



Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector

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WORKING PAPER (DATED 12-04-10)

LAWFUL BUT CORRUPT

**Gaming and the Problem of Institutional
Corruption in the Private Sector**

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Abstract

This paper describes how the gaming of society's rules by corporations contributes to the problem of institutional corruption in the world of business. "Gaming" in its various forms involves the use of technically legal means to subvert the intent of society's rules in order to gain advantage over rivals, maximize reported earnings, maintain high credit ratings, preserve access to capital on favorable terms, and reap personal rewards—just mention several possible motives. It is one of the most corrosive forms of institutional corruption in business. "Institutional corruption" refers to company-sanctioned behavior and relationships that may be lawful but either harm the public interest or weaken the capacity of the institution to achieve its primary purposes. The most salient consequence of institutional corruption is diminished public trust in the governance of the institution. In this paper, I describe the twin phenomena of gaming and institutional corruption—and how the former contributes to the latter, often with the support of professional advisors at law and auditing firms. I illustrate these phenomena with examples from Enron, which (apart from outright fraud) pursued one of the greatest gaming strategies of all time. I also point to the implementation of the Dodd-Frank Act as an excellent source of clinical data pertaining to gaming in a more contemporary setting. I then discuss how gaming and other trust-destroying behavior have been encouraged by the short-term decision-making horizons of both corporate executives and managers of large investment funds, how those time horizons are largely driven by ways in which the performance of operating executives and investment fund managers is measured and rewarded, and how the directors of these entities become complicit in the gaming of society's rules and the spreading of institutional corruption. I end by suggesting possible remedies for curbing the ill effects of continued gaming of society's rules and restoring much needed public trust in the offending institutions.

I. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in July 2010, requires regulatory agencies to write 243 new rules clarifying provisions identified but not crafted by Congress, such as rules pertaining to the “Volcker Rule” on proprietary trading by banks. Congress left such detailed language to regulators to ensure passage of the act. That, in turn, has unleashed massive lobbying by the finance industry to determine how the remaining rules will read and how much “gaming” these rules will allow.*

In the business world, gaming society’s “rules of the game” refers to subverting the intent of socially mandated or legislated rules for private gain without resorting to blatantly illegal acts. Possible motives include gaining advantage over rivals, maximizing reported earnings, maintaining high credit ratings, preserving access to capital on favorable terms, and reaping superior personal rewards, just to name a few. Gaming comes in two basic forms: a Rule-Making Game and a Rule-Following Game.

The Rule-Making Game involves influencing the writing of society’s rules by legislative or regulatory bodies, so that loopholes, exclusions, and ambiguous language provide future opportunities to “work around” or circumvent the rules’ intent for private gain. The Rule-Making Game is an influence game.

The Rule-Following Game involves the actual exploitation of these gaming opportunities. This game involves following the letter of the law but not necessarily its intent or spirit, as well as violating grey areas of the law in ways that are not easily understood or recognized as violations. The Rule-Following Game is thus a compliance game.

Gaming is not always easy to identify because it is so closely related to conduct that is a perfectly acceptable part of business life. Indeed, many members of the business community perceive gaming as entirely proper. They believe that every purposeful economic actor is by definition self-interested, and that economic agents (managers) are expected, by explicit or implicit contract, to represent and protect the private interests of their principals (owners). They view their efforts to petition or lobby the government to shape rules in ways that benefit their businesses’ competitiveness and profitability as a right guaranteed by the Constitution. These business leaders also argue that in the absence of outright violations of established rules, there is nothing inappropriate about exploiting ambiguities in those rules, especially when critical judgments regarding proper (or improper) compliance have been ratified by expert legal and accounting professionals. While these views may be technically correct, I argue in this paper that gaming crosses the line of acceptability and becomes institutionally corrupt when such institution-sanctioned behavior subverts the intent of society’s rules,

* On October 29, 2010, the *Wall Street Journal* reported concerns of former Federal Reserve Board Chairman Paul Volcker about the final crafting of his namesake rule—namely that “narrow or prescriptive rules would invite gamesmanship on the part of banks and could allow firms to evade the rule’s intent.” The report also described how some banks and their lobbyists were already seeking to sway regulators and encourage them to narrowly define certain types of trading activities. On November 2, 2010, the *Journal* reported that Volcker said in a letter to the new Financial Stability Oversight Council that the new rule must be written so that “bankers and their lawyers and lobbyists” don’t exploit “ambiguities” and try to evade the law. He also said in the letter that he was conscious of the fact that proprietary trading may continue under another name and recommended that regulators be on the lookout.

thereby harming the public interest, or weakens the capacity of the institution to achieve its espoused goals by undermining its legitimate procedures and core values.

According to this definition, “corruption” does not necessarily involve a violation of legal rules. Rather, the relevant standards for defining institutional corruption include a public interest standard and a private procedural standard. These twin standards show how corrosive institutional corruption can be: it involves both social injury (corruption *by* the institution), whether illegal or not, and institutional injury (corruption *of* the institution).^{*} The most important consequence of institutional corruption is diminished public trust in the governance of the institution in question.

Persistent institutional corruption—including corruption stemming from gaming of society’s rules of the game—inevitably shapes capitalism and democracy, including how Congress and regulatory agencies monitor and control business enterprises, and how markets function. That’s because few institutions in a democratic society—whether in the private or public sector—can survive over the long run in the absence of public trust. If the kind of trust-destroying behavior we have seen during the financial crisis continues unabated, then the Dodd-Frank bill may turn out to be only the beginning of far more radical changes in our systems of economic and corporate governance.^{**}

With this unsettling possibility in mind, I aim here to describe what gaming and institutional corruption in the private sector looks like. I also show how the way Congress writes many of society’s rules—and the strong temptation for business executives to game those rules once enacted—fosters institutional corruption. I point to implementation of the Dodd-Frank Act as a promising case study for furthering our understanding of private-sector gaming, and then speculate about the kinds of remedies most likely to contain this increasingly troublesome blight on U.S. capitalism.

The working hypothesis underlying this paper is based on three related propositions. The first is that extensive lobbying by business interests during congressional and administrative rule-making aims not only to minimize regulatory constraints. Such lobbying also seeks to preserve—and even open up—future opportunities to game or legally subvert the intent of those rules for private gain.

The second proposition is that the purposeful gaming of society’s rules by business firms is fueled by the short-term decision-making horizons of corporate executives and investment fund managers, whose behavior is conditioned and reinforced by perverse incentives embedded in their compensation plans.

^{*} The clear characterization of “corruption *by* the institution” and “corruption *of* the institution” was suggested to me by Dennis F. Thompson.

^{**} This observation is compatible with the well-developed thesis of Benjamin Heineman, the former general counsel and senior vice president of law and public affairs at GE that “the fusion of high performance with high integrity is the foundational goal of global capitalism and are necessary to the trust without which company’s cannot operate.” See *High Performance with High Integrity* (Harvard Business School Press, 2008).

The third proposition is that corporate boards of directors become complicit in the gaming of society's rules when they allow gaming to take root and persist as an acceptable organizational norm—by failing to articulate and promote quality objectives and actively monitor behavior according to the standards implied by these objectives.

This working hypothesis also acknowledges the influence of corporations' professional advisors, such as those at law and auditing firms. These advisors often support clients' gaming of society's ambiguous rules because the economic benefits of retaining these clients overwhelm the advisors' professional responsibility to uphold rules and regulations governing business conduct.

The Concept of Institutional Corruption

Scholars interested in political philosophy, public policy, and the law have long been working to develop a set of ideas that adequately define corruption in public life.

According to Dennis Thompson, who has been studying corruption in the Congressional setting for two decades*, institutional corruption is “a form of corruption in which an institution or its agents receives a benefit that is directly useful to the institution, and systematically provides a service to the benefactor under conditions that tend to undermine legitimate procedures of the institution.” In Thompson's construct, corruption is defined by institutional behavior that damages that institution's central, “legitimate” procedures. Legitimate procedures refer to processes “necessary to protect the institution against interests that undermine its *effectiveness* in pursuing its primary purposes, and the *confidence* of the relevant publics that it is doing so.”¹

Lawrence Lessig has also initiated a study of institutional corruption, primarily focused on the public sector.** According to Lessig, the seeds of institutional corruption are planted when an entity's behavior becomes rooted in dependent relationships with *outside* parties that conflict with the institution's intended purpose. Institutional corruption also occurs when an organization's *internal* “economy of influence”—such as performance measurement and reward systems, and leaders' directives—leads people to act in ways that compromise that organization's essential processes, espoused values, and intended purpose.²

Institutional corruption is confirmed, according to Lessig, when public trust falls in response to a collective perception that the institution and its leadership no longer behave according to society's understanding of its espoused purpose. The greater the perceived dependence of an institution on external and internal sources of influence that detract from its espoused purpose and compromise its essential processes, the higher the level of public distrust in the conduct and governance of that institution.

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Lessig's study of Congress is a prime example of institutional corruption in the public sector. He shows how nonstop fundraising by members of Congress has debased the legislative process, as powerful interests have become increasingly active in "purchasing public policy." Lessig's description of how members of Congress are elected and conduct their business once in office starkly reveals how lawful relationships with donors, patrons, and lobbyists have reduced public trust in Congress—now below 20 percent, according to various polls.

Lessig's concept of institutional corruption, like Thompson's, also applies to the private sector, despite a few complicating factors that I address below. The recent history of the U.S. financial industry and Enron-type breakdowns shows how personal and institutional opportunism undermines society's perception of the purpose and obligation of business institutions. Recent history also shows how quickly those institutions can become severely disabled or collapse when key constituencies—including customers, clients, and trading counterparties—start doubting the institutions' espoused purpose and the way they govern their affairs.

In commenting how the concept of institutional corruption to business situations, Thompson focuses on the institutional (rather than the more directly societal) aspect of corruption and explains the important difference between individual and institutional corruption. His conception is broadly compatible with Lessig's construct.

