

SPECIAL REPORT ON BUSINESS ETHICS

Enhancing Corporate Governance



February 2016



Introduction

Knowledge@Wharton is delighted to present the first in a series of four special reports on business ethics in collaboration with AKO Foundation.

This report explores how firms can enhance their understanding and implementation of corporate governance. It does so by considering five topics:

- A. Corporate governance and the purpose of the firm
- B. Corporate governance and the moral responsibility of firms
- C. Corporate governance and compliance programs
- D. Corporate governance and corporate culture
- E. Corporate governance, leadership and the role of boards

Future reports in this series will tackle topics such as moral philosophy, corruption and business for peace. These will be published over the course of this year.

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Corporate Governance and the Purpose of the Firm

Thomas Donaldson, a professor of legal studies and business ethics at the University of Pennsylvania's Wharton School, studies ethics, corporate governance and leadership. His books include *Ethical Issues in Business and Ethics in International Business*. He was at a conference where experts were sitting around a table and a question came up: Law is to justice, as medicine is to health, as business is to ... what? "The response, even among some leading strategic theorists in the West, was a kind of awkward silence," Donaldson recalls. "People were surprised that the answer did not come naturally." Gradually, the assembled experts began to offer suggestions to fill in the blank – value creation, prosperity, profit, exchange, innovation ... and so on. But Donaldson was struck by the fact that the answer was neither easy nor obvious. "It says something about how we've neglected the concept of purpose," he says.

Donaldson believes that the notion of purpose – the reason why a company exists, as opposed to what a company does (mission) or how it does it (strategy) – is closely tied to corporate governance. "We can't talk about corporate governance without talking about purpose," he says. According to Donaldson, corporate governance is "a collective term that refers to the rules, policies and institutions that affect how a firm is controlled." He provided a more detailed definition in 2013 to the International Encyclopedia of Ethics, describing corporate governance as "the rules, policies, habits, institutions, and laws affecting the activities of the organization. Corporate governance in this sense is concerned with phenomena that philosophers call 'prescriptive' or action-guiding. The rules, policies, and other elements of governance are what guide or control the firm."

In other words, corporate governance deals with what firms should be doing. This, says Donaldson, is the normative or prescriptive aspect, since governance implies control; it imparts a sense of direction to the firm's actions. This prescriptive aspect, he explains, binds governance to the firm's purpose. You cannot decide what a firm should do unless you first indicate why it exists in the first place.

Before considering the firm's purpose, it may help to take a step back and return to the question that Donaldson and his colleagues asked themselves about the broader purpose of business. As Donaldson says, it is difficult to

discuss what a firm is all about before addressing the issue of what business is all about. He and a colleague have written a paper on this issue that they presented to the Academy of Management Society and the Society for Business Ethics. It was also published in the journal, *Research in Organizational Behavior*. Their hope is to convey a better idea of the purpose of business and, in turn, the firm. "When we call it a better idea, we mean we are trying to create or establish an idea that is self-consistent, reasonable and fits well with other existing well-accepted theories. We can't really claim to be doing it better because we don't think there's much out there that tries to answer this question," he notes.

What, then, is the purpose of business? "Our answer is that it has to be seen as a form of cooperation involving production, distribution and exchange for the purpose of creating collective value," says Donaldson. "We see business primarily as a form of cooperation, which may seem strange because so much attention is given to competition." For Donaldson, competition is essentially a means to an end. "It is an enormously effective mechanism for increasing efficiency," he explains. "Competition in a free marketplace is a powerful engine for prosperity but it is a cooperative activity. It requires social institutions that are cooperative. There are rules of the game. There are tributary procedures. There are socially defined exceptions. It's a bit like sport. Sport requires a huge amount of cooperation on the outside so the competitors can compete on the field. The same is true of competition in the marketplace."

If business exists to generate collective value through cooperative activity, then individual firms can help or retard that purpose in different ways, Donaldson explains. "Some firms structure their ownership in ways that we think of as social impact or B corporations," he says. "Such corporations explicitly identify their purpose as having a moral aim, such as bringing fresh water supply to parts of the world that don't have it. (Editor's note: [One such company was Ethos Water](#), later acquired by Starbucks.) They also want to make a profit, but the moral aim is built into their definition. The governance system, of course, has to support those purposes. Other companies may interpret the broader idea of collective value by just being the best and lowest cost producers of their products. Such firms may have much more traditional forms of governance mechanisms."

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– Thomas Donaldson

Donaldson describes himself as a pluralist, in the sense that he does not believe that a monolithic notion of governance fits all corporations. Some of his colleagues – including Gwendolyn Gordon, a professor of legal studies and business ethics at Wharton – have done research on alternative, indigenous forms of governance. “Some firms created by the Maori of New Zealand, for example, have a corporate form that matches to some extent their community tribal traditions,” Donaldson says. “We also know that firms in other parts of the world – in Europe and Asia – have different corporate structures and forms of governance. There does not have to be a single structure for all firms.”

Once companies – regardless of their structure or governance – have identified their purpose, can they put that purpose to use? Donaldson believes they can and they do. “The big wave that is cresting now has to do with focused work that motivates employees by creating an amalgam of economic and social value,” he says. Donaldson saw a vivid example during a visit to LinkedIn, the professional services social network firm in California. While speaking with employees, he found “they are almost fire-breathing contributors to the mission of allowing everybody who has talent to have that talent recognized. They want workers in developing countries to make use of their services. The digital world provides an opportunity for them to make the world better,” he says. In that sense, LinkedIn has succeeded in putting purpose to work. Donaldson notes that Wharton management professor Adam Grant’s research shows how motivational an inspiring purpose can be for employees. In a study of call center workers, Grant found that motivation increased when they saw the actual benefits and human consequences of what they were doing.

