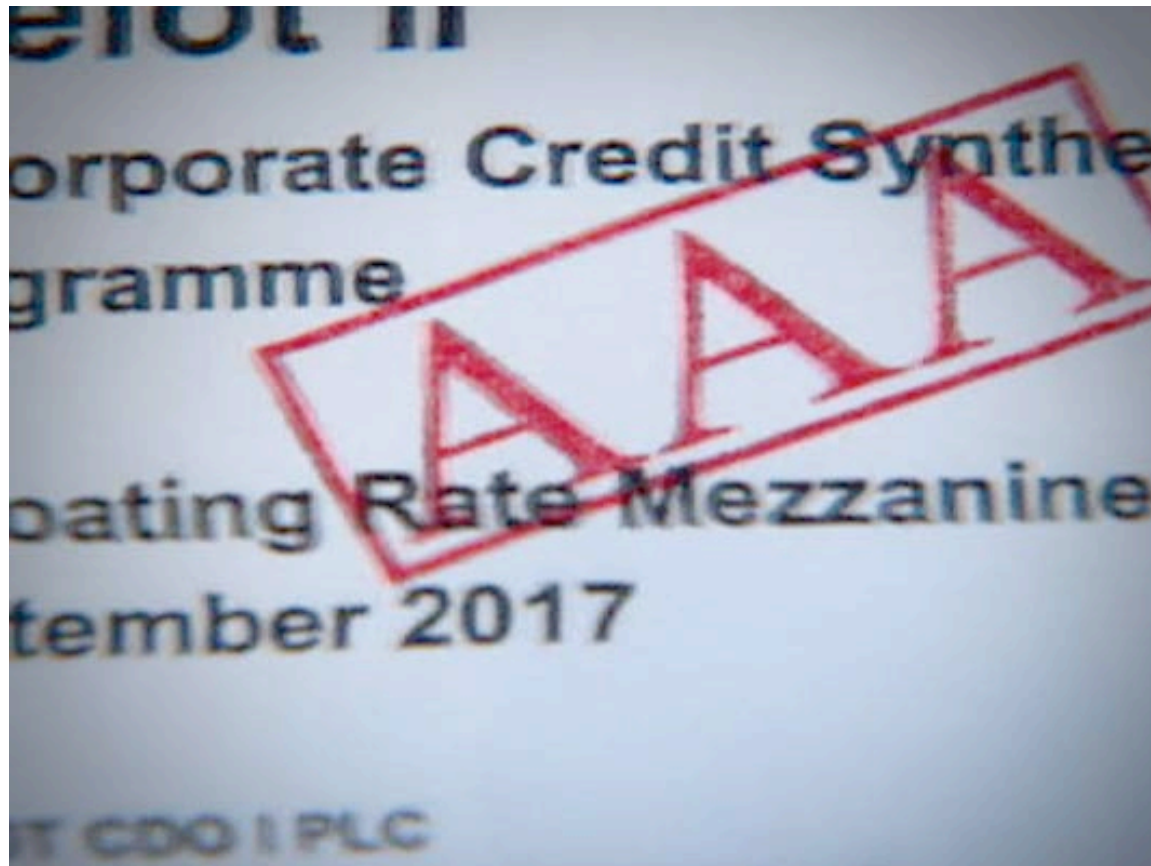


Overleveraged Subprime Home Owners

The seeds of the crunch were being sown for years--outsized and risky financial bets by overleveraged banks and pension funds from Mississippi to Dusseldorf on the value of complex "tranches," packaged and sold by Wall Street firms, of "collateralized debt obligations" or "mortgage backed securities" based on an unreliable stream of payments by overleveraged American homeowners holding "subprime" mortgages.



The size of the bets grew exponentially when Wall Street "innovated" by creating "synthetic securities" allowing "counterparties" to bet against each other without the need for either of them to actually own any legal interest in the underlying loans and "credit default swaps" that enabled the bettors to take out insurance in case one of the counterparties could not pay off on the bet.



Rating Agencies

Incompetently assigned investment grades to mortgage backed securities even when in some cases they were designed by the underwriters to fail