Institutional corruption [in the world of business] is a form of corruption in which a corporate executive allows or encourages outside interests to influence his decisions in ways that undermine the proper procedures or long-term goals of the corporation. It differs from individual corruption in that even if the executive personally gains (from higher compensation, for example), the conduct is closely related to the job and can be rationalized as necessary or useful to the job.³

There is perhaps no clearer recognition of the magnitude of institutional corruption in its broadest sense by the private sector than "Restoring Trust in Corporate Governance," written by Ben Heineman, former senior vice president for law and legal affairs of GE, and published by the Committee for Economic Development (CED), a business-led policy group.⁴ The very existence of this report reflects a broad-based crisis of confidence in the business community about its public standing in the aftermath of both the Enron/WorldCom scandals and the recent economic turmoil, brought on by imprudent business decisions, self-serving behavior, extensive gaming of rules and regulations, and inadequate corporate governance practices.

Other recent work on private-sector corruption has focused on corporate behavior that clearly crosses the line into illicit and unlawful activity. One example is Washington, D.C.-based Global Financial Integrity, which works with 55 governments to curtail the flow of illicit funds (those "illegally earned, transferred, or utilized"). Another is Transparency International, which also seeks to expose manipulations of normal commercial procedures, such as transfer pricing used to evade taxes, and the use of agency fees for bribery

embezzlement, fraud, and price fixing. A third example is research by HBS professors Rawi Abdelal and Rafael Di Tella on criminal behavior in the global financial system.

While not specifically addressing lawful but corrupt institutional behavior as I have defined it in this paper, this cluster of work reflects broad interest in the business and political communities in curbing illegal financial transactions to ensure that global markets function well.

Structure of This Working Paper

In contrast to work addressing illegal transactions and conduct, I focus here on socially destructive corruption that lies *outside* the reach of the national and international legal system. In Section II, I say a few words about the challenges of applying the general concept of institutional corruption to the private sector.

In Section III, I explore three of the four most common forms of trust-destroying private-sector behavior, all well documented by scholars and practitioners. These include violating norms of fairness, tolerating conflicts of interest, and exploiting cronyism embedded in business-government partnerships.

In Section IV, I describe a fourth key form of institutional corruption in the private sector: the gaming of society's rules of the game by business executives—often supported by their external legal and accounting advisors. This insidious and increasingly ubiquitous behavior is my core focus because it is perhaps the least visible variant, and has therefore received much less systematic analysis than the first three. In this section, I illustrate both Rule-Writing and Rule-Following Games with examples drawn from the history of Enron's dramatic collapse, which (apart from outright fraud) showcases one of the greatest gaming strategies of all times.

In Section V, I build on the paradigmatic Enron case by hypothesizing how entirely lawful lobbying efforts by the business community often serve to preserve opportunities for gaming rules created by Congress and regulatory agencies. I also suggest that overly narrow or, alternatively, highly ambiguous rules built into many regulatory regimes may actually have been drafted to preserve “wobble room” for affected parties. When private entities exploit this wobble room for private gain—and in so doing violate the intent of the rules—they court institutional corruption. I point to implementation of the Dodd-Frank act as an opportunity to study this phenomenon in more depth.

In Section VI, I hypothesize that the shrinking time horizon of corporate executives and investment fund managers reinforces, and even promotes, the gaming of society's rules and regulations, and thus institutional corruption in the private sector.

In Section VII, I propose possible remedies for curbing both rule-making and rule-following games and restoring public trust in business institutions. These partial remedies are aimed at extending the decision horizon of corporate executives and fund managers through possible changes in public policy (such as reduced tax rates on “super-long-term” capital gains) and business policies (affecting executive pay and the monitoring practices of

corporate boards of directors). My suggestions both embrace and go beyond recommendations in the recent CED report.

II. Applying the Concept of Institutional Corruption to the Business World

As noted above, a principal consequence of institutional corruption is diminished public trust in the governance of an institution. Public trust is therefore an important indicator of the degree of institutional corruption.

Measuring public trust in business is not a clear-cut exercise. To begin, “the public” in the world of business includes a diverse collection of sub-publics, such as shareholders, bondholders, creditors, employees, customers, communities, the media, elected officials, opinion leaders, and the general public. For each of these publics, trust or distrust may depend on particular factors requiring a different measure in each case. Each of these publics may also act in different ways based on its assessment of institutional performance.

For example, trust by investors may depend on the predictability of company returns and corporate transparency. In the absence of either, distrust sets in: equity holders sell their stock, or, given persistent distrust, may initiate a proxy fight or a battle for corporate control. Or, as another example, trust among employees often depends on perceptions of fairness in pay, benefits, and working conditions. In the absence of perceived fairness, employees organize against owners or initiate work stoppages, and those with job mobility simply quit. In contrast, trust in business institutions by elected officials may depend on campaign support, ideological predisposition, and transparency among corporate leaders during congressional testimony, and political convenience.

To complicate matters, it is not at all clear that various publics can rely on the print, TV, or electronic press—key sources of information—to capture and interpret the behavior and performance of business institutions. The media’s reading on individual companies is often poorly researched, and members of the media are often subject to the herding tendencies of Wall Street analysts, whom they regularly interview. Similarly, the expressed opinions of elected officials regarding the conduct of industries and firms often reflect a less-than-full understanding of the facts of a case—not to mention partisan interests. Business firms and their executives are therefore often subject to false charges or insinuations of corruption by the press and its readers or, alternatively, awarded uninformed “free passes.” As Thompson has aptly said, “Sometimes they [public and private institutions] are unfairly accused, sometimes unfairly excused.”⁵

Given these complicating issues, we must rely on polls that can only *suggest* the level of public trust in business institutions. For this reason, we need to be careful not to overgeneralize or overextend the apparent meaning of spotty data.

So what does recent polling data suggest? Edelman, a public relations firm, recently reported that only 29 percent of college-educated Americans surveyed in fall 2009 trust bankers to do the right thing—down from 68 percent in 2007. For U.S. business in general, the level of public trust was about 50 percent in 2009, according to the Edelman Trust

Barometer.* This highly skeptical view of bankers casts a long shadow of public distrust over many of our largest financial institutions.

Focusing on the pharmaceutical industry, a Harris poll found that the percentage of adults who believe that drug companies adequately serve their customers fell from 79 percent to 44 percent from 1997 and 2004. Less than 14 percent of respondents described drug companies as “generally honest and trustworthy.”⁶ Other polls have revealed even higher levels of public distrust and vitriol regarding this industry.

Despite its lack of firm-specific findings, this survey casts a long shadow over the reputations of players in this industry. Two practices, in particular, provoke public criticism: drug marketing and patent protection. Critics argue that industry marketing often disguises itself as physician education or research, and that drug companies pursue inappropriate gaming strategies to fend off competition from lower-priced generics.

Another challenge in measuring institutional corruption in business involves unbundling it from outright violations of statutory law, regulations, and accounting and SEC rules. Not surprisingly, the borderline between the two is not always crystal clear.

Take, for example, the Enron story. A close reading of the report of the bankruptcy court examiner—itsself based on tens of thousands of pages of subpoenaed documents—reveals that Enron’s executives engaged in both clear fraud and far more ambiguous relationships and transactions. Many commentators focused solely on the more easily understood instances of statutory fraud, totally missing the most interesting and instructive part of the Enron story: institution-supported behaviors and transactions that were legally and ethically unclear and, over time, trust destroying.

In another example, European leaders have criticized Goldman and other banks for allowing the Greek government to borrow 1 billion Euros through swaps, and in so doing avoid adding to the official public debt. Did Goldman design and participate in a transaction that aimed to doctor national statistics? Did the artificially low exchange rate assumed in the swaps reduce Greece’s apparent debt? Was this camouflage legal? The EU commissioner and other parties will need time to unravel the legitimate from the potentially illegal aspects of this relationship.

In marked contrast to public officials, who cannot expect to be reelected if they lose public trust, business executives have few incentives to consider that ambiguous notion in their decision-making. Both Simon Johnson, former chief economist of the IMF, writing in the May 2009 *Atlantic*, and Michael Lewis, in *The Big Short*,⁷ which exposes Wall Street’s behavior before and during the recent financial crisis, reveal the paucity of incentives for the financial community to consider—let alone nurture—public trust.

One problem is the lack of widely accepted and enforced professional standards of conduct in the business world—which are at least nominally present in the public sector and the legal profession. As a result, more measurable and immediate concerns, such as consumer

* The 50 percent trust level for U.S. business may be overstated, because Edelman also reports that only 38 percent of high-income earners surveyed said they listened to what a firm’s most senior executive had to say when forming an opinion of the company.

loyalty, sales growth, and reported profits, often crowd out considerations of public trust in the compensation, retention, and promotion of business executives.

When the result is a decline in public trust, public excoriation (such as by President Obama), regulatory reform (such as in the Dodd-Frank Act), and even the criminalization of failure (such as investigations by Congress or state attorneys general) may follow.

III. Common Forms of Institutional Corruption in the Private Sector

Four activities and behaviors that foster institutional corruption seem especially prevalent and corrosive in today's conduct of business affairs.⁸ These include violating norms of fairness, tolerating conflicts of interest, exploiting cronyism, and gaming "society's rules of the game." I address the first three in this section.

Violating Norms of Fairness

Fairness, as we might expect, is a difficult notion to pin down. Who, after all, is able to judge fairness objectively? Don't we all have a natural tendency to rely on self-serving interpretations of fairness? Is fairness treating everyone alike? Treating others as you would like to be treated? Providing equal opportunity? Preserving a level playing field? These are challenging questions. However, we can intuit norms of fairness in the business world by examining activities such as commercial transactions and executive compensation.⁹

On the transactional side, the subprime mortgage debacle provides two noteworthy examples of unfairness. Largely unregulated predatory bankers and brokers promoted subprime mortgages with less-than-full disclosure of complicated obligations to customers who bought them without understanding the consequences. Although no prosecutable violations of law may have occurred, the sellers broke basic norms of fairness: some combination of the obligation to ensure a level playing field and "treat others as you would like to be treated."