Donaldson offers two examples of firms that have been able to make purpose work in their favor. One is Alibaba,

an e-commerce giant in China, which Donaldson visited during a Wharton tour. He came away with the impression that Alibaba CEO Jack Ma and his colleagues view the company’s purpose more broadly than building a successful e-commerce business; they want to “make a better China,” he says. “They talk that way, they feel that way.” Another example is eyewear provider Warby Parker, which sees its purpose as being much more than a seller of affordable eye-glasses. On its website, Warby Parker says it was founded with a “rebellious spirit and a lofty objective” that includes recognizing that “everyone has the right to see. Almost one billion people worldwide lack access to glasses, which means that 15% of the world’s population cannot effectively learn or work. To help address this problem, Warby Parker partners with nonprofits like VisionSpring to ensure that for every pair of glasses sold, a pair is distributed to someone in need.”

By defining their purpose in such terms, companies are going further than they did in the past. “The old-style purpose statement was a sort of mission statement,” Donaldson notes. “Those statements said, ‘We will be the best provider of widgets in the world. We will delight our customers,’ that sort of thing. The new approach seems to be to strip that down to the essential. ‘We want to connect people in the world with one another.’ ‘We want to make talent recognizable in the best way we can.’ Some purpose statements could have been written by Mother Teresa; they sound over the top, but people live them, and they are motivated by them.” Donaldson says one of his friends who runs a company in Minneapolis-St. Paul recently said it is hard to inspire people by saying something like, “Come on, guys, let’s really make some major return on investment for the shareholders.” Such a statement would inevitably fall with a dead thud. People are motivated by more than carrots and sticks. So for firms, putting purpose to work implies defining a goal beyond its own narrow business objective that infuses people’s work with meaning.

Given the motivational impact of defining purpose as broadly as the examples above suggest, should companies formally recognize that they have a purpose beyond creating shareholder value? A well-known argument against that view came from economist Milton Friedman in 1970, who wrote an article in *The New York Times* that year titled, “[The Social Responsibility of Business Is to Increase Its Profits](#).” The issue of whether companies should primarily serve their shareholders or cater to a broader set of stakeholders – including customers, employees, members of the community, and so on – has continued to be debated for decades. According to Donaldson, Friedman’s model is “pretty simple and it carries a lot of weight. There’s a deal cut between owners and managers, but if I’m an owner, I may not just have a single-minded interest in maximizing my return on investment. Studies show discouragingly enough that that’s what most investors say they want, but if you query a little further, very few people want the companies they own to blatantly abuse people, violate their rights, exploit workers, break laws, pollute the environment, and so on. So shareholder primacy – the idea that shareholders’ interests should be the sole criterion for decision-making – needs to be leavened with that insight.” (Note: Friedman’s view has been challenged by scholars such as Lynn Stout at Cornell University, as we will discuss below.)

According to Donaldson, managers too generally do not think in terms of simply maximizing shareholder wealth. Recently, some critics have begun to lambast companies for excessively coddling investors. A case in point: In April 2015, Laurence Fink, CEO of BlackRock – the world’s largest asset management firm, which oversees investments of more than \$4 trillion – wrote [a letter to the CEOs of 500 large U.S. companies](#) in which he took managers to task for returning money to shareholders through paying dividends and stock buybacks. “The effects of the short-termist phenomenon are troubling both to those

seeking to save for long-term goals such as retirement and for our broader economy,” Fink wrote in the letter. He argued that such steps should not be taken at the cost of investing in “innovation, skilled work forces or essential capital expenditures necessary to sustain long-term growth.” Donaldson says Fink’s statement made quite a splash. It showed that this perspective is still about “investor value, but lengthened by the shadow, so it is longer. It is a different way of thinking about things.”

The view that companies should pursue both purpose and profit – and not necessarily limit themselves to shareholders’ financial returns – has been gaining ground around the world. In surveys where international executives are asked to choose between shareholders versus stakeholders, “even in the U.S., it has never been true that a majority of managers opt for the shareholder,” Donaldson says. “By the time you get to Japan or Singapore, hardly 10% to 15% of managers say that the company should think only about satisfying the interests of shareholders.” In Japan, Donaldson notes, some purpose statements sound like “the founding of the United Nations or something ... it is saintly language ... ‘We are here to lift up the entire world and make every person smile and be better.’”

The tendency to define purpose broadly is particularly strong in family-owned firms, Donaldson notes. “It is an entrenched belief among many family business owners that they exist in part for legacy, in part for family, in part for employees, and that they don’t see themselves as being shackled to the same rigorous – and from their standpoint, irrational – constraints of the quarterly report.”

New as these attitudes might appear be, the issues they address have been around for ages. “There has been ongoing discussion for two millennia about what the purpose of business should be,” Donaldson says. Some firms have shown how impactful these ideas can be over time. For example, Johnson & Johnson, the New Jersey-based health care firm, formalized its attention to values and decentralization in its credo, crafted in 1943 by Robert Wood Johnson, a member of the company’s founding family and J&J’s chairman from 1932 to 1963. According to Donaldson, J&J is not a perfect company by any means, but “if you track them over 60 or 70 years, they have done pretty well. If you speak with J&J employees, they will say [the credo] is the reason they are able to have such independence and autonomy. They are more powerful because they share these values.”

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According to Henrik Syse, a senior research fellow at the Peace Research Institute in Oslo, Norway, one additional question needs to be considered: “What is the exact link between corporate governance, in the sense of organization and structure, on the one hand, and ethics, in the sense of choosing between right and wrong, on the other? To a certain extent, the idea of purpose that we have just discussed answers that question. Without a sense of purpose, a corporation is left without a direction, one could even say without a rudder. In short, the governance of a company is inextricably linked to its purpose.”