Lawyers and Accountants

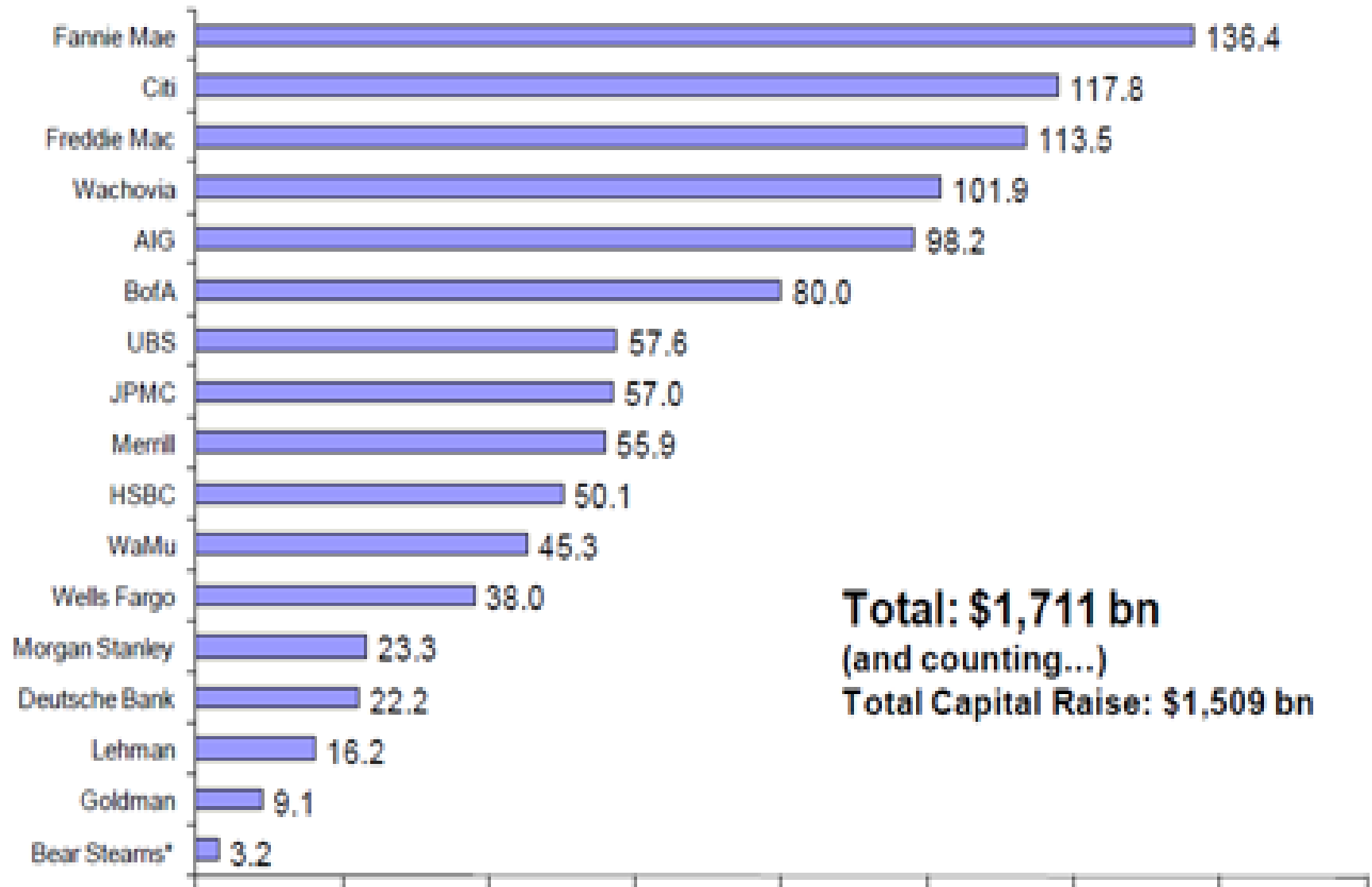


The U.S. Government and Financial Crisis

Passed legislation and promulgated regulatory loopholes that made the whole mess possible and then by falling asleep at wheel and being caught completely off-guard by the gathering storm.

Financial Institution Write Downs

billions; through January 8, 2010





TOO

BIG

TO

FAIL





The Bailout

Government Policies

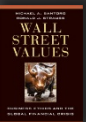
- 1970 NYSE Rules on Partnerships Revised (Wall Street Goes Public)
- 1994 Secondary Mortgage Market Enhancement Act (Wall Street can originate Mortgage Backed Securities)
- 1999 Glass–Steagall Act Repealed (Investment Banking Insurance, Commercial Banking)
- 2000 Commodities Futures Modernization Act (enabled \$600 trillion in unregulated Credit Default Swaps)



The Gathering Storm

Financial Deregulation Era (1984-2005)

- Secondary Mortgage Enhancement Act 1984
- Repeal of Glass Steagall 1999
- Commodity Futures Modernization Act 2000