Assemblers of mortgage-backed securities at leading investment banks also violated a fairness norm in not guaranteeing to "take back" defective products built around poorly understood and priced risks. This behavior contrasts sharply with that of other product developers and sellers, such as computer and auto manufacturers, who guarantee the performance of their goods. If a circuit board turns out to be defective shortly after a sale, the manufacturer typically repairs or replaces the computer. It is simply good business, and the fair thing to do: who wants to be sold a defective good, especially if it is a "risk product"? But who has ever heard of an investment bank repairing or taking back a defective product?

Public trust in bankers—as well as credit-rating agencies—has plummeted, polls show. So these financiers have not only violated fairness norms but also fostered institutional corruption.

Financial institutions—especially investment banks, which many now regard as publicly owned compensation machines—have also violated fairness norms in executive pay practices, explaining the extremely negative reputation of Wall Street with the general public.

According to my colleague, André Perold, Goldman Sachs' pretax income in 2007 was \$17.6 billion, while the firm's salaries, bonuses, and benefits totaled \$20.2 billion. Comparable numbers for Merrill Lynch were \$14.5 billion and \$15.9 billion, and for Lehman Brothers, \$6 billion and \$9.5 billion. From 1997 to 2007, the combined totals for Goldman, Merrill, Lehman, Morgan Stanley, and Bear Stearns were \$222 billion in pretax income and \$422 billion in salaries and benefits.

Strong negative public reaction to the compensation of Wall Street executives reflects several tests of fairness. These include unconscious notions of equitable payments for specific jobs, usually associated with our sense of their scope, importance, longevity, and risk; and more conscious comparisons of job inputs (technical, professional, and social strengths) and job outputs (personal satisfaction along with tangible rewards). Other fairness norms include our assessment of the relationship between an executive's pay and his or her performance, and our sense of the marketplace for human talent.

As both the media and a wide array of political actors have attacked the high pay of Wall Street executives for one of more of these reasons, the banking industry has taken a beating in public support and trust. Some firms have modified executive pay in response, while others are holding firm or pushing back, citing the market for executive talent as their principal justification. While we might all agree that determining what compensation systems qualify as fair defies systematic logic, the widespread pushback on banker and CEO pay—especially public outrage over the use by AIG and Merrill Lynch of public bailout funds to dispense enormous bonuses—reflects these norms of fairness and propriety.

This is not just an issue of appearances: violating these norms can have serious consequences for our economic system. Outsized Wall Street bonuses disconnected from real economic achievement and risk—and any consideration of performance relative to peers—were key factors in the downfall of the banking system, along with excessive opportunism and greed by both sellers and buyers of poorly conceived financial products, flawed models for pricing risk, poor risk management, and accounting shenanigans. Indeed, poorly designed and excessive payouts put tremendous pressures on executives to take excessive short-term risks, and to minimize or disguise those risks and the true financial conditions of their firms through deceptive accounting and reporting practices.

Tolerating Conflicts of Interest

Debilitating conflicts of interest appear in numerous settings and disciplines. Conflicts of interest can involve, for example, violation of people's trust in professionals such as lawyers, physicians, engineers, auditors, and architects, who hold respected positions and gain socially granted privileges owing to their formal training, certification, continuing education, and oversight by professional bodies with the power to enforce standards and exclude members who fail to meet those standards. However, business managers are not professionals in this sense: no entity defines criteria for entry and certification, sets ethical standards, or has the power to exclude someone from practice. We therefore need to reach for another definition of conflict of interest among managers.¹⁰

A useful definition is offered by Dennis Thompson, whom I have already cited as a pioneer in studying institutional corruption: “A conflict of interest in a corporate setting can be understood as a set of circumstances that are reasonably believed to create a substantial risk that an executive’s judgment of a primary interest (say, the long-term profitability of the corporation) will be unduly influenced by a secondary interests (say, personal compensation, personal ambition, short termism).” Thompson emphasizes that a conflict is not an occurrence. “It is not when a personal interest actually dominates the institutional interest. When that occurs, the less respectable interest has won; it has overpowered the more respectable one. The executive is then guilty of a different offense—not a conflict of interest, but dishonesty, self-dealing, cronyism, bribery and the like.” Violating conflict of interest rules precedes such behavior. It involves a failure “*to avoid situations*” [italics added] that from past experience appear to reasonable people to create a risk that one might do some of these things.”¹¹

Avoiding conflicts of interest in business becomes most problematic when managers acting as agents for a company’s owners—such as in investment banking, real estate, and the corporate boardroom—have a personal stake in a negotiated outcome.¹² Without being intentionally corrupt, such agents are naturally motivated to see the world in a way that maximizes their own returns. Conflicts of interest between principals and their agents are ubiquitous in corporate life.

Unfortunately, avoiding conflicts of interest between principals and agents is easier said than done. One key reason is our inability to recognize such conflicts in our own lives, and to devise provisions to limit them, as Max Baserman and his students have shown. Owing to our stubborn view of ourselves as moral, competent, and deserving, and often as more ethical than the average person, we develop ethical blind spots that enable us to feel immune to conflicts of interest, and that help us rearrange self-knowledge to sustain this unrealistic view.¹³

This occurred repeatedly, of course, during the buildup to the recent financial crisis, as embedded conflicts of interests and risks received far less attention from managers and regulators than deserved. In the absence of awareness and systematic oversight, deal originators at major banks received large bonuses for developing and selling triple-A-rated collateralized debt obligations (CDOs) stuffed with subprime mortgages before anyone knew whether the CDOs could perform as designed. This, of course, is a major perversion of the pay-for-performance principle and led executives down the path to self-dealing and dishonest transactions.

Once credit-rating agencies colluded (inadvertently or not) with deal originators in assigning triple-A grades to subprime mortgages bundled into portfolios of diversified mortgages, clients expected returns from the CDOs to be as secure as those from triple-A-rated U.S. treasuries. When the CDOs failed to perform on a massive scale, the interests of both the initial investors, the issuing banks, and the public (which bailed out the banks) were fatally compromised—while the deal originators kept their bonuses. This picture of winners and losers is a classic example of what happens when the risks of conflicts of interest are

unrecognized or unacknowledged. Self-dealing and dishonesty follows, which of course leads to diminished public trust in the institution.

Other examples of persistent, unacknowledged conflicts of interest that have weakened public trust in offending institutions come quickly to mind. These include rating agencies that failed to avoid the conflicts involved in helping credit issuers structure instruments to meet certain standards, and then rating the instruments, charging two sets of fees; and investment banks that failed to see the conflicts involved in advising companies on mergers and acquisitions, and then assembling a syndicate to finance the transactions, also charging two sets of fees (ditto for many swap advisors). It is not difficult to imagine how self-serving cognitive biases “ethically bounded” the principle actors in these cases.

Exploiting Cronyism

In the aftermath of the financial crisis, Simon Johnson has written about “the faint whiff of corruption” that has accompanied the cronyism or “partnership” between our financial oligarchy and elected officials.¹⁴ This is a third key form of institutional corruption.

Johnson argues that this cronyism—revealed in the confluence of campaign contributions, personal connections, and ideology nourished by uncompromising self-interest—led to the “river of deregulatory policies” that so benefited Wall Street oligarchs and contributed to the global financial crisis. Johnson’s description of the Wall Street–Washington “partnership” is far subtler than most. He describes how “the American financial system gained political power by amassing a kind of cultural capital—a belief system”:

Once, perhaps, what was good for General Motors was good for the country. Over the past decade, the attitude took hold that what was good for Wall Street was good for the country. The banking-and-securities industry has become one of the top contributors to political campaigns, but at the peak of its influence it did not have to buy favors the way, for example, the tobacco companies or military contractors might have to. Instead, it benefitted from the fact that Washington insiders already believed that large financial institutions and free-flowing capital markets were crucial to America’s position in the world...A whole generation of policy makers has been mesmerized by Wall Street, always and utterly convinced that whatever the banks said was true.¹⁵

Both Alan Greenspan and Ben Bernanke, his successor, repeatedly justified and celebrated the nation’s deregulated financial markets and the ability of banks to measure and manage their risks. Mathematical theories and risk-assessment models developed by the economics and finance faculties of leading universities gave this costly judgment academic legitimacy.

This belief system—coupled with campaign contributions and personal connections—spurred congressional repeal of the separation between commercial and investment banking, major increases in the leverage allowed investment banks, and an international agreement

permitting banks to measure their own riskiness. If ever a case could be made against such free-wheeling deregulation and confidence by policymakers in industry self-regulation, the 2008–09 financial crisis is it. Yet the veto power of the financial sector over public policy remains remarkably strong even as the sector has lost popular support.

Johnson characterizes cronyism in the finance industry as corrosive. I would add that hypercompetitive forces in the marketplace—intensified by personal opportunism nourished by turbocharged short-term incentives—also served to corrupt risk management and balance sheet management of financial institutions.

IV. Gaming as a Form of Institutional Corruption

For more than two hundred years the American political process has been at work cobbling together a form of capitalism with ever-expanding “rules of the game,” designed to create norms and boundaries on acceptable behavior by profit-making enterprises. These rules originate largely in Congress and are interpreted by state and federal courts, enforced by regulatory agencies, and hopefully overseen by attentive corporate boards of directors.

In a world with so many complex rules of the game and high financial stakes, businesses have plenty of incentives to game the rules to their advantage. In its most blatant form, this entails using every legal means short of fraud to gain advantage over rivals, manage earnings, minimize taxes, and maintain high credit ratings and access to capital on favorable terms.

As I noted in the Introduction, gaming involves both rule-making and rule-following. The Rule-Making (influence) Game involves sending campaign contributions to politicians and then lobbying them to include loopholes in new laws—and then exploiting those loopholes, even when such behavior subverts the laws’ intent. More subtly, the Rule-Making Game also involves ensuring that new rules have either *ambiguities* or overly *narrow regulations*, offering rich opportunities for businesses to pursue innovative strategies to circumvent the rules in a murky legal environment. The Rule-Following (compliance) Game involves complying technically with existing rules while exploiting their ambiguities for self-interested reasons—again even when such behavior subverts the rules’ intent. Both games risk harming the public interest and undermining the espoused goals and legitimate procedures of a company.