Syse notes that once “we open ourselves to the possibility that the purpose of a firm goes beyond mere profit-making, we also introduce a crucial element of ethical thinking into the heart of corporate governance. We could add to this, however, that good corporate governance in itself is about more than organization and structure in the purely technical or juridical sense. Corporate governance, after all, is centrally about such topics as accurate reporting, a sound board structure, sustainable finances, a positive work environment, consciousness of the relationship between principals and agents, and long-term strategies for the firm as a whole. Such topics are obviously ethical, as they deal with how a firm relates to the outside world, and how it builds relationships within. We may not always explicitly talk about such issues as ethical, but ipso facto they are. Hence, to think of corporate governance and ethics as belonging to two different realms is clearly mistaken.”

Leading with Values: The Pursuit of Purpose and Passion

In 2007, Wharton School Publishing published a book titled, *Firms of Endearment: How World-Class Companies Profit from Passion and Purpose*. In that volume, co-authors Raj Sisodia, Jag Sheth and David Wolfe argued that by emphasizing principles such as empathy and authenticity, companies gain “share of heart,” and not just share of wallet – and over time, this provides them with a competitive advantage over firms that are engaged purely in the pursuit of profit. Sisodia, a professor of marketing at Babson College in Massachusetts, who has since also co-authored *Conscious Capitalism* with Whole Foods CEO John Mackey, believes that for quite some time, there has been a default assumption that the only legitimate purpose of a corporation is to maximize shareholder value. In addition to Milton Friedman’s view (presented above), Sisodia says academics such as Harvard professor

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Michael Jensen have argued that “this is the definition of fiduciary responsibility.”

But is the default assumption true? Not really, according to Sisodia, who believes the view that companies exist solely to maximize shareholder value is “based upon misconceptions.” A significant book in this area, he says, is *The Shareholder Value Myth* by Lynn Stout, a professor of corporate and business law at Cornell Law School. “She looked at the entire legal aspect of this argument and examined many cases, but nowhere did she find that the law requires that. Stout did not find any cases where CEOs were dismissed for not doing everything to maximize shareholder value.” In short, Sisodia argues, no law requires firms to maximize shareholder value.

What does this mean for firms trying to define their purpose? According to Sisodia, while some firms – where CEO compensation is closely tied to share prices and stock options – may choose to pursue shareholder value as their sole purpose, other companies are free to make different choices or create their own definition of why they exist. “I believe that companies, just like human beings, have the ability to define their own purpose. They certainly have that freedom whether they choose to take it or not. All the research I have seen and done shows that it makes a significant difference in terms of the level of passion, commitment and engagement that they are able to generate among their stakeholders –especially employees, but other stakeholders as well.”

The reason, notes Sisodia, is that “ultimately, every organization runs on human energy. When companies have an inspiring purpose that resonates with people and which is

relevant to what is happening in the world, such firms can elicit far greater levels of human energy – not just physical energy, but emotional, creative energy. That has to make a difference – because that is the real difference across companies.”

Focusing on an inspiring purpose does not mean ignoring shareholder value or the drive to be profitable, according to Sisodia. “Generating shareholder value and creating profits is essential; it is a requirement for being able to continue in business,” he says. “Of course you have to earn more than your cost of capital. Otherwise you are destroying value – and business has to be about creating value.” Sisodia cites an analogy coined by R. Edward Freeman, a professor at the Darden School of Business at the University of Virginia. “Freeman says we all need red blood cells to survive. But that doesn’t mean the purpose of our life should be to produce as many red blood cells as possible. We use that as a source of vitality so that we can achieve or move towards the purpose we have designed for ourselves.”

Extraordinary Power of Caring for Your People Like Family, which was published last October. Co-authored with Robert Chapman, CEO of Barry-Wehmiller Companies, a \$1.7 billion manufacturing firm in St. Louis, Missouri, the book argued that companies need not define their purpose in terms of inspirational ideals or even breakthrough products or services. “There are companies out there – and these may be the majority of companies – that are involved in somewhat mundane businesses in the sense that they produce necessities and things that don’t necessarily have a lot of excitement to them.”

Barry-Wehmiller, for instance, makes capital tools and equipment to produce goods such as toilet paper or cardboard boxes. “They say that our products are relatively straightforward,” says Sisodia. “So they think in terms of the impact they have on all the people whose lives they touch. If we measure success by the way we touch the lives of people, that includes the employees, the employees’ families, the communities; it includes their customers and everybody. Their higher purpose is

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How do firms find their purpose? Sisodia believes the process is as different and unique as the way each individual finds her or his own passion and purpose in life. “One of the frameworks we use is the so-called Platonic ideals,” he explains. “Plato talked about the good, the true and the beautiful as being pursuits that are worthy of human beings that do not require any further justification.” Sisodia has added a fourth dimension to that list – the heroic. He says these are just some ways for firms to get started. “Every company can figure this out on their own by asking the right questions. Why do we exist? Why do we need to exist? Why would we be missed if we did not exist? What would be missing in the world were it not for us?” Questions such as these are helpful to firms that are trying to define their purpose.

Sisodia’s work on purpose has evolved further. Some of it appeared in a recent book titled, *Everybody Matters: The*

rooted in the impact on people. That is a fairly universal aspiration that all companies can have. We can have a product-related purpose, but we also should have a people-related purpose.”