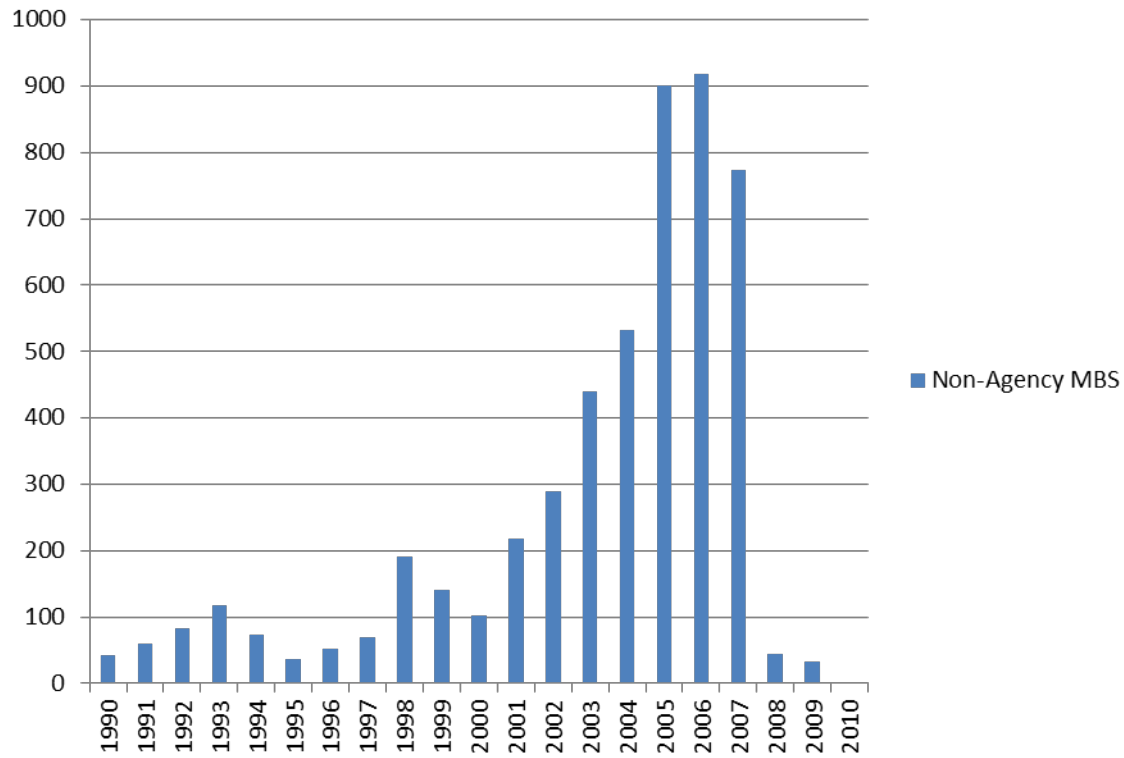
The Gathering Storm

Negligent Oversight Phase (2005-2008)

- August 2005 - First Concerns Raised
- Summer 2006 - The Big Short
- December 2006 - Goldman Decision
- July 2007 - Bear Stearns CMO Hedge Fund Collapse



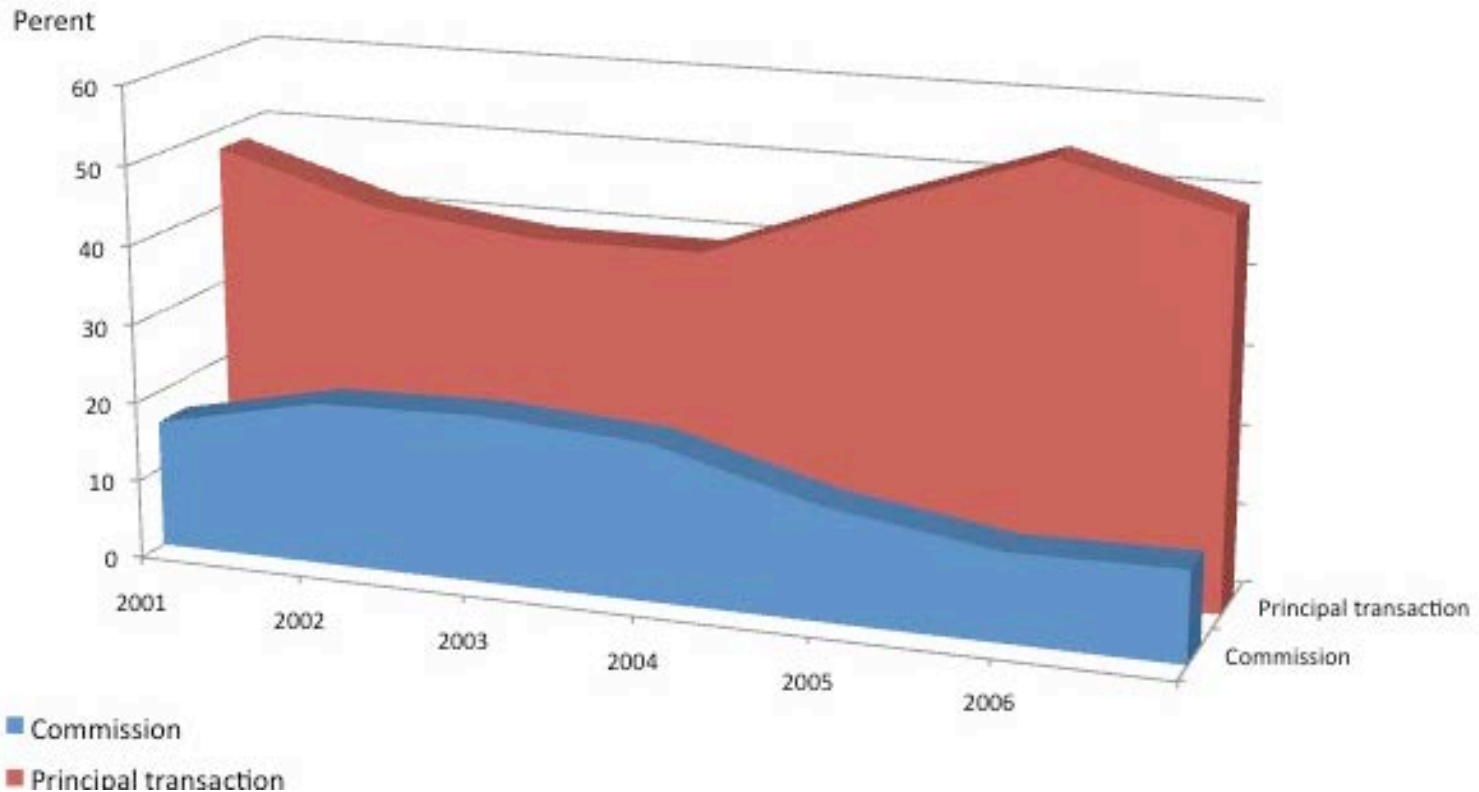
Non-Agency MBS (in million\$)



From Underwriter to Issuer

Principal Transactions

Principal transaction and Commission for 2001 - 2006



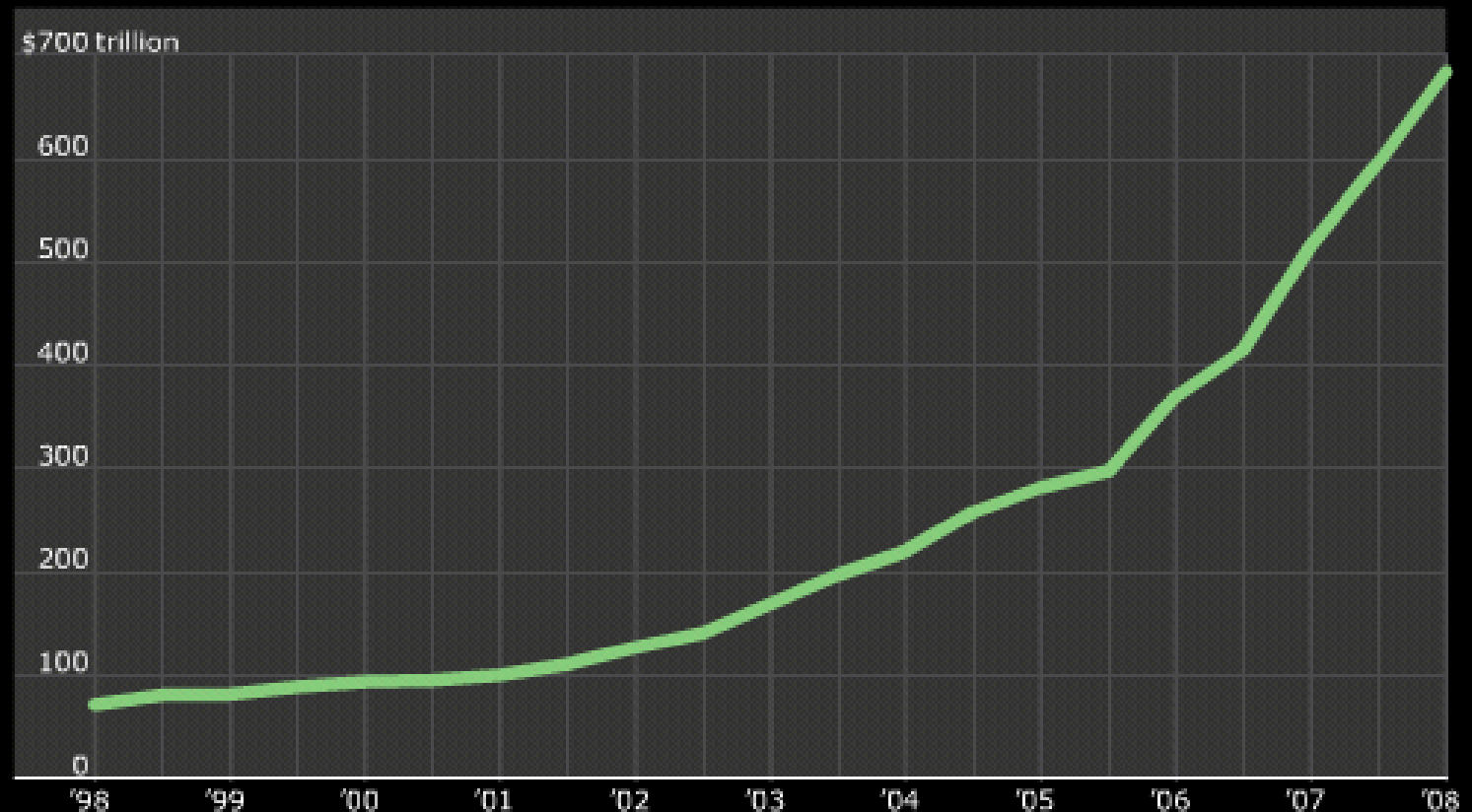
Derivatives

Private Derivative Contracts Explode

Bloomberg

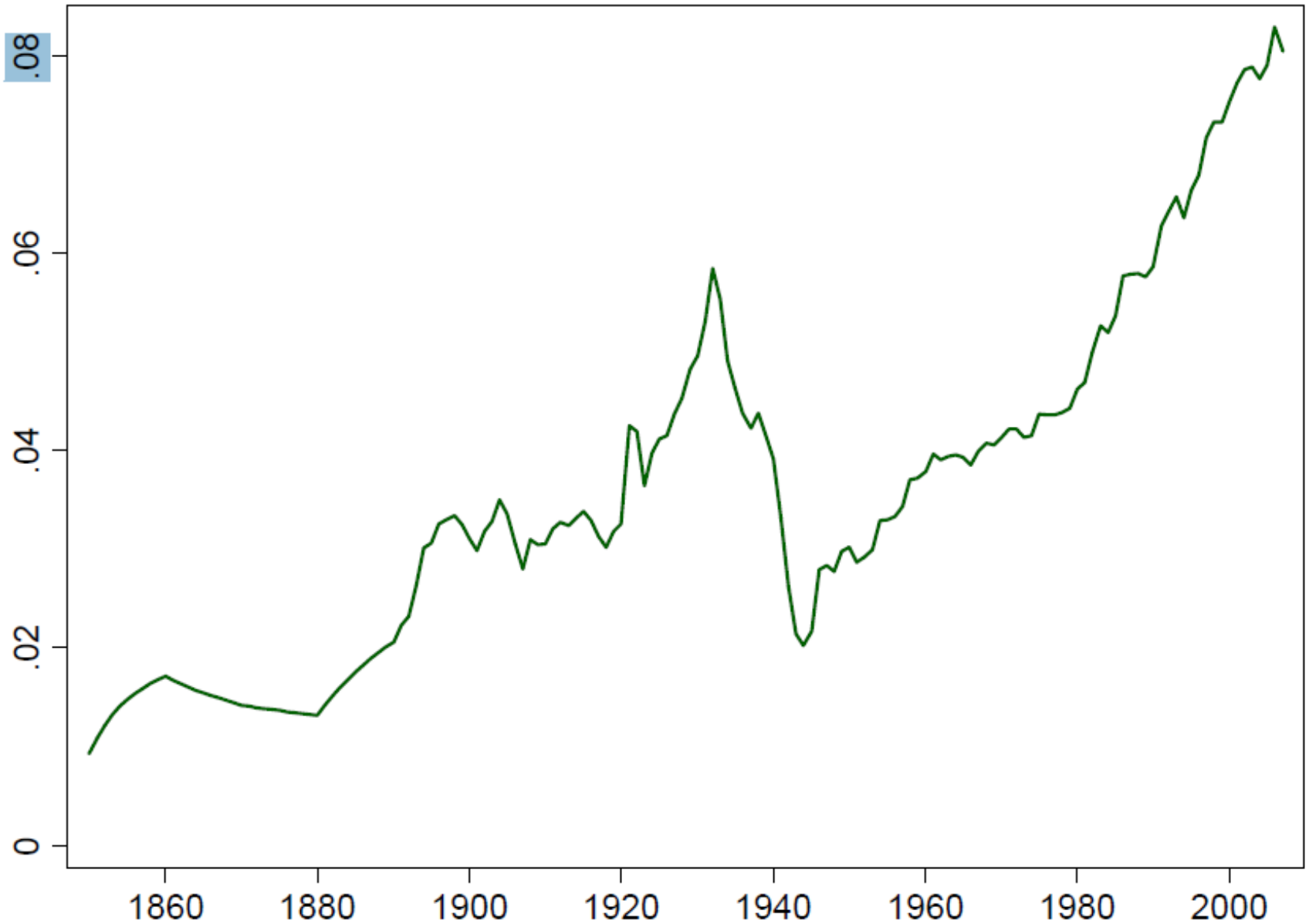
In the years following Brooksley Born's failed attempt to regulate over-the-counter derivative products in 1998, the complex contracts grew six-fold.

Over-the-counter derivatives market total, reported semiannually



Source: Bank for International Settlements

GDP Share of US Finance Industry



Traditional Wall Street Values



“We do not speculate with the firm’s money. That means we do not invest it in common stocks except where we are market-makers; then we hold stocks in our inventory, but only for brief periods of time....We are of course, in business to make money. **But if adherence to this careful philosophy of Merrill’s had benefitted only Merrill Lynch, those of us who direct the firm would have a sense of incompleteness.** In a time when our interests and some broader interests of the public coincided more clearly than ever before, we were gratified by the knowledge that our policies served other people besides ourselves, and served them well.”

1970 Merrill Lynch Annual Report

The Death of the Client

“We didn't have the word 'client' or 'customer'We had counterparties - and that's because we didn't know how to spell the word 'adversary’.”

——Lloyd Blankfein



Wall Street Business Model Shift

FROM

Clients

Business model dominated by revenues and profits from customers/clients

Partnerships
Partner Capital – long-term return outlook

Compensation – aligned with customers and partnership model

Government— implemented financial industry regulations and oversight Wall Street



TO

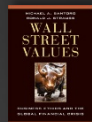
Counterparties (adversary)

Business model dominated by revenues and profits from trading/principal transactions

Public Companies
Other People's Capital – short term return outlook

Compensation – encourages risk taking; rewards executives while shareholders retain risk.

Government— abandons financial industry regulations and oversight



Senator Carl Levin

Senate Permanent
Subcommittee on
Investigations (April
2011)



“The evidence shows that Goldman repeatedly put its own interests and profits ahead of the interests of its clients.”

“Goldman knowingly sold securities to clients at prices above its own book values and, within days or weeks of the sale, marked down the value of the sold securities, causing its clients to incur quick losses and requiring some to post higher margin or cash collateral.”

“The Goldman Sachs case study focuses on how it used net short positions to benefit from the downturn in the mortgage market, and designed, marketed, and sold CDOs in ways that created conflicts of interest with the firm’s clients and at times led to the banks profiting from the same products that caused substantial losses for its clients.”

Market Information Short-Circuited at Crucial Time



The greatest damage was done to the financial markets at a crucial time—2007—when a change of course might have been able to significantly mitigate the fallout that continues to plague the global economy.

Not only the ethics of relations with clients at stake.
Information flows from those relationships.



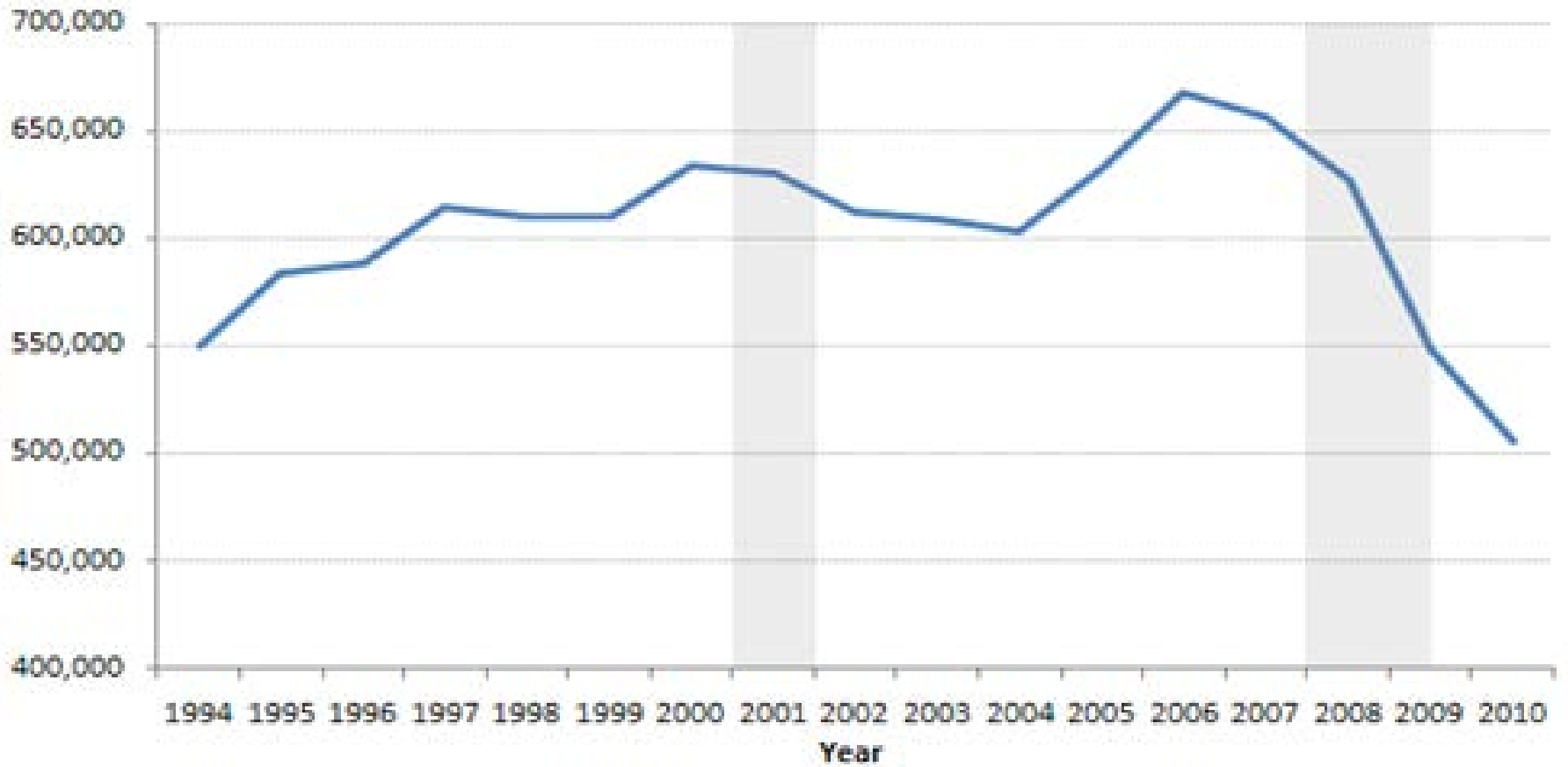


Role of Compensation Practices

In 2006-2007 nearly \$500 million of executive incentives were paid in cash to the senior managers of the seven major financial services firms that failed less than a year later between March 2007 and September 2008.

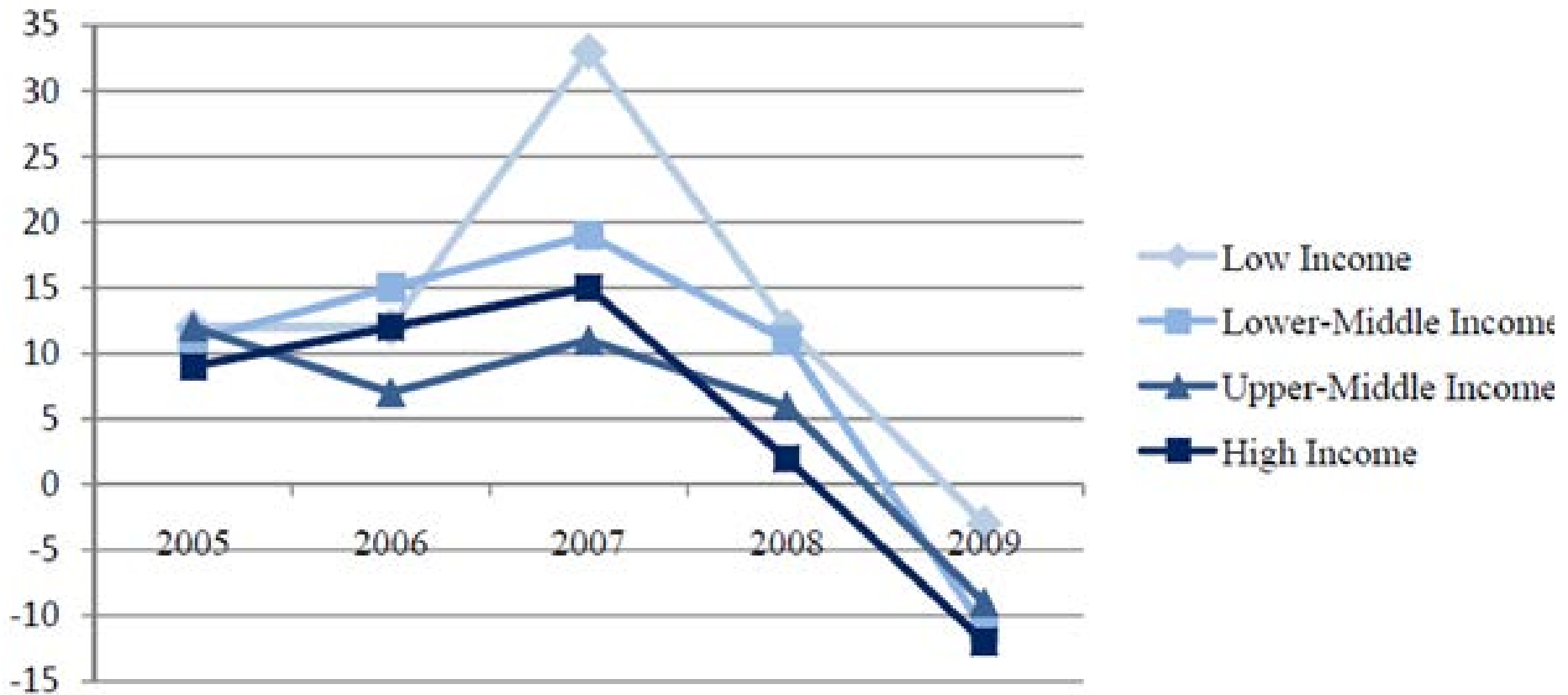
Who Was Hurt?





Source: U.S. Bureau of Labor Statistics

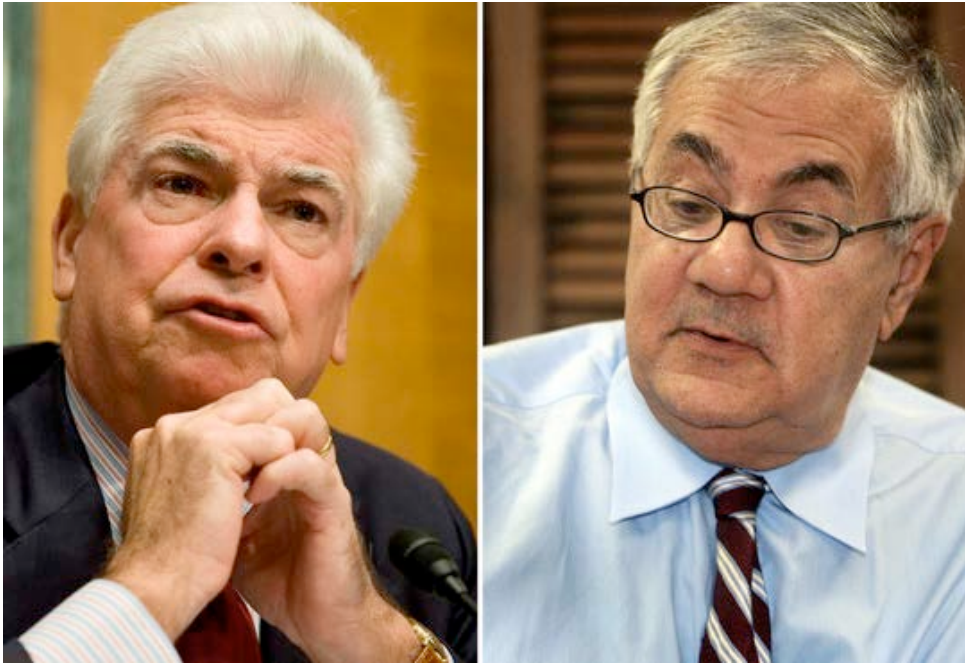
Number of Businesses <1 Year Old



One year growth (percentage change) in new firm formations

Source: Klapper, L. and Love, I. (2010). The Impact of the Financial Crisis on New Firm Registration. World Bank Policy Research

Dodd-Frank Act



“To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes”

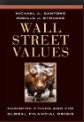
Would, inter alia, prohibit proprietary trading by “insured depository institutions.”

Conclusion: The Ongoing Crisis

- Wall Street is dangerous even when it doesn't fail; crisis for critical role at epicenter of capitalism.
- Intelligent Regulation. Must also be alert to business models which impede information flow and capital formation. DF: Relations of “banking entity” with hedge funds?
- Wall Street Values: Wall Street needs to reflect on its role in free markets and capitalism beyond rhetoric.

Unfinished Business and Ongoing Risks

- What are the new Values that Reflect the Modern Wall Street Business Model?
- Wall Street remains detached from reflection and deep reassessment of core ethics
- Compensation
- Conflicts of Interest
- Volcker Rule
- Dodd-Frank
- JPMorgan Whale
- LIBOR scandal

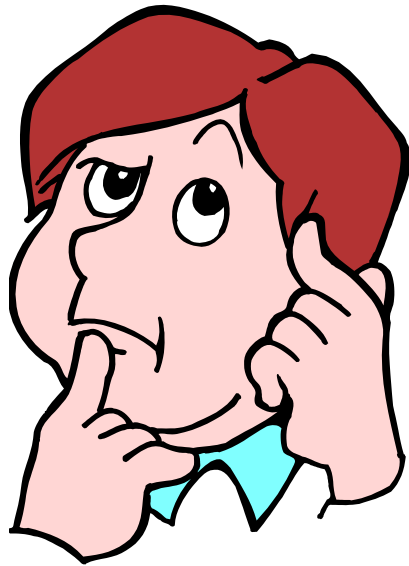


CFE



Company CEO:

How much is two plus two?



First accountant: **Four.**

Second accountant: **Four.**

Third accountant: **How much would you like it to be?**



Three key elements of ethics:

- involves questions requiring reflective choice (decision-making)
- involves standards of right and wrong (moral principles)
- is concerned with values (the “greatest good”)



But the right choice
is not always clear...

Do we choose the one that...

a) produces the greatest good

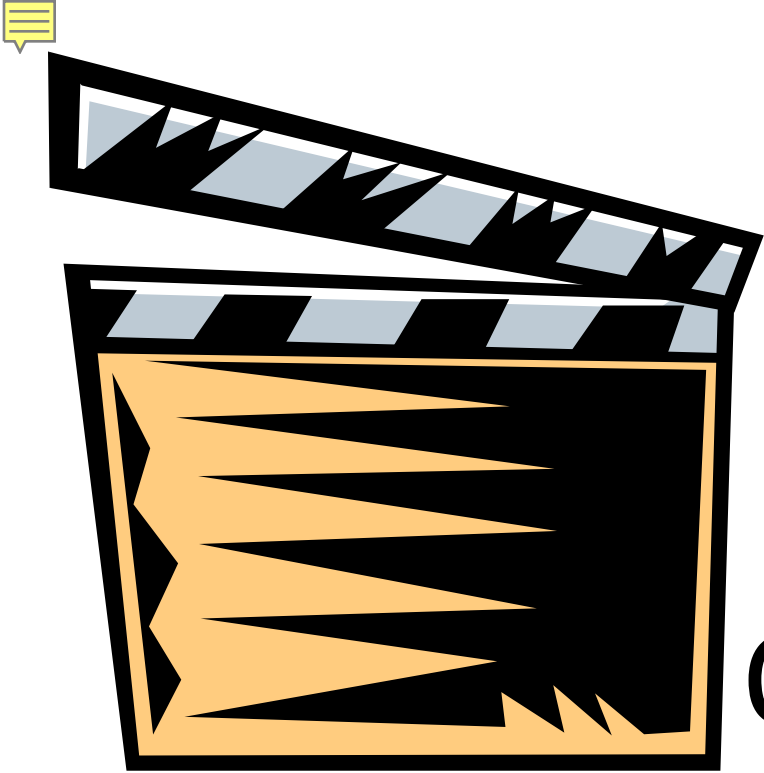
OR

b) conforms to moral rules and
principles?

Does the end justify the means?

Is it OK to lie,
to catch a
crook





One of the main
purposes of ethics
is to direct our
actions...



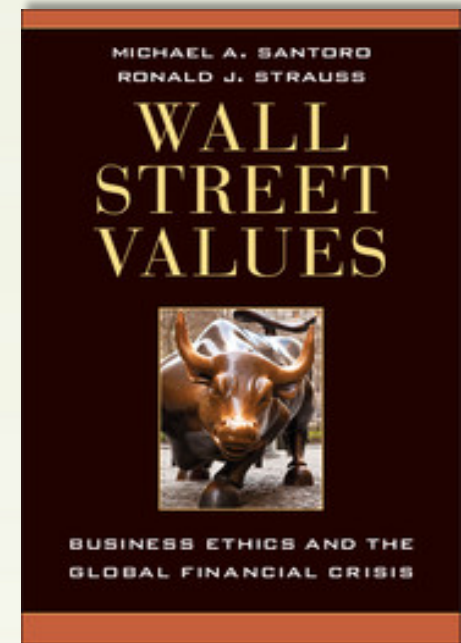
ACFE Code of Professional Ethics

- A Certified Fraud Examiner shall, at all times, demonstrate a commitment to professionalism and diligence in the performance of his or her duties.
- A Certified Fraud Examiner shall not engage in any illegal or unethical conduct, or any activity which would constitute a conflict of interest.
- A Certified Fraud Examiner shall, at all times, exhibit the highest level of integrity in the performance of all professional assignments and will accept only assignments for which there is reasonable expectation that the assignment will be completed with professional competence.
- A Certified Fraud Examiner will comply with lawful orders of the courts and will testify to matters truthfully and without bias or prejudice.
- A Certified Fraud Examiner, in conducting examinations, will obtain evidence or other documentation to establish a reasonable basis for any opinion rendered. No opinion shall be expressed regarding the guilt or innocence of any person or party.
- A Certified Fraud Examiner shall not reveal any confidential information obtained during a professional engagement without proper authorization.
- A Certified Fraud Examiner will reveal all material matters discovered during the course of an examination which, if omitted, could cause a distortion of the facts.
- A Certified Fraud Examiner shall continually strive to increase the competence and effectiveness of professional services performed under his or her direction.
- **A CFE shall continually strive to learn more about ethics and the importance of ethics to informing choices**

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