Rule-Making and Rule-Following Games occur in an environment where the legislative process is inevitably chaotic. Ambiguous rules, along with rules that apply to only an extremely narrow set of conditions, typically reflect compromises among parties that cannot agree, and intensive lobbying by parties who know exactly what they want. Determining the substantive basis on which to define gaming is therefore sometimes difficult. In the case of the Rule-Following Game, discriminating between gaming and simply living with “legislative mush” and compromise is not always easy. Piercing this complexity requires case-by-case analysis of the intent of a rule and a judgment of whether or not a company’s leadership seeks to subvert the intent of society’s rule for private gain. Thus, if a company’s objective is to subvert the intent of a rule through essentially lawful means, the resulting behavior qualifies as a gaming strategy.

Like violations of fairness norms and conflicts of interests, the Rule-Following (or compliance) Game is often fueled by self-serving interpretations of appropriate conduct. Many business people and their lawyers and accountants view testing the outer limits of the law as a natural and acceptable feature of U.S. capitalism—as “American as apple pie.” Herein lies the particular insidiousness of gaming—and the major difference between it and clearly illegal conduct.

Of course, many firms that find themselves living in the murky borderlands of the law attempt to nurture a corporate character reflecting high ethical and legal standards. They create internal codes of ethics emphasizing compliance with the law and certain ethical standards as conditions of employment. Some firms also require executives to sign a certificate of compliance and periodically reaffirm their commitment to values such as respect, integrity, and excellence. However, as laudable as these codes may be, an inconsistent management style by institutional leaders—coupled with perverse incentives, breakdowns in internal controls, ineffective board oversight, and an absence of transparency—can quickly neutralize published codes, grease the wheels of ethical drift, and encourage gaming of society’s rules of the game.

So, too, can ethical drift and gaming be perpetuated by the ratification of questionable interpretations of rules and regulations offered by outside legal counsel and auditing firms. Indeed, the reliance on professional advice on legal “close calls” by outside lawyers and auditors is often at the center of institutional corruption in business. Professions such as the law and auditing are defined by the standards they enact and enforce. However, the prospect of large, continuing fees based on helping clients skirt the law rather than adhere to its spirit often looms large. When it does, the “inappropriate dependence” of professionals on clients—rather than the rules they have pledged to uphold—can easily corrupt the application of professional standards.

In the Enron case, for example, the examiner appointed by the bankruptcy court criticized the (now-defunct) accounting firm Arthur Anderson, and Enron’s outside counsel, Vinson & Elkins, for inappropriately approving the accounting treatment of many questionable transactions, and for disseminating favorable opinions regarding Enron’s structured-finance transactions. Both firms were extremely well compensated for their opinions.¹⁶ For that and other reasons, Enron is an instructive case of the gaming of society’s rules.

Enron as the Ultimate Gamer of Society’s Rules

Enron pursued both forms of gaming with equal energy. The results of that gaming activity led to unwise business decisions, an abrupt decline in client and investor trust, eventual bankruptcy, and unprecedented criminal indictments and convictions, many of which are still being contested in the courts. Along the way Enron’s gaming behavior destroyed the legitimacy of its internal risk management and governance processes and sabotaged the company’s goal of becoming the world’s most innovative energy company. Over \$60 billion in shareholder value was destroyed in the process. This was institutional corruption of the most virulent and infectious kind!

Enron's Rule-Making Game

Enron's efforts to rewrite society's rules of the game centered on the deregulation of electricity and the opening up of mark-to-market accounting for non-financial institutions. The deregulation initiative is a particularly instructive example of the Rule-Making Game in action.

Key to achieving the company's strategic objectives was a large-scale lobbying organization that Enron developed, and aggressively deployed, to communicate the benefits of free, unregulated energy markets, and to actually make deregulation happen. The complex pattern of energy regulation in the U.S. took root in the 1930s with the goal of putting an end to electrical holding company abuses, enforcing the social responsibilities (rights) of local electric power companies as natural monopolies, protecting their customers from discriminatory pricing. From his earliest days as a member of what was to become the Federal Energy Regulatory Commission (FERC), Kenneth Lay, who was to become Enron's Chairman and CEO, had argued for deregulation in the form of removing regulated retail prices for energy.¹⁷

When FERC finally began to overhaul its regulations, Enron pressed for further changes. It staffed a Washington office with more than 100 lobbyists, and from 1999 to 2001 spent a large portion of the office's \$6.5 million budget on efforts to block government agencies from regulating its derivatives trading business, and to influence appointments at the Securities and Exchange Commission, FERC, and the Commodity Futures Trading Commission. This total does not include another \$1.6 million that Enron paid in 1999 and 2000 to outside professional lobbyists who supported Enron's in-house staff. The company was also a steady and heavy contributor to legislators and their political parties, pumping \$2.4 million into the political system during the 2000 election cycle.¹⁸ Lay eventually got the price deregulation he sought from FERC, but FERC will always be remembered for its lack of oversight of subsequent market manipulation of energy prices by Enron.

Enron's objectives were not merely to change the rules in the natural gas and wholesale electricity businesses in the early 1990s, but also to preserve maximum freedom in designing the rules of the game for the derivatives trading market it was pioneering. The company was notably successful in its 1992 petition to the Commodity Futures Trading Commission, which argued for exempting the budding market for "energy swaps" from government oversight.¹⁹ Consequent to this success, Enron developed a trading operation that was virtually unregulated.²⁰

Its lobbying operation also succeeded in the 1990s in obtaining waivers from registering the Oregon unit of Enron's Portland General Electric Co. and its wholesale power trading operations under the Public Utility Holding Act—thereby exempting Enron from reporting requirements and public oversight.²¹ Most notably, in 1997 Enron won an exemption from the Investment Company Act of 1940, which could have prevented its foreign operations from shifting debt to off-balance-sheet partnerships, and barred executives from investing in partnerships affiliated with the company. Enron's exemption cleared the path for it to both

expand overseas and make greater use of the special partnerships that eventually caused so much turmoil and again subverted the intent of energy deregulation.²²

After SEC lawyers approved the exception “as narrow because it applied only to the foreign operations of Enron and some of its subsidiaries,” Enron pushed the limits of the ruling. Remarkd a former SEC official: “[The ruling] gave them carte blanche to go all over the world and set up subsidiaries and affiliated entities that would have been prohibited under the act.”²³

Enron won another lobbying victory in December 2000, when the Commodity Futures Modernization Act—cosponsored in Congress by Senator Phil Gramm (R-Texas)—included a special exemption that permitted Enron to operate an electricity auction free from federal scrutiny.²⁴ Documents disclosed in March 2002 reveal that the company also lobbied successfully for several years for permission to postpone the payment of U.S. taxes on some overseas profits, including income from Enron’s derivatives deals.²⁵

Besides successfully exempting itself and its competitors from oversight by industry-specific regulators, Enron also lobbied to remove itself from the scrutiny of securities regulators. In the 1970s and 1980s, Congress members from oil-producing states pressured the Financial Accounting Standards Board and the SEC not to pursue tougher standards for reporting by petroleum companies of reserves, operating costs, and capitalized costs.²⁶ It was because of these and subsequent efforts that the SEC paid so little attention to the partnerships that proved to be Enron’s undoing. The company did not fit the definition of a traditional utility, industry experts maintained.²⁷ In fact, the last year the SEC did a thorough review of the company’s annual report was 1997.²⁸

These exemptions and successful lobbying efforts went largely unnoticed by the public. That was not so in the case of Enron’s lobbying efforts on behalf of electricity deregulation in California. The company attracted heated public criticism during the energy-shortage crisis in 2001 for its perceived role in raising prices and manipulating the power supply. It did so by (1) deliberately creating congestion on power lines; (2) transferring energy in and out of the state to avoid price caps; and (3) charging for services the company never actually provided.²⁹ The State of California eventually sued Enron and its lead energy trader in the California market for alleged conspiracy and price fixing. These shenanigans were surely aimed at subverting the intent and expected benefits of energy deregulation for private gain. They depict rule-making and rule-following games (and outright criminal behavior) at their worst.

Enron’s lobbying efforts were not limited to the United States. Both the Labour and Conservative parties of the UK received donations from the company, and the Indian government was plied and lobbied in connection with its large investment in Enron’s massive power generation and distribution project in Dabhol. As in its domestic lobbying efforts, Enron’s “sole focus was removing as much government oversight from its operations as possible.”³⁰ In the end, the Dabhol project failed, costing Enron nearly a billion dollars in losses, and leaving local Indian authorities without the promised source of energy for vital regional economic development.

The success of the U.S. lobbying efforts reflected Enron's unusual access to high-ranking government officials in both major political parties. Ken Lay's ties to the Republican Party dated from his contributions to George H. W. Bush's race for president in 1988. In 1990, Lay served as co-chair of a committee for then-President George H. W. Bush's economic summit in Houston. In 1992 he headed Houston's host committee for the Republican National Convention.

Lay's ties with the Bush family flowed from father to son. From 1993 and 2001 Enron gave more than \$700,000 to George W. Bush—more than any other donor. Ken Lay was one of the Pioneers, raising more than \$100,000 for the Bush presidential bid. The company also contributed to the Florida presidential election recount fund, and Lay personally contributed \$100,000 to the Bush inaugural committee.³¹

George W. Bush reportedly returned the favors. While he was governor of Texas, his regulators were Enron friendly. He even lobbied his friend, then-Pennsylvania governor Tom Ridge, on behalf of Enron's plan for deregulating electricity in that state.³²

However, Enron and Lay were careful to hedge their political bets by making significant contributions to legislators in both parties. Lay was a sometime golf partner of President Clinton, and a frequent visitor to the Clinton White House. Enron also contributed more than \$1 million to the Democratic Party during the Clinton years.³³

These contributions and connections gave Enron a significant presence and easy access in Washington. When President George W. Bush asked Vice President Richard Cheney to chair a task force charged with developing a new national energy policy, Ken Lay was given a chair at the rule-writing table as a prominent member of Cheney's list of industry advisors. Once it became clear to Lay that an Enron bankruptcy was possible, he and other executives did not hesitate to call the president to seek government assistance in rebuilding the company's lines of credit.³⁴ But, in marked contrast to Lay's success in rewriting rules of the game, these requests for help went unanswered.

Enron's Rule-Following Game

Despite its glossy code of conduct, Enron consciously chose to live in what Owen D. Young—founding chairman of RCA and General Electric during the late 1920s—once called the penumbra, or shadowed space, between the clear light of “rightdoing” and the clear light of wrongdoing.³⁵

This penumbra is the legally ambiguous territory where many firms choose to live. The territory exists because rules promulgated by legislatures, courts, professional societies, industry associations, and religious institutions are sometimes not easily adapted to specific business situations, or, as noted, they are just plain ambiguous or excessively narrow so as to allow many apparent exceptions. Many of these rules also serve as poor guides for decision making because they are advanced in isolation, and thus often conflict. Finally, it is often unclear when executives cross the line between rightdoing and wrongdoing because that line is never precise, and guidelines may not shed light on what will be overlooked or tolerated and what will be condemned and attacked.

My own research on the origins and legacy of Enron's collapse shows that many executives understood that they lived in a legally gray area, as they sought to game ambiguities of existing accounting and reporting rules by pushing financial structures and transactions to their legal limits.³⁶ This behavior reflected three motives: to protect Enron's all-important credit rating, to manage volatility in cash and earnings, and to serve executives' needs for money, pride, and power.*

Because Enron executives knew they were walking on uncharted legal ground when they designed new structured-finance vehicles, and used complicated transactions to shield debt from public view and enhance reported earnings, these leaders consulted heavily with outside advisors. However, evidence suggests that these advisors felt pressured to issue opinions favorable to Enron's interests—and in so doing colluded with Enron in gaming the rules of the game.

Congressional committees, forensic accountants, lawyers representing creditors, class-action suits representing shareholders, and ultimately Justice Department attorneys roundly criticized many of Enron's financial practices. However, while the desire to circumvent the intent of existing rules is reasonably apparent, the actual legality of Enron's financial maneuvers and the gaming of existing rules is often less clear.

For example, quite apart from the CFO's admitted fraud, and an alleged conspiracy by top management to conceal the company's true financial position (now being reviewed by an appellate court), reasonable parties can differ on whether many examples of Enron's devious management and gaming are actually unlawful—based on different readings of ambiguous rules and interpretations of intent. These examples include the use of off-balance-sheet partnerships to manage reported earnings, the reorganization of business structures to obfuscate line-of-business reporting, the use of accounting techniques for asset sales to boost reported earnings, the use of “prepay” transactions to disguise the firm's true level of debt, and the use of opaque financial disclosure to support Enron's stock price. Here are three instructive cases in point. All three contributed to both an erosion of public faith in the company's internal governance and the costly collapse of Enron.

Accounting for Asset Sales. Undocumented side deals—wherein Enron allegedly verbally agreed to protect buyers of the firm's assets from financial loss—were a popular topic at the trial of Chairman Kenneth Lay and CEO Jeffrey Skilling. Andrew Fastow, Enron's CFO, referred to these verbal assurances as “bear hugs” in his plea bargain with the Justice Department.

*These motives and Enron's history of cutting accounting corners reflects, in large part, leaders' unwillingness to face serious operating problems, and their fear that unprofitable new business strategies and failing speculative investments would, if discovered, impair the company's credit rating and stock price. Enron's credit rating was particularly critical to the company's short-term success and long-term survival, because its energy trading operation required large amounts of low-cost debt to run at its envisioned scale and intended profitability. A downgrade in Enron's debt rating would have thrown its trading operation into severe financial distress.

The 1999 “Nigerian barge transaction” is one disputed example where it certainly looks like Enron gamed the rules governing asset sales and profit reporting, at great cost to its leaders and shareholders:

In that transaction, Merrill Lynch purchased from Enron the rights to energy produced by a power plant barge. In prosecuting executives involved in that transaction, the government contended that Fastow made a verbal promise to remove Merrill Lynch from the deal within six months, by finding a new buyer or repurchasing the asset. In actuality, LJM2—an off-balance-sheet partnership controlled by Fastow—did end up repurchasing the asset from Merrill Lynch.

In court, Enron’s senior executives claimed that the company had agreed only to help Merrill Lynch find a third-party purchaser, and that the transaction was thus a sale. However, determining the true intent of such verbal assurances is very difficult—it is a fine gray line.

If such assurances were a formal pledge by Enron to protect a buyer from loss by agreeing to buy back assets at a minimum price, then the so-called sales transaction was clearly a loan, since no risk was ever transferred to the acquirer. If, however, Enron merely pledged to help the purchaser find another party that *might* want to buy the assets, then risk did pass to the purchaser, and the transaction was a bona fide sale, according to accounting standards, and could be recorded as such in the company’s profit and loss statements.

In the Nigerian barge trial, the jury stepped to the government’s side of the gray line and sent five men to prison based largely on its interpretation that the company had promised to provide assistance. While an appeals court later vacated the convictions of four Merrill Lynch executives on technical and procedural grounds (without suggesting “that no fraudulent, wrongful, or criminal act has occurred”), Skilling vehemently defended Enron and himself against any violations of accounting rules in his own trial.* Irrespective of the court’s finding and Skilling’s defense, this case is a near perfect example of a Rule-Following Game aimed at subverting the intent of accounting rules for short-term financial benefit. Along with many other legal “close calls,” the Nigerian Barge transaction reinforced the culture of deceit that eventually brought Enron down.

Financial Disclosure. A second example of gaming for short-term benefit concerns how much a company must publicly reveal about its financial condition. For competitive and other reasons, executives do not want to disclose every last detail about their operations. However, according to accounting and SEC rules, they must provide enough information to enable investors to understand a firm’s financial position. Both a committee convened by

* In the criminal case against Jeffrey Skilling, government prosecutors argued that Skilling was actually the source of binding “side deals” or guarantees that masked phony sales of assets, and that these side deals were the principal device that Skilling used to perpetuate his scheme to defraud. Skilling’s appeal provides a detailed discussion of the difficulties involved in determining when normal negotiations with a potential buyer of an asset reach the level of an actual guarantee. Skilling argues that the government’s factual showing on this issue was “thin and ambiguous,” and that the judge’s guidance to the jury on this complicated matter was virtually non-existent, and therefore extremely prejudicial to his defense. Skilling also argued that there was “no irregularity in Enron’s accounting treatment” of transactions such as the Nigerian barges, “no error in its financial reports, no omissions in its public disclosures, no false statements to its auditors—in short no violation of the law.” *Brief of Defendant-Appellant Jeffrey K. Skilling at 107-122, U.S. v Skilling (5th Cir. 2007)(06-20885).*

Enron's board and the court-appointed bankruptcy examiner criticized the footnotes to Enron's financial statements as "calculated to disclose as little as possible," and "fundamentally inadequate." Yet while these criticisms appear valid, Enron's approach largely complied with SEC rules regarding disclosure on proxy statements.

Such rules require companies to disclose information about insider interests in external ventures only "where practicable." The footnote to Enron's 2000 proxy statement did not include details on Fastow's compensation from LJM2. Because several LJM2 transactions had not been completed before the 2000 proxy statement was issued, Enron—in consultation with Arthur Andersen and its outside counsel—decided that calculating Fastow's interest was not practical, and therefore that it did not need to be disclosed.

While this decision was clearly "calculated to reveal as little as possible" about Fastow's external ventures, SEC guidelines appear to permit it. On the other hand, shareholders may have found details about the Fastow's compensation from LJM2 critically important in judging Enron's internal procedures and oversight of potential conflicts of interest. Remember, the LJM2 partnership purchased assets from Enron, so Fastow, as Enron's CFO, was effectively on both sides of such transactions and received compensation from both entities. The decision to withhold that information not only put the firm's executives well within the shadowed space between right and wrong, but also reveals Enron's rather consistent effort to game the SEC's rules of the game pertaining to the disclosure of material facts related to investors' holdings. With this and similar obfuscations, Enron's integrity was further compromised.

Statements to Security Analysts. A conference call between Jeffrey Skilling and securities analysts in April 2001 provides another example of the legal ambiguities and gaming surrounding financial disclosure. During that call, Skilling reportedly said that Enron Energy Services—Enron's new high-profile retail electricity unit—had earned \$40 million in the third quarter. According to testimony by Paula Reiker, Enron's former corporate secretary, who was sympathetic to the prosecutor's claims, Skilling failed to mention that \$30 million of that amount came from stock gains, rather than from operating earnings related to the core business of supplying energy and energy services. Reiker claimed that this information "should have been disclosed."

Skilling's defense lawyer countered by calling attention to Enron's financial report for the first quarter of 2001, filed with the SEC one month after the conference call. In that report, a table summarizing the unit's results shows the \$30 million in stock gains. Skilling's lawyer suggested "this disclosure fulfilled any obligation Enron had to tell investors about the stock gains—particularly in the case of Wall Street analysts, whose jobs involved dissecting such SEC filings."

Under cross-examination, Reiker refused to budge. She pointed out that Enron's SEC filings were not available until weeks after the public announcement of earnings, and that "most analysts relied on the earnings release and the quarterly conference call" with Enron executives.

Executives are obligated to provide all “material” information needed to prevent a statement from being misleading. Let’s assume the information above was material. One could argue that not providing a breakdown of the sources of earnings during the conference call gave the impression that the unit was more successful than it really was. But one could also argue that it was impractical to provide a lot of detail “under the circumstances”—in this case a conference call—and that it was reasonable to assume that analysts would peruse SEC filings for more information.