When firms fail to define or pursue a people-related purpose, this imposes a cost upon their operations that may be difficult to measure but still is very real. “To me, the biggest symptom of dysfunction in the traditional way of doing business is the lack of employee engagement,” Sisodia points out. “Worldwide it’s 13%, according to Gallup. The U.S. has one of the highest rates at 30%. That is still a shockingly low number – that 70% of the people in the U.S. and 87% worldwide are indifferent or hostile to their work. If you do not have a sense of meaning or purpose in what you do as a business, then your employees will not derive a sense of meaning or purpose from their work – and that is a big driver of human happiness.”

If firms want to make employees happy, they may initially incur short-term costs that lower profits. Still, Sisodia says research shows that investing in people pays off over time. “Costco, for example, pays its people roughly double, the last time I looked, than Wal-Mart does, and some 60% more than Sam’s Club. Costco also provides a much higher level of benefits. The company gets criticized for taking money away from shareholders. And Costco’s response is: ‘Our staff turnover is 7% compared to 70% for our competitor. We save a huge amount of time on hiring and training. Our people stick around for a long time and they get better and better at what they do.’” According to Sisodia, Costco’s sales per employee are three times as high as those of its competitors. That is how investing in people pays off over time.

Sisodia says research by Zeynep Ton, a professor of operations management at MIT, has come to similar conclusions. In Ton’s book titled, *The Good Jobs Strategy*, about which she spoke at a TEDx event in Cambridge, Mass., in 2013, she argues that many companies structure jobs badly – with minimal pay, long hours, huge workloads and little chance of growth. Little wonder that employees feel “like human robots” – and disengaged and alienated. The solution, Ton argues, is for companies to do just the opposite. According to Sisodia, Ton’s research shows that “when we treat people well, pay better wages and provide better benefits, turnover goes down, engagement goes up, creativity goes up and productivity goes up over time. All those things start to happen. In the long term, you are creating more value, and your customers can see that and appreciate that. And the business just thrives.”

Sisodia believes that firms that have learned to put purpose to work can establish systems in which the goal is that everybody wins. “We need the full capabilities of people to

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– Raj Sisodia

be deployed if we want to make a difference and be successful in the long run,” he says. “So it is a matter of enlightened self-interest to say, ‘This is how we turn people on.’ We don’t do that in a manipulative way, but by giving people the chance to be part of something great. And if we do that, people can do extraordinary things. All businesses need that. Ultimately, if people are not happy, they cannot be productive and they cannot be innovative.”

Sisodia’s last statement raises another critical question: Can purpose help companies become more innovative?

Can Purpose Drive Innovation?

Dan Pallotta’s bio describes him as the person who “invented the multi-day charitable event industry.” He is credited with having created the Breast Cancer three-day walks and the multi-day AIDS Rides, which are believed to have raised more than half a billion dollars in nine years. Pallotta’s methods are said to have been used by dozens of charities “to raise in excess of \$100 million a year for causes ranging from pediatric leukemia to AIDS to suicide prevention and many others.” He is a much-sought-after speaker on topics such as charity, creativity and social change; his TED talk titled, [“The Way We Think About Charity Is Dead Wrong,”](#) has been viewed more than 3.6 million times. Pallotta now also speaks about the relationship between purpose and innovation. For anyone who believes that corporate governance requires encouraging firms to become more innovative, it is useful to explore and understand this relationship.

Many companies today, Pallotta claims, view the notion of purpose too narrowly. They equate it with “not committing any corporate sins, not polluting the environment, not employing slave labor, not encouraging downstream effects that are negative, or doing something charitable,” he says. “So, when corporations talk about their social responsibility, they mean what their charitable program is or what their social impact program is. To me, the primary social responsibility of a company ... is not to produce crappy consumer products and services that waste people’s money.”

In other words, says Pallotta, the purpose of a corporation should be defined by the attention it pays to its core products and services. “I won’t say its core business – because that then brings in the idea of profit – but if you pay attention to your core products and services, then good business results follow.” This approach lets firms contribute

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– Dan Pallotta

to humanity in unexpected ways. Take Apple, for instance, which ordinarily would not be described as a “social business” and yet in pursuing its mission to advance the human race, it produces iPads, which provide great benefits to education; iPhones have made an enormous difference in the lives of the blind; and its ResearchKit project aims to help medical research. “Even beyond these perhaps unintended charitable social purposes, the products bring joy to the lives of everyday people,” Pallotta notes. “They remove frustration from the lives of everyday people. That is a huge contribution to society.”

Another example he offers is JetBlue, a New York-based low-cost airline, which defines its purpose as “bringing humanity back to flying,” according to Pallotta. “If you fly a lot, that’s a huge contribution to humanity – to be treated like a human being on an airplane. We have confused things by making purpose about what charitable gifts the corporation makes to non-profit organizations.” If companies want to put purpose at the heart of their activities, they should focus on building products and services that improve people’s lives – rather than cutting corners on primary business operations for short-term gains and then trying to whitewash their myopia through philanthropy. “Does Apple have a responsibility to set up a fund that gives money to schools?” he asks. “No, I don’t believe that, and I would rather they didn’t, in some cases. I would rather that they focus on making a phone that makes people’s lives easier and less frustrating than delivering a product that nobody can figure out and then paying for their sins by donating \$50 million to charity.”

Companies that view purpose this way can balance purpose and profit while upholding high ethical standards. “My definition of ethical standards is, ‘Are you delivering value to consumers who are giving you their hard-earned money? Are you being authentic and true in your advertising?’” Pallotta says. “If you do that, profits will follow. Look at Samsung. Their mobile phone business is headed

into the toilet. Profits have been down four or six quarters in a row, and what do they do? They try to copy Apple and get a product to market as quickly as they can. These products don’t have the quality that an Apple iPhone has. The iPhone might be more expensive, but Apple has 97% of the profits in the smart phone market. That is an example of how a high ethical standard, by my definition, creates a product that brings joy to people’s lives and allows you to charge a premium. There is so little of that in the world, and people will pay for that.”

Citing another example, Texas-based grocery chain Whole Foods Market, says Pallotta, is a company that “would not compromise its ethical standards in terms of delivering quality food to the human body that isn’t toxic and doesn’t harm animals. They knew they were going to have to charge a premium for that. Business schools 25 years ago might have said, no pun intended, ‘They’re going to get their lunch eaten by Stop & Shop and other grocery chains,’ but that just did not happen. It turned out that human beings had a big demand for a quality product and were willing to pay for it at many socioeconomic levels. It’s not just the wealthy whom you see shopping at Whole Foods.”

If companies approach purpose the way that firms like Apple, JetBlue and Whole Foods Market do, Pallotta notes, this can help make them more innovative. “Innovation is all the rage in the business literature these days, but let us take a step back and ask why. What is behind this drive to be innovative?” Many times, according to Pallotta, the unspoken purpose is “to win at any cost, crush the competition, to gain an advantage over competitors. If executives can show they have innovation skills, they can advance their careers.” This approach, he says, is motivated primarily by fear.

In contrast, Pallotta believes “the most powerful innovation comes from love. It comes from a desire to contribute

to the lives of other people in some beautiful way. That is not to say you should not make money. It is not about the money; it is just not about the money primarily. It is “primarily about introducing something beautiful and new into the world. Steve Jobs’s famous quote wasn’t, ‘I want to make a billion dollars’ or ‘I want to provide shareholder value.’ It was, ‘I want to put a dent in the universe.’ That statement of purpose – coming from love and humanity – has created the largest corporation by market capitalization in history.”

If Pallotta is right, companies that are true to their purpose can achieve high profits and become more innovative. But how does a company that has thousands of employees all over the world go about defining its purpose, especially if it has existed for more than a century? The experience of a New York-based firm can help answer that question.

How Marsh & McLennan Companies Defined Its Purpose

NYSE-listed Marsh & McLennan Companies (MMC) is a professional services giant with annual revenues of \$13 billion, 57,000 employees and clients in more than 130 countries. It consists of four operating companies – Marsh, which provides insurance broking and risk management services; Guy Carpenter, a provider of risk and reinsurance intermediary services; Mercer, which provides consulting services in talent, health, retirement and investment consulting; and Oliver Wyman, a management consultant. How does such a vast and sprawling organization go about defining its purpose and its relationship with corporate governance? And what lessons can other firms learn from MMC’s experience?

Knowledge@Wharton posed these questions and more to Laurie Ledford, MMC’s senior vice president and chief human resources officer, who is responsible for the firm’s corporate human capital and talent strategy. Ledford notes that MMC did not start its work on purpose with the notion of corporate governance being the “spotlight connection, although there clearly is a connection.” Defining MMC’s purpose involved taking stock of “this interesting organization of four very distinct and very strong brands with incredible client relationships ... [that] are connected to one another through the MMC organizational structure,” Ledford says. “I’ve been here for quite a few years, and one of the questions that our colleagues and shareholders ask most frequently is, ‘What is MMC?’”

According to Ledford, Daniel Glaser, MMC’s president and CEO, asked a different and more fundamental question: Why does it matter? “We could answer the question in a long-winded kind of way, but we needed something that was more contemporary and distinct and brought the organization together. This is because there are a lot of things that we do have in common. That is where the purpose work started.”

Part of the challenge, especially at the beginning, lay in forging together the views of four operating companies as well as the corporate parent – not only about what MMC is, but also about the key “purpose” for why MMC exists. “The operating companies had their own set of organizational discussions, dialogues, frameworks, and yet they did not really answer that question about why,” Ledford says. As MMC moved along the path of trying to articulate its purpose, executives had to come up with a core purpose statement. “If we are to be a company that is positioned for long-term growth, which we believe we are – and it’s something we espouse internally and externally – we have to figure out how to make the pieces work even more effectively,” she notes. “Purpose was a way to connect to our core identity. We are a growth company; we have this portfolio with incredible assets; and the parts of the organization can collaborate in a way to bring more to the party than if they were separate organizations.”

Tactically, the process involved an internal discovery that reviewed written materials from each of the operating companies. Some limitations soon became apparent. “What we saw was a very institutional approach,” Ledford says. “We always had the company first; everything was very scripted and we talked at people.”

To get to the “why” of MMC’s existence, the organization needed a more human approach, Ledford notes, especially since the purpose had to resonate with tens of thousands of people in some 130 countries. “Frankly, people want to

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core identity.”
– Laurie Ledford*

Having recognized that it is possible to pursue both purpose and profits, MMC tracks how this process is working out by looking at internal and external metrics.

talk to people, and people respond to people,” she says. “So we made a big shift that showed that we’re a company that is human, and that we’re going to make things simple and straightforward. We worked with one of our own companies, Lippincott, that specializes in corporate identity and brand. It was an iterative process.”

One of the key things in this discovery was that each of the companies is a pioneer in innovation. That was the inspiration. In defining its purpose, MMC decided to draw upon its own history – the company’s predecessor firm was founded weeks after the great Chicago fire of 1871 and played a role in helping employees and clients recover and rebuild after that tragedy. Over the past 140 years, MMC has been repeatedly involved in recovery efforts after earthquakes in countries ranging from Japan to New Zealand. Its legacy also includes the creation of the pension and benefits consulting industry as well as industry-specific management consulting. “As we looked at that, we realized that we make a difference in moments that matter. That is what we came up with as the defining purpose that unifies all the operating companies under the MMC umbrella. We make a difference in moments that matter.”

Having defined its “why” with a statement of purpose, how has MMC put purpose to work for the umbrella organization and the four operating companies? Ledford says the first step was to test the purpose statement across the organization, and “it really resonated with people ... but then that has to translate into an extra level of commitment that we’re willing to make.” In MMC’s case, she explains, this was spelled out in the form of four core commitments. The first was to enable clients’ success. Second, MMC encouraged its people to “find a smarter way” through innovation. Third, by collaborating across all organizations, it made a commitment to “working side by side.” And finally, the fourth commitment was to “living the greater good” by acting with integrity. These four commitments, says Ledford, tie MMC’s definition of purpose to the effort to uphold high ethical standards of corporate governance.

As for the debate over whether firms exist primarily to enhance shareholder value, or whether they have a purpose beyond that, Ledford believes the two cannot be separated. This, she says, is because “unless the firm has a broader purpose, you’re not maximizing shareholder value. There are some interesting statistics around the millennial workforce – and I actually think it applies to the entire workforce – that people are attracted, millennials particularly, to work for companies that perform well [on the business front] but also do good for society. Those two things have to go together, or you really don’t get the best out of people who come to the organization.” This is borne out by traffic on the MMC websites, she adds. The pages that are read most are those that tell stories about people helping communities and clients. “It takes us back to the people issue,” she says.

Having recognized that it is possible to pursue both purpose and profits, MMC tracks how this process is playing out by looking at external and internal metrics. On the external front, MMC measures revenues, operating income and shareholder returns. “On the internal side, we look at engagement of our colleagues. We have found that when employers have a strong sense of purpose, these companies have a much higher level of performance. Shareholders are more confident that these companies will grow. Clients are looking for a company that is going to be an industry leader, and a sense of purpose helps us demonstrate that. And, of course, our colleagues believe that their careers will be fulfilling, which drives a higher level of engagement.”

Ledford says MMC’s experience in going through its purpose exercise could offer a few lessons for other firms that want to make a similar journey within their organizations. One thing that amazed her, she notes, is “just how quickly people responded to the change in tone. We didn’t say, ‘Oh, by the way, look, it’s really different. We’re talking to you differently as a colleague.’ We just did it – and that was great. People responded immediately. It was hard to miss the change.” Ledford’s advice is to not get

stuck in the weeds or over-worry about how elaborate a campaign about purpose should be and whether every piece of communication needs to change. “First, start with something,” she says. “We started with our CEO’s quarterly note to colleagues. We just did it differently. We did it using this more empathic, human approach – and he was flooded with e-mails. That would be the lesson I would learn and what I would encourage other companies to do. And it will really grow. It’s viral – it catches on very, very quickly.”

One challenge to be aware of, Ledford says, is that sometimes a few senior executives feel that the time spent on

discussions about purpose is “soft.” It is up to the CEO to ensure that everyone knows it is not. “We did not see this as soft at all,” Ledford notes. “We have a CEO who said, ‘I want to be able to articulate who we are, what we are, and why what we do matters. When I’m sitting next to someone on an airplane and I’m talking about MMC, I want to have this really crisp.’ And that is by no means ‘soft.’”

MMC emphasized the importance of “a human approach” in defining its purpose. But are companies like people? Even if corporations are “legal people,” can they have moral responsibility? ■

Corporate Governance and the Moral Responsibility of Firms

In May 2015, five global banks with household names agreed to pay fines totaling \$5.6 billion to the U.S. government for manipulating the U.S.-euro currency market to benefit their own trades. Four banks – Barclays, Citigroup, J.P. Morgan Chase and the Royal Bank of Scotland – pleaded guilty while UBS received immunity but pleaded guilty to charges that it manipulated the benchmark interest rate London Interbank Offered Rate, or LIBOR. Remarking on the crimes, U.S. Attorney General Loretta Lynch said the stiff fines reflect the conspiracy’s “breathtaking flagrancy, its systemic reach and its significant impact.” It was only three years ago that many of the same banks were fined billions of dollars for manipulating the LIBOR. In both scandals, few or no individuals faced charges and the banks have continued to operate.

The U.S. practice of going after corporations as criminals is steeped in a long legal history that believes businesses bear moral responsibility for their actions. Companies are criminally liable because they are deemed to be moral agencies and thus have to answer for misdeeds. Without that assumption, it would be tantamount to filing charges against a knife for injuring a cook. “In the U.S., it has been accepted for many years now that you can sue a corporation or any other business for a criminal act,” says Eric Orts, Wharton professor of legal studies, business ethics and management who is co-editing the upcoming book *The Moral Responsibility of Firms*.

Such a view is “based on an assumption that usually in criminal law, you cannot be held criminally liable – and that it doesn’t make sense in most theories of criminal law for you to be a criminal – unless you’re morally culpable,” Orts adds. This belief is not a trifling matter; it underpins legal theory and carries widespread reverberations. For example, in Germany, companies are not seen as moral persons and as such cannot commit crimes. “You cannot sue a corporation for being a criminal in Germany,” Orts says. “So, the penalties that we’re assessing in the multibillions in the United States against banks, for example – you can’t do that in Germany.” Instead, German authorities hold individuals responsible.

These different views stem from how societies answer this question: Is a company a person with social rights and responsibilities? Orts believes so, and he lays out his rationale in another book, *Business Persons: A Legal Theory of the*

Firm. “We have recognized corporations and business firms of many kinds – partnerships, limited liability companies and others – to have a legal personality for many years, even centuries,” he says. “Business firms have rights to own property, make contracts and sue and be sued in court.” However, if companies are people, does that mean they also have the full panoply of constitutional rights given to human beings? The answer is not that simple. Orts says that no one would dispute that companies have the constitutional right to sue if the government takes over their property for the public interest. On the flip side, people would also think it ludicrous to give companies the right to vote.

Orts says the courts have not helped settle the debate by taking “extreme” positions on issues when there should be recognition of a middle ground where corporations have some constitutional rights but not others. Case in point is “Citizens United v. Federal Election Commission,” in which the U.S. Supreme Court decided in 2010 that political spending by corporations or unions is a form of protected speech under the First Amendment as long as they did not directly contribute to a campaign. The court’s opinion gave rise to so-called super PACS or political action committees, and money going into them has ballooned, according to a 2014 study by the Brennan Center for Justice Analysis. Orts says the controversy in the Citizens United case centered on extending constitutional rights to firms as opposed to individual people, giving rise to commentary that “corporations are not people.” But he argues that it is a “false debate” to say that businesses are not persons when they do have legal rights.

Two Sides of the Debate

Philip Pettit, a philosopher and Princeton University professor of politics and human values, takes the view that companies carry moral responsibility, according to Orts. “The reason is that they are cognitively structured as a large agent of people,” Orts says. A company is “people acting together.” On the other side of the debate is Amy Sepinwall, Wharton professor of legal studies and business ethics. She believes it does not make sense for a firm to have moral responsibility because they do not feel anything. “In order to have moral responsibility, there has to be an emotional ability to feel the shame of wrongdoing or be able to feel good about doing something good,” Orts says. “That, in [Sepinwall’s] account, is an individual response. So, it doesn’t really

In the case of the U.S. banks fined for LIBOR manipulation, many of the same financial institutions were caught years later controlling the U.S. dollar-euro currency market.

make sense to think that a corporation, which is an artificial construction of lots of people, can actually feel anything itself. The individual people within the firm can be talked about as having a moral responsibility, but in her view, the larger firm cannot.”

Scholars are about evenly divided on the issue because there are strong arguments on both sides, Orts adds. If a company is a moral person and therefore culpable for its crimes, prosecutors can sue for fraudulent actions and exact big fines, which is what happened during the 2008 financial crisis. The U.S. government can crow about its settlements to the public even though “nobody actually goes to jail. No individual pleaded guilty,” he says. But this is a “perverse” outcome because innocent people get punished instead of the employees or executives committing the crimes – for example, shareholders who take a hit if the stock price falls. “This has been one of the arguments that people have made so far in the financial crisis – that if there had been crimes, then people have not been held responsible,” Orts notes.

At least, if a company is sued the victims can get compensation especially since isolating the misdeeds of individual perpetrators can be tricky due to the complex interconnections within a business. “Firms are so complicated that it might be very difficult to prove a specific individual had full criminal culpability to do a specific fraud,” Orts says. “It’s easy for individuals to hide their actions within a firm,” Even if specific culprits can be found, they could be acting under the direction of a senior officer or conforming to a culture of weak ethics in the company to do such things as lying to customers, falsifying records, padding expense reports, not reporting sexual harassment, and others. They could be functioning in an organization where the incentive and reporting structure is set up in a way to make it hard for conscientious people to buck the system. “It’s very difficult [for

employees fearful of losing their jobs to take a stand] when someone they respect at the top level says, ‘Look the other way on this,’ or ‘This is something you don’t have to worry about,’” Orts adds.

Another downside of allowing charges against companies – instead of individuals – to go forward is that it does not seem to deter future crimes. In the case of the U.S. banks fined for LIBOR manipulation, many of the same financial institutions were caught years later controlling the U.S. dollar-euro currency market – even as the global financial crisis remains fresh in people’s minds. “The question is, what does it really do? What is the real incentive [to deter future wrongdoing]?” Orts asks. “What signal have you sent? Those guys got off without penalty. That is why I’m in favor of trying to pin some of the responsibility on individuals.”

Setting up a Strong E&C Program

An increasingly critical solution is for companies to set up strong ethics and compliance (E&C) programs – and they are doing so. In a study of more than 6,400 large companies, the latest report of the National Business Ethics Survey of the U.S. Workforce said that 81% of firms provided ethics and compliance training in 2013, up from 48% a decade earlier. Investment in E&C training also pays off: 20% of workers in companies with strong ethics cultures said they have witnessed misconduct, compared with 88% at companies with the weakest ethics cultures. The study said these E&C initiatives range from incorporating ethical conduct into employee evaluations to communication within the firm that ethics is a priority.

The ethics survey also revealed that management commits most of the misdeeds: 64%, compared with 36% for non-management workers. Moreover, “senior leaders are more likely than lower-level managers to break the rules,”

the report said. “The very people that are supposed to act as role models or enforce discipline are often guilty of bad behavior.” These findings are not due to lower-level employee frustrations with management. Indeed, senior and middle managers reported on each other as committing the misdeeds, the study said. Another troubling finding of the survey is that a “significant” amount of misconduct is ongoing rather than one-time incidents. Among firms with the weakest ethics cultures, 82% of misconduct happens repeatedly while 35% represents an “ongoing pattern,” the study said. Meanwhile, in firms with strong ethics cultures, 60% of misdeeds are one-time events.

After the financial crisis, the Dodd-Frank Act of 2010 attempted to set rules to rein in corporate malfeasance. Among other things, it required investment banks, hedge funds and other financial services firms to install a clawback provision in employment contracts that lets firms “claw back” big bonuses paid to executives later found to have committed wrongdoing. Now, the U.S. Securities and Exchange Commission is expanding the rule to all publicly traded companies in compliance with Dodd-Frank. Under the SEC’s proposed clawback rule, the three-year provision would be triggered if businesses have to materially restate their earnings even if there was no misconduct. The commission is now accepting public comments on the proposed rule.

Orts applauds the use of clawbacks to guard against bad corporate behavior but wishes it would go further. “Clawback arrangements are at least an attempt to say, ‘Look, we need to get the incentives right so that people are not getting away with crimes, basically, or getting away with fraud,’” Orts says. But one problem is their limited reach. “They’re just focused on one thing – accounting restatements rather than ... larger issues.” Executives can also get around clawbacks by re-routing where they get additional compensation. Instead of piling up on incentive-based bonuses, executives can ask for a bigger salary upfront, he adds.

“There’s a radical expansion going on of limited liability of firms.”
– Eric Orts

Meanwhile, more businesses are setting up as limited liability enterprises to curb their exposure. “There’s a radical expansion going on of limited liability of firms,” Orts says. “And it’s not only corporations, but the standard small business enterprise today is a limited liability company.” It has also now become standard for partnerships to be structured as a limited liability business, such as accounting and law firms. “Almost all the big partnerships have switched to that,” he adds. A key advantage of doing so is that “the financial liability of a firm is limited to the total amount of equity invested in that firm.”

Companies also attempt to shield their executives and directors from liability through insurance and indemnification agreements, where firms promise to defend them against lawsuits for certain actions they made during the course of business, Orts says. But nearly all of these agreements exclude criminal activities. “You can’t, as a matter of public policy, indemnify people for crimes,” he adds. “That’s one of the reasons why criminal law becomes increasingly used as a threat [against officer malfeasance] because for anything else, basically the corporation can indemnify you.” But there is one caveat: The company has to stand behind you.

As the risk of malfeasance increases, so does a major challenge that confronts those responsible for corporate governance: How can companies ensure compliance with rules and escape the wrath of regulators? ■

Corporate Governance and Compliance Programs

For more than a decade, William S. Laufer, a professor of legal studies and business ethics at Wharton, has been asking how and why investments that companies make in compliance add value. Of course, some firms invest in the compliance function to genuinely embrace ethics, integrity, and good governance practices. Other firms undertake such investments, however, for less obvious reasons. There are significant regulatory incentives for firms to make compliance expenditures as evidence of their due diligence to comply with laws and regulations. In fact, according to Laufer, compliance expenditures, standing alone, are an essential part of a more elaborate regulatory game. Part of what makes this game complex, though, is the fact that “regulators and prosecutors are far from clear about which programs and policies are effective. Corporations also lack the metrics and measures to know which of their compliance programs actually work,” he says. “The combination of regulators and firms (the regulated) not knowing the effectiveness of compliance expenditures is problematic in many ways.

“If neither regulators nor the regulated have evidence of the efficacy of the compliance function, and expenditures are an accepted proxy for due diligence, then regulators might shy away from those firms who meet expected levels of compliance investment,” Laufer says. In theory, he notes, there exists here a potential for moral hazard – defined as a failure to guard against risks because potential victims believe they are protected from their harmful consequences. (Example: Motorists who take risks in driving that they would not in the absence of collision insurance.) In other words, “These companies could rely on a “cosmetic” or “paper” compliance machine, hold out their compliance spend to show due diligence, and engage in more significant deviance that largely escapes regulatory scrutiny. Compliance dollars become a form of insurance against both regulatory scrutiny and, ultimately, liability.

The question of compliance effectiveness goes back more than several decades. In 1995, for example, Laufer presented the results of a survey of the compliance practices of SMEs at a conference sponsored by the United States Sentencing Commission. As Laufer recalls “After my presentation, I raised my voice about the need for more objective metrics for compliance effectiveness. In the audience was Lynn Paine [a professor of management at Harvard].

Lynn asked, ‘What kind of measures are you talking about, though? What would be an objective measure of compliance effectiveness?’ To this day, more than 20 years later, it is not clear what a good answer is.”

Even so, in recent years an evidence-based movement has emerged around the effectiveness – or otherwise – of compliance programs. “More so today than ever before, there are new measures and metrics,” Laufer says. The Open Compliance & Ethics Group (OCEG), a non-profit organization, offers tools and standards for governance, risk management and compliance. In addition, ISO 19,600 specifies the elements necessary for enterprise-wide compliance. Finally, the Department of Justice recently hired a “compliance counsel” to evaluate, more systematically, the quality of compliance programs under prosecutorial scrutiny. “We are seeing the beginning of a real push for some social science behind corporate compliance expenditures,” Laufer notes.

As part of these efforts, in June 2015, the [Zicklin Center for Business Ethics Research](#) at Wharton co-sponsored with the National Academy of Sciences in Washington, D.C., a workshop on the science of corporate criminal justice. “We invited leading experts from the social sciences and from the legal academe to discuss how we can move towards a social science of compliance that would justify the kinds of regulatory expenditures that firms have now,” Laufer says. “Our hope is that over time, regulators will understand which compliance programs actually work, and at the same time, firms will be incentivized to integrate evidence-based solutions. The objective is for

“Corporations lack the metrics and measures to know which of their compliance measures actually work.”
– William S. Laufer

Corporations are spending vast sums on compliance and risk programs and policies that may or may not work, and, thus, “risk wasting shareholder resources.”

– William S. Laufer

companies to more effectively self-regulate, in ways that are consistent with formal regulatory requirements.”

Laufer points out that the University of Pennsylvania for many years championed the Campbell Collaboration, which emerged from a comparable initiative in medicine called the Cochrane Collaboration. The Campbell Collaboration, he explains, is a research network offering systematic reviews of the effects of interventions, programs, