FINANCIAL ANALYSTS JOURNAL®
EDITOR'S CORNER

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Ethics and Unintended Consequences

This issue of the *Financial Analysts Journal* focuses on the interplay between business governance, ethics, and investing from various interesting perspectives—from the makeup of the board of directors and its committees to the impact of "full disclosure" on the dissemination of information. We have dealt with unethical and illegal behavior in past issues; we now focus almost an entire issue on the subjects because of the topic's importance in many ways:

- Ethical "red flags" can help us to avoid investments that go bust, thus improving our clients' investment results.
- If we do not play a constructive role in policing the ethics of the business community for which we provide capital, then society will impose added regulations upon us all—regulations that are frequently crafted by those who don't understand the healthy workings of a capitalist system.
- Ethical lapses can shake confidence in the system, directly triggering lower markets and increasing idiosyncratic risk.
- A moral compass is a key component of self-respect, and it can give us the satisfaction of succeeding (in the words of the old Smith Barney commercials) "the old-fashioned way—by earning it."

Avoiding Unintended Consequences

We face a difficult set of choices. How do we improve ethical standards without introducing additional legislative or regulatory burdens that do more harm than good? If we turn a blind eye to the obvious ethical lapses in the business world, will society *demand* additional legislative or regulatory "cures" without knowing quite which cures might help or hurt?

The finance community must help to shape this dialogue. If unethical conduct can be made generally unprofitable, it will become less prevalent. We can remove the rewards for unethical behavior by selling our holdings in companies that engage in any red-flagged activities. We can refuse to provide investment capital—through new stock or bond issuance—to organizations that accept ethical ambiguity. When we don't play a proactive role in correcting unethical conduct, the legal or regulatory remedies can trigger serious unintended consequences:

- By reducing the value of Wall Street research because of the apparent ethical lapses of some analysts, are we at risk of stifling the information flow that is the life blood of a smoothly functioning economy? Those who rely on Wall Street research might well have already noted the obvious conflicts of interest and thus take that research with a grain of salt. Cliff Asness has noted that when we buy a car, we don't go to the local dealer's "strategist" to give us unbiased advice on which car to buy. Why should Wall Street research be materially different? Caveat emptor; trust but verify.
- On 25 February 2004, the House Financial Services Committee approved an amended version of H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003, an amendment that would require all mutual fund boards to appoint either a lead independent director or *an independent chair*. Why, in an effort to rein in miscreants, would we impose on mutual fund shareholders a part-time chair who has no long-term stake in the success of the firm?
- In the fervor to control dissemination of inside information and fraudulent earnings management, are we at risk of making it harder for a company to invest in new ideas? In this issue, Lee, Rosenthal, and Gleason suggest that Regulation Full Disclosure facilitates free flow of information, thereby leveling the playing field. But other new controls (Sarbanes–Oxley?) may do more harm than good.

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- In the focus on overtly fraudulent earnings, is society overlooking the widespread problem of aggressive earnings management?

In our efforts to protect investors—particularly small investors—we need to choose the path that is likely to help. The question is whether we in the industry, serving as part of the invisible hand of capitalism, make the corrections or leave it to the government. If we cannot trust 1 percent of the people we deal with, we write off the losses; if we cannot trust 10 percent, we introduce an array of protective business practices and regulations to avoid getting ripped off.

To borrow a phrase from Paul McCulley, the steel fist of government and regulation acts far less subtly. And the promulgation of new laws and regulations, which are often confusing and conflicting, can stifle innovation, driving the best talent and innovations away from overregulated businesses into less regulated ones (as in the "brain drain" into the hedge fund community), raising the cost of entry for product innovation, and increasing the cost of operations for related industries. If our industry does not set high ethical standards and, through our investing decisions, impose those standards, we bear some responsibility for the resulting steel fist of government.

Defining Terms

Ethics means different things to different people. We can all agree that ethics relates to some assessment of right and wrong, but by what definition?

U.S. society has been moving away from a *moral* definition of ethics toward a *legal* definition. But from the perspective of moral ethics, best practice should be better than legal practice. Marianne M. Jennings (2000), professor of legal and ethical studies at Arizona State University, wrote, "The law . . . was never intended to be the maximum [ethical standard]. It should be the minimum, but it has been moved . . . so that it is now the maximum" (p. 5).

With legal ethics, the questions are: Is this action forbidden or permitted under the law? Is there an unintended interpretation of the rules that I can benefit from? Is there plausible deniability so that I can credibly claim innocence? If I am caught, what are the possible consequences?

Moral ethics involves a single straightforward question: Is this action right or wrong? Moral ethics are surprisingly independent of culture. For example, in all religions and cultures, lying is considered bad and the truth is considered good. Stealing is considered bad; working hard for one's recompense is considered good.

The business world has ethical precepts: The customer is always right; the client comes first; work in the interests of shareholders; invest other people's money as a prudent investor would. For analysts, AIMR provides the Code of Ethics and the Standards of Practice, which teach practitioners how to carry out the Code.

Best practice should be better than legal practice. The more the business community embraces a legal definition of ethics, the more society tries to cure the resulting violations of moral ethics with new legal restrictions, often in the face of a wide array of existing laws that would already address the problems if the laws were vigorously enforced.

Ethics and Markets

An unintended consequence of failing to enforce existing ethical standards is that investors may demand greater reward to compensate for the resulting increase in risk. A reciprocal unintended consequence of seeking to enforce these standards—through ever-tighter and often conflicting regulatory strictures—is that investors may demand greater current yield to compensate for the resulting lower growth rates. These effects are subtle, but terribly important: A demand for higher returns or higher current yield means a lower price for the asset. The dual threats of lax ethical standards and the resulting regulatory excesses can, in fact, trigger a bear market.

Most of the recent serious ethical lapses relate to overt misrepresentation of earnings, self-serving research reports, insider trading [the mutual fund (mal)practice of late trading and so-called market timing through using stale prices are both forms of insider trading], and outright fraudulent conveyance. But softer forms of each of these lapses are going on, and our industry can help to rein them in.

Aggressive Accounting

If a company accelerates revenues or defers expenses, the managers risk jail time. Yet, aggressive accounting is tolerated. Aggressive accounting takes many forms—frequently in the same earnings report! If a company uses pension return assumptions to bolster its earnings or if a company pretends that management stock options are free, it's engaging in aggressive accounting.

Why do we not pay higher multiples for companies that use conservative pension assumptions and recognize that management stock options are a compensation expense? When insiders sell their holdings as soon as their stock options vest, why don't we do the same and shift our money into other companies where managers remain aligned with the interests of external shareholders even when the managers have the right to sell?

The aggressive earnings reports of the past several years create two problems. First, they create an artificially tough benchmark for future generations of managers to surpass. Second, overstated earnings are an acceleration of future earnings, which must be "paid back" out of future earnings, creating an explicit drain on future earnings. This nuance is not widely understood, but we need to recognize that, eventually, the cumulative sum of reported earnings will closely match the cumulative true earnings.

If we evaluate governance structures and are alert to the red flags of aggressive accounting, we may avoid costly portfolio management errors and improve returns for our clients and ourselves.

Changing Rules and Capricious Enforcement

Too often, society changes the rules of doing business after the fact and seems to enforce the law unpredictably. For example:

- Martha Stewart is jailed, not for insider trading, but for lying about her actions (which may not in themselves have been illegal). How many others have engaged in insider trading on a far larger scale while hiding behind a legal fig leaf of "materiality"?
- Mutual funds are under attack for permitting what appeared to be legitimate trades by long-term investors but which later turned out to have been rapid-fire trades. As Gary Gastineau says in this issue: "If an order turns out to be from a market timer, the fund may refuse future orders, but funds rarely reject the first order anyone enters at 3:59 p.m." (p. 25). Indeed, how could an open-end fund do so?
- Jamie Olis, a 38-year-old Korean immigrant with a wife and a six-month-old daughter, is sentenced to *24 years* in prison—more than he would have faced for premeditated murder—for accelerating future earnings at Dynegy through relatively modest fictions.
- Some Wall Street analysts have seen their careers ruined for truthfully stating their (ultimately correct) views, while others have reaped immense rewards by touting stocks that they wouldn't touch with the proverbial 10-foot pole.
- Some who may have perpetrated vast frauds for personal gain remain free while countless others still engage in *legal* forms of aggressive earnings management, which our industry rewards with higher multiples and higher prices.

No one should object when society punishes those who behave unethically or illegally. When society applies rules retroactively, when enforcement seems capricious, or when new regulations punish the *victims* of crime (e.g., mutual fund shareholders), businesses shift more and more resources away from product innovation into defensive business practices.

Conclusion

In an important sense, the problems with ethics and governance in business are a microcosm of society at large. When a highly regarded chairman of the Federal Reserve can propose changes in the ways we calculate inflation, rather than reasoned negotiation, as a means to abrogate moral and legal obligations in Social Security and in inflation-indexed bonds, and when many members of the administration and Congress pile onto the bandwagon, have we lost the ethos that "our word is our bond"?

The business community is afflicted with a small but metastasizing cancer. Do we want society to kill the cancer with the sledge hammer of regulation, or do we want the self-regulatory organizations (AIMR, FASB, ICI) to work proactively with the U.S. SEC and the state attorneys general to shape regulations and best practices that are productive, not destructive?

Our obligation is to honor our moral compact with our employees, by funding their pensions, and our shareholders, by engaging in conservative accounting. But this obligation is seldom discussed, and conservative accounting is not rewarded with a higher share price. Our industry should be in the vanguard in rewarding companies for their conservative accounting, in ferreting out miscreants for prosecution under *existing* law, and in shaping law and regulation for the betterment of the capitalist system. Our industry can play a leading role in guiding society's reaction to ethical lapses into productive directions and reducing dangerous unintended consequences.

Now, I turn the bully pulpit over to our eloquent contributing authors.

References

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