Although an alarming portion of Enron’s financial maneuvers had an aroma of deception, lacked respect for the spirit of the law, and thus reflected ethical sleaze and delinquency, much of this behavior was not clearly unlawful. Many of Enron’s complex transactions, questionable accounting choices, and incomplete or convoluted disclosures lived instead in the penumbra between the clear light of wrongdoing and the clear light of rightdoing. Many of the instances where Enron executives consciously sought to game accounting and reporting rules are compelling incidents of institutional corruption—where institutional behavior contravened and thus corrupted the company’s espoused values, legitimate procedures, and espoused goals.

In Enron’s case, the jury sided with Paula Reiker, but it is doubtful that this decision will put an end to the reporting game. As indicated by the “under the circumstances” condition, the legal analysis of disclosure decisions is highly case-specific. This provides lots of opportunity for executives to game complex disclosure rules for short-term gain, although in so doing they expose themselves to risk.

Incentives to game society’s rules are not likely to diminish. For example, a key concern shared by the so-called Basel Committee of central bankers and U.S. regulators under the Dodd-Frank Act Congress is how much capital banks should have to hold as rainy day reserves. The higher the capital requirement, the less capital “at work” (as loans, for example), and the lower shareholder profits. The Basel Committee and Congress will undoubtedly try to close major loopholes in the definition of capital reserves, to ensure that banks have enough reserves. However, the high economic stakes will also spur banks to maneuver around those definitions, perhaps trying to count borrowed funds or projected high-probability profits.

Assessing the social costs of such gaming of society’s rules is difficult because it typically occurs completely out of view of the public, which has little knowledge of highly technical compliance questions. Still, despite the technical and largely invisible nature of gaming, whenever it is exposed—such as in the aftermath of a financial crisis—it breeds public cynicism and destroys public trust in the institutions of capitalism.

V. The Rule-Making Game: When Lobbying Courts Institutional Corruption

I hypothesized at the outset that extensive lobbying of Congress by businesses aims not only to ensure that new and existing rules do not undermine their economic interests (as in

the Enron example), but also to preserve—and even open up—opportunities to *game* new rules, thereby subverting their original intent.

The financial services community deployed more than 3,000 lobbyists to influence the Dodd-Frank reform bill. Meanwhile 12 of the senators on the conference committee that melded the House and Senate versions have received more than \$57 million in campaign contributions from that community, according to the Center for Responsive Politics.³⁷

The extent of business lobbying of congressional lawmaking, including through campaign contributions, is well known.³⁸ More important for my hypothesis is the extent to which this lobbying attempts to preserve “wobble room” for gaming *after* new rules and regulations are created. A brief look at how the Dodd-Frank financial reform act tackles the Volcker Rule, championed by former Federal Reserve Chairman Paul Volcker, helps illuminate my hypothesis.

To minimize systemic risks, Section §619 of the act bars federally insured commercial banks from proprietary trading—that based on short-term price movements for the banks’ own benefit. Section 619 also prohibits federally insured banks from investing in hedge funds, private equity funds, and numerous other types of funds. However, banks can invest in such funds for unaffiliated entities, if such investments do not exceed 3 percent of a bank’s Tier 1 capital.*

One might ask why the hedge fund provision exists in a section largely devoted to a ban on proprietary trading. The best way to understand the connection is to consider the 3 percent rule as a massive loophole that allows every banking entity in America to skirt the ban on risky proprietary trading by investing as much as 3 percent of their capital in such funds. (Proprietary trading in “unaffiliated entities” continues, under the new law.)

The justification for this loophole was that banks needed to retain their traditional business to remain competitive against hedge funds. However, the 3 percent limit leaves most banking entities, except for Goldman Sachs, with as much leeway for this type of risky investing as they had prior to the Dodd-Frank reform.

The act’s ban on proprietary trading also allows banks to engage in trade in several other types of instruments, such as those issued by Ginnie Mae, Fannie Mac, the Federal Home Loan Bank, two federal agricultural banking institutions, and states and municipalities. Some of these exceptions seem sensible on the surface. However, the wording is often so vague that it invites the kind of gaming that subverts the act’s essential purposes.

For example, the proprietary trading ban allows banks to engage in hedging activities designed to reduce specific risks related to their holdings. That is not only a sweeping

* Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and retained earnings, and may also include non-redeemable non-cumulative preferred stock.

exclusion but also open to wide interpretation—not least because the act does not define “risk-mitigating activities.” The ban on proprietary trading also allows banks to buy and sell on behalf of their customers. That exclusion has already led banks to consider how to involve privileged customers in essentially proprietary trades just to meet the letter—but not the intent—of this rule.

Other Gaming Opportunities under the Dodd-Frank Act

When the legislative history of the Dodd-Frank Act is written, it will likely confirm much of what we already know about the influence of business and finance in congressional rule-making. That is, the political context of modern day rule-making has become increasingly vituperative over the past quarter-century; bills, including reform bills, have always been written to secure or protect private advantage; influential contributors and lobbyists play an enormous role in determining the positions of presidential candidates and the votes of members of Congress; and, as a by-product of this process, individual citizens and voters have been steadily edged out of the public sphere.³⁹

Two excellent recent books have painted a disheartening picture of these features of congressional work. In *The Broken Branch*, Thomas Mann of the Brookings Institution and Norman Ornstein of the American Enterprise Institute⁴⁰ describe the impact of partisan bickering and internal rancor on the work of both chambers. In *So Damn Much Money: The Triumph of Lobbying and the Corrosion of American Government*, Robert G. Kaiser, long-time congressional correspondent for the *Washington Post*, describes the impact of the lobbying industry on congressional legislation and rule-making.⁴¹

From these and other sources, we understand the scope and scale of private money that seeks influence over an increasingly debilitated Congress. We also understand that the cost of campaigns has skyrocketed (\$2.4 billion for all candidates for president, the House, and the Senate in 2004, three times what was spent in the 1976 elections, adjusted for inflation). And we know that lobbyists have become indispensable advisers, fundraisers, major contributors, and even finance chairs of many congressional campaigns—all to preserve access to legislators and public funds.⁴²

What we do not yet fully understand are the ways in which lobbyists and other influencers work to preserve and create opportunities to lawfully game and subvert proposed or newly legislated rules. If this phenomenon turns out to be as common as I suspect, then traditional remedies aimed at curbing lobbying—such as banning earmarks, and providing public financing to candidates who agree to strict limits on fundraising—will not by themselves prove effective countermeasures.

The Dodd-Frank Act offers an opportunity to deepen our understanding of how today’s rule-making processes perpetuate gaming. As noted, the act charges regulatory authorities with crafting hundreds of critical definitions and rules.⁴³ The success of financial reform depends largely on whether regulators write definitions and rules that support the intent of the act, and then, of course, enforce them. Given the stakes for the financial industry, this

large-scale rule-making process provides a superb window through which to observe and record how lobbyists work to preserve gaming opportunities for financial institutions.

One example of rules and definitions remaining to be written again relates to the Volcker Rule: Section 619 requires further definition of what financial instruments the proprietary trading ban allows and excludes. The Volcker Rule also bars banks from investing in any fund that may expose the bank's "high-risk assets," which have yet to be defined. The act also prohibits banks from investing in any fund whose transactions involve material conflicts of interest, and these, too, remain to be defined. Finally, we have yet to develop a clear idea about how the Volcker Rule will actually be enforced.

The final form of Section 619 rules will have important financial implications for Wall Street's largest and most profitable banks because of the size of their trading operations. While there is no easy way to determine how much money the major banks make from proprietary trading as opposed to serving their clients, Reuters has estimated from Federal Reserve data that proprietary trading accounts for 55 percent of Goldman Sachs' operating income, 36 percent for Morgan Stanley, 18 percent for Barclays U.S., 17 percent for Deutsche-Taunus, 12 percent for Bank of America and JP Morgan Chase, and single-digit percentages for Citigroup, Bank of New York–Mellon, and State Street. The average for the top 77 banks, each with over \$10 billion in assets, is 2.5 percent.⁴⁴

For Wall Street's largest banks, the uncertainties regarding what kind of proprietary and high-risk trading regulators will allow under Section 619 rules are significant. Will Goldman be forced to spin off its proprietary trading the way Morgan Stanley and Bank of America are rumored to be considering? Or will it simply move its traders to market-making or client-service desks, and have them continue operating more or less as before? Will prohibitions on proprietary trading and related investments in hedge funds seriously compromise the ability of federally insured banks to remain at the center of "price determination," reducing their ability to compete with less-regulated nonbank competitors in servicing their clients?

These are only a few of the questions that regulators must clear up. We can therefore only imagine how much energy and funding the banking community will invest in preserving ambiguity in the law, and in stretching loopholes to maximize opportunities for lawful gaming of new rules and regulations. Following the story of this second-stage rule-making process could help us better understand the ability of industry lobbyists to preserve opportunities for their clients to subvert the intent of new rules.

VI. The Rule-Following Game: When Time Horizons Court Institutional Corruption

When corporations employ longer rather than shorter time periods for measuring and rewarding individual and group performance, executives' decision horizons expand. They have more time than under short-term performance regimes to manage the personal risks of short-term disappointments and implement productive longer-term strategies, without having to resort to gaming and other corrupt behavior. Conversely, the decision horizons of executives tend to shrink as incentives become tied to shorter-term financial results. Shrinking decision horizons and short-term incentive schemes stimulate the desire within the

business world to pursue gaming and other trust-destroying strategies (like cheating) for immediate and, perhaps, temporary advantage.

Longer time periods for assessing performance also allow for “lookbacks” (at, say, “product deterioration” in the mortgage business), assessments of real economic performance, and “clawbacks” of bonuses by corporate boards or other oversight bodies within firms.

Over the past two decades, CEO pay packages have become increasingly performance-based, with bonuses and stock options and grants based largely on annual performance. What’s more, equity-based rewards now account for as much as 80 percent of CEO compensation. Growing reliance on equity-based compensation has driven the rapid rise in pay for senior executives, given steep increases in stock prices during this period.

Because equity-based incentives have become such a large portion of executive compensation, a first look at short-term time horizons should concentrate on the dangers posed by stock options and grants of restricted stock. Harvard Law School professor Lucian Bebchuk has succinctly laid out the risks with the current pattern:

Consider an executive who expects to be rewarded at the end of a given year based on performance measures tied to the stock price at the end of that year. This compensation structure may lead to two types of undesirable behavior. First, managers may take actions that boost the stock price in the short run even if such actions would destroy value in the long run. For example, executives may enter into transactions that improve the current bottom line but create large latent risks that could cripple the firm in the future. Second, managers may engage in financial manipulation or other forms of “window dressing” that do not build firm value, merely to pump up short-term prices. In both cases, executives receive higher pay even though they fail to build firm value. And in the first scenario, executives receive more pay even though they destroy firm value. Thus, rewarding executives for short-term results not only fails to serve the goal of encouraging executives to improve firm performance--it can actually work in the opposite direction.⁴⁵

There is no question that Enron’s financial targets and operating plans were extremely biased toward quarterly results, because the company’s marginal credit rating was so dependent on current cash flow from operations. As trading margins began to decline, and as various diversification moves failed to deliver expected returns, this bias was reinforced. This short-term bias was exacerbated by the aforementioned method by which business originators, commodity traders, power plant developers, and senior executives received bonuses. With only several visible exceptions, Enron’s generous bonus plan related directly to short-term economic results.

Cash bonus plans can be equally perverse in collapsing decision makers’ time horizons. Businesses that pay cash bonuses before establishing the true profitability of transactions, such as the estimated present value of a futures contract—or without considering “product deterioration” years after a sale or fee payment, as with high-risk mortgages—promote short-

termism and gaming of accounting rules, especially when businesses cannot rescind such performance awards.

This, of course, is the story of both Enron and the mortgage banking fiasco. Bonus plans that co-exist with equity-based pay-for-performance plans greatly magnify the short-term pressures of the capital market on operating executives—and the incentives to game the system (and cheat customers).

As managers of mutual funds buy and sell shares, their judgments of a company's prospects also have a major impact on the rewards that company's executives receive. And investment fund managers, too, have an ever-shorter time horizon. A telling indicator is the turnover rate of the equity holdings of purportedly long-term investment funds. Research shows that that turnover rate is high, and has risen markedly over the past 25 years.

For example, *Investment Horizons: Do Managers Do What They Say?*, a study financed by the Investor Responsibility Research Center and conducted by Mercer, examined 991 strategies of self-professed “long-only” equity fund managers across geographic regions and styles from June 2006 to June 2009. The study found average annual portfolio turnover of 72 percent, with some 20 percent of strategies recording more than a 100 percent turnover. The study also found that U.S. strategies have the highest average turnover rates, while UK, Canada, and Australia the lowest.

The Investment Company Institute reports a 60 percent average annual turnover in investment funds for the past decade, with peaks of 70 percent before the 2002 market crash and after 2008. Although the studies did not use the same methodologies, these rates are significantly above the 50 percent level in 1990 found by the Employee Benefit Research Institute.

Of course, there are many possible causes of short-termism in the investment community, including volatile markets, rapidly changing macroeconomic conditions, the emergence of short-term traders such as hedge funds, mixed signals from investors, excessive worry about a fund's quarterly performance, and herding biases among investment managers. However, many fund managers are, in effect, paid to be aggressive over short time periods—especially when their bonuses are linked to a quarterly or annual market benchmark.

The solution is to reward fund managers based on longer-term performance, to allow their supervisors can identify excessive risk-taking and persistent trends more readily. However, establishing performance-based fees can be time-consuming and difficult to implement in the absence of industry standards (but certainly not impossible).

VII. Potential Remedies

The strategies suggested here for curbing gaming and institutional corruption are of course preliminary. Much more work remains to be done on the essential nature and corrosive effects of such behavior.

Tackling Rule-Making Problems

Lobbying is at the epicenter of most rule-making activities involving business. However, in thinking about remedies for the kind of lobbying that leads to diminished public in business, it is important to differentiate between lobbying aimed at ensuring that a new rule or regulation places minimal adverse constraints on productive innovation, for example, and lobbying aimed at preserving gaming opportunities. This distinction is important because not all lobbying is corrupt in the ways defined in this paper. Some businesses might have very good economic reasons for resisting further regulation, and some of those reasons may actually serve the public interest.

Furthermore, there is nothing intrinsically inappropriate about lobbyists serving as public policy advocates and counselors for their clients. Lobbyists' participation in rule-making is potentially a productive aspect of our political process. But when businesses or industries publicly support a rule because lobbyists have preserved ways of subverting it, that duplicity—when discovered, as it inevitably is—becomes a major driver of public distrust and institutional corruption.

To understand the full force of business interests in the rule-making process, and its potentially corrosive impact, we need to consider campaign contributions and lobbying as a single source of influence. For example, the financial sector—including finance, insurance, and real estate—spent \$1.7 billion on such contributions and \$3.4 billion on lobbying expenses from 1998 to 2008, according to one source. The comparable figures for the securities industry alone (not counting millions of dollars in contributions from law firms that serve that industry) were \$500 million and \$600 million, respectively.⁴⁶ Not surprisingly, the largest recipients of these funds were Christopher Dodd, chair of the Senate Banking Committee (\$2.9 million from the securities industry in 2007–08, more than three times that of any other senator not running for president), and Barney Frank, chair of the House Financial Services Committee.⁴⁷

In light of these numbers, reforming lobbying without addressing campaign contributions seems misguided. To do both, one leading jurist has proposed separating the work of advocating among elected officials from efforts to raise and donate funds to them. (Presumably, this would be a professional conduct guideline for lawyers offered by the American Bar Association.) The presumption, entirely correct in my opinion, is that nothing so contributes to the perception of lobbyists not as public policy advocates but as agents of corruption as the confounding of these two functions.⁴⁸ Such a reform would protect the First Amendment right of people to address their elected officials directly, while also retaining the ability of Congress to take advice and counsel from parties affected by their rule-making.

Such a reform would also preserve congressional independence, and would not be inconsistent with other efforts to reform campaign financing. Indeed, attacking the increasingly ubiquitous gaming of society's rules of the game may require even more systematic change in the way we as a nation finance the elections of our representatives in Congress and influence their rule-making activities.

However, given past challenges in legislating meaningful campaign finance reform and other measures to preserve the institutional independence of Congress, we may need to pursue a dual track. A conventional track would pursue campaign finance reform. If no progress is forthcoming, an unconventional track, such as modifying the Constitution to prohibit corporate campaign contributions, as Lawrence Lessig has suggested, would bypass the gutting of any legislation that aims to reform campaigning and lobbying.⁴⁹

Addressing Rule-Following Problems

I have argued that the short-term decision horizon of corporate executives and fund managers is at the core of rule-following or gaming problems in business. Fortunately, potential remedies for the time horizon problem are less daunting than those for the rule-making problem, but will also require extreme patience and steady commitment.

Two principal approaches to extending the time horizon of executives and investment managers are possible: changing public policies that influence private sector behavior, and voluntarily changing business policies and practices within firms to encourage long-term decision horizons. Most business executives and fund managers understand that extending the market's focus further into the future would diminish pressures to "manufacture" short-term financial performance and pursue other gaming and corrupt practices. The challenge is building energy and consensus for collective action.

Public Policy Measures

The range of public policy (and regulatory) options related to extending time horizons include restricting hedge fund activities in some way to limit the volume of hedge fund trading, introducing a transaction tax to raise trading costs, and changing capital gains taxes to favor long-term holdings. Practical economic and political factors constrain prospects for all three options.

For example, introducing restrictions on hedge fund trading or imposing a turnover tax would be a very difficult "sell" to many investment houses and financial economists at the present time, who would strongly argue against shutting down or limiting the primary engine of short-term capital market liquidity and efficiency. Changing capital gains tax rules has only a slightly better chance of consideration in the current economic and political environment. Still, the potential benefits are sufficiently significant to merit its discussion here.

As most people know, taxes on capital gains vary by the seller's marginal income tax rate the year the assets are sold. If President Obama lets the Bush tax cuts expire on December 31, 2010, the long-term capital gains tax rate on individuals in the top two income tax brackets (with income over \$250,000) will rise from 15 percent to 20 percent for assets held longer than one year. Gains on "super-long-term" assets—those held for more than 60 months—will be taxed at 18 percent for those in the top two brackets. Whatever the merits of such changes in enhancing revenue, they would move in precisely the wrong direction as far as encouraging long-term holding of financial and real assets.

The debate on the capital gains tax has so far centered on the tradeoff between tax revenues on one hand and economic growth and jobs on the other. A higher tax rate is usually intended to increase federal revenues, accepting the slower economic growth that follows. Proponents of higher rates argue that the revenue gains are worth the meager losses in jobs, while opponents argue the revenue gains are meager, at best, because the adverse economic effects on investment and job creation are substantial.⁵⁰

While economists have debated for years how a higher capital gains tax rate affects tax receipts and jobs, very little debate has focused on how a significantly lower (or zero) capital gains tax rate would affect the time horizons of decision makers in the corporate and financial sectors. If a lower tax rate could have a positive effect on long-run government revenues by boosting investment, hiring, income, and taxes—while also reducing temptations to game society’s rules of the game—such a tax rate could greatly buttress public trust in business.

A new study by Allen Sinai, president of Decision Economics, Inc., supports the economics behind just such a conclusion. For example, Sinai’s reports that “a reduction in the capital gains tax rate to 5% from 15% raises real GDP growth by 0.2 percentage points per year, lowers the unemployment rate by 0.2 percentage points per year, and increases nonfarm payroll jobs by 711,000 per year. Productivity growth improves 0.3 percentage points per year...Taken to its logical conclusion, moving to a zero capital tax rate would have an even bigger effect.”⁵¹ Sinai also reports that higher capital gains taxes would not substantially reduce the deficit.

The problem, of course, is that the golden era of low tax rates is over, no matter what their long-run benefits may be. Taxes as a share of GDP are now 15 percent, in contrast to a historical rate closer to 17 percent. Meanwhile U.S. government spending is 25 percent of GDP. That is a significant gap, even before policymakers consider all the unfunded liabilities lying about. Nevertheless, as we work our way out of the current economic mess, a full analysis of the macroeconomic and business benefits of a lower capital gains tax would be useful.

Business Policy Measures

It should be increasingly apparent that introducing business policies and practices aimed at curbing short-termism and its two derivatives—gaming and institutional corruption—requires institutional leadership committed to high ethical standards with respect to writing and following society’s rules. One of the most important lessons of the paradigmatic Enron story is that despite its espoused objectives embedded in its code of ethics, the company’s leaders failed miserably in their supportive role. Indeed, they actually sabotaged whatever quality objectives Enron’s code was meant to promote.⁵²

The Enron case and other recent corporate scandals reveal that developing and distributing corporate codes of ethics is rarely enough to curb gaming and ethical drift. What

is often missing in many U.S. companies is not a code of ethics. Rather, it is a deep commitment to “quality” objectives: compliance not only with the law but also with the principles underlying it, and with ethical standards that promote public trust. When corporate boards and their delegated agents fail to build sustained commitment to such standards and provide clear guidelines for responsible action, they put the institution’s reputation, and indeed its very future, at risk.

The key to achieving quality objectives and preserving public trust in the corporation lies in three organizational commitments: qualitative attention, balanced incentives, and active monitoring.

Qualitative Attention.⁵³ The Enron story shows that without persistent attention to qualitative aspects of individual and group performance, the chances of developing an organizational environment conducive to thoughtful social and ethical deliberation are minimal. For this reason, negotiation and review of personal and business plans must include attention to the organization’s qualitative objectives and ethical standards, such as the protection of corporate integrity and reputation, truth-telling, complying with the intent society’s rules and regulations, and host of other possible goals. To be effective, this process must include qualitative measures related to these objectives and standards, in addition to whatever standard quantitative measures the plans may require.

One reason that formal performance-management plans such as Enron’s so rarely include qualitative measures is that decision-making quality and ethical ability are difficult to observe in practice. But where senior executives fail to give adequate attention to qualitative indicators of management performance, or lack the courage to make subjective judgments based on these performance indicators, pressures to meet short-term economic targets will inevitably crowd out thoughtful reflection on how employees’ decisions can best reflect the organization’s ethical values.

One attractive byproduct of committing to difficult, subjective evaluations is that incentive rewards become easier to administer, and more defensible. Subjective evaluations are also less susceptible to the kind of gaming associated with Enron-style, financially based performance measures. Qualitative performance measures also help individual managers see the full nature of their jobs more clearly.

Any effort to liberate an evaluation process by adding qualitative judgment to the numbers requires a parallel effort in managerial development—not so much through formal training as in how companies develop careers. If organizations elect to foster quality objectives and high standards, then they will have to nurture the character and values of “promotable” managers. Somewhere in their early careers, promising managers must be exposed to important moral dilemmas in executive decision-making, including the subject of gaming society’s rules. The purpose of this mid-career education should be to emphasize the practical requirements for retaining public trust in their institution.

Balanced Incentives. A commitment to qualitative aspects of organizational performance requires a disciplined approach to incentives.

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Beyond linking rewards to qualitative measures of performance, the policies governing financial incentives for corporate executives and investment fund managers requires a serious rethinking. Consider the case fund managers. While the dominant, short-term bias of compensation schemes would be difficult to wipe out completely, for competitive and other reasons, the adverse effects could be minimized by linking bonuses partly to assets under management (AUM) and client retention. Those criteria do shed light on investment performance, and they would also help extend the time horizons of investors.

Other ideas for curbing short-termism include paying out annual bonuses over three years, and basing "clawback" provisions on substantial changes in investment performance—a radical practice, but one used for the highly paid managers of Harvard's fixed-income portfolio. Investment companies could also link bonuses for fund managers to the firm's quarterly or annual profits, and perhaps peer-group comparisons over a three-year period. Leaders of investment companies and mutual funds could also base annual bonuses partly on the quality of fund managers' research, and their contributions during investment team meetings.

Rules governing the unwinding or selling of vested stock awarded to executives and officers of operating companies should similarly minimize focus on short-term changes in stock price. That is, executives should have to hold stock for a specific time period after it vests, and then sell the equities only gradually. To reinforce long-term decision making and performance measurement, the vesting period should correspond to the time horizon of executives' business strategies—surely longer than a year or two for most significant enterprises.

CEOs, CFOs, and other executive officers should also be subject to clawback: a company must recover from current and former officers compensation based on annual measures that are later found to be erroneous (including estimates of product performance) or misrepresentations of corporate performance. Such a provision, recently adopted by many public companies, is called for in a more aggressive form in the Dodd-Frank act. However, the act does not otherwise address the ills created by the short-termism embedded in executive pay and corporate governance practices.

Finally, Lucian Bebchuk has suggested limiting executive reliance on hedging and derivative transactions, as they weaken the connection between executive pay and long-term results:

An executive who buys a “put” option to sell his or her shares at the current price, as executives are generally free to do under standard pay arrangements, is ‘insured’ against declines in the stock price below current levels. Empirical evidence indicates that executives engage in a significant amount of hedging, and that such hedging is at least partly motivated by their inside information.⁵⁴

One reason for restricting hedging and derivative transactions is that significant limits on unwinding vested stock would likely spur executives to engage in such transactions—to neutralize the effects of those limits.

Active Monitoring. How many CEOs and their boards of directors routinely and systematically review critical decisions by key executives?

Audits of critical decisions by boards of directors are as important as internal audits by management in building a strong organizational commitment to quality objectives and high performance standards. In the post-Enron rush to revitalize board oversight and control of corporate affairs, Section 404 of the Sarbanes-Oxley Act required extensive and expensive documentation of internal controls by management, and annual review of these controls by outside accountants. Whatever the benefits (and costs) of documenting systems designed to inform and control corporate behavior, this is no substitute for actually looking at the behavior itself. Imagine the possibilities if internal audit teams summarized for directors the actual behavior they observed with respect to rule-writing and rule-following, for example, and the problems they uncovered related to the company's qualitative objectives. Directors could then strongly support a willing CEO in moderating management's understandable

interest in short-term achievements and reinforcing attention to the organization's highest long-term aspirations.⁵⁵

Achieving quality objectives also requires directors of operating companies to work at detecting and monitoring the societal benefits and costs of incentive structures that have approved, as well as the private benefits and costs. In the absence of such monitoring, corporate boards and the organizations they govern become complicit in the gaming of society's rules.

There is, of course, no legal duty for directors to monitor and serve the public good under our system of corporate law. However, if we accept (a) the public trust indicator of institutional corruption along with (b) the proposition that few institutions in a democratic society—whether in the public or private sector—can survive over the long run in the absence of public trust, then there is, as a practical matter, a duty for directors to protect the integrity and perpetuity of their firms. This duty comes pretty close to classical task duties of directors to monitor and protect the corporation against harm and known risks.

* * * * *

Kenneth Andrews, an eminent Harvard Business School professor, observed many years ago that a commitment to quality objectives is an organizational achievement, and that a failure to pursue them is an organizational failure:

The stubbornness of corporate ethics as a problem obscures the simplicity of the solution that can be found once the leaders of a company decide to do something about their ethical standards. Ethical dereliction, sleaziness, or inertia is not merely an individual failure but a management problem as well.⁵⁶

That is, the “simplicity of the solution” to problems of corporate behavior lies in thoughtful attention by institutional leaders to building an environment conducive to the exercise of moral judgment. Without resorting to the nomenclature of this paper, Andrews was addressing the problem of institutional corruption with which we are still grappling today.

Endnotes

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- 15 Johnson (2009), p. 4 of online version. See www.theatlantic.com/magazine/archive/2009/05/...quiet-coup/7364/.

- 16 See U.S. Bankruptcy Court, Southern District of New York, *In re Enron Corp.*, Chapter 11, Case No. 01-16034 (AJG), “Final Report of Neal Batson, Court Appointed Examiner” (November 4, 2003), Appendix B (Role of Anderson), p. 29, and Appendix C (Role of Enron’s Attorneys) to U.S. Bankruptcy Court, “Final Report,” p. 21. Both Arthur Anderson and Vinson & Elkins were well compensated for their work for Enron. Anderson earned \$121 million in fees from 1998 to 2000, while Vinson & Elkins collected more than \$162 million in legal fees from 1997 to 2001. It is not hard to imagine that such payments could compromise their objectivity.
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This process had many espoused advantages, including rewarding those who had contributed real economic value to the organization, serving as a safeguard against office politics by socializing the review process, promoting specific skills and abilities by making clear what Enron valued and rewarded, and improving communication, moving faster, and getting the right jobs done. However, this process sparked many complaints. Some employees characterized it as a ruthless rank-and-yank system with a short-term focus. Others complained that it conditioned success on making deals happen, not necessarily making them work. Still others felt that the process stunted teamwork and became a tool for rewarding loyalists and punishing dissenters (precisely what Skilling had hoped to avoid). According to testimony from one of my former students, "People were routinely treated as objects or commodities, loyalties were regularly sacrificed, and moral contracts were rarely honored."

Whatever the pluses and minuses of this process, there is little evidence that Enron used it to hold employees to the principles and values laid out in the company's code of ethics. Neither is there strong evidence of swift discipline in the

face of incontestable wrong-doing. Add to this record of ethical blindness Lay's and Skilling's inability to tolerate internal dissent, and it is not difficult to conclude that few meaningful investments were being made in developing a culture conducive to ethical judgment. For further details see, Salter, *Innovation Corrupted*, Chapters 2, 3, and 10.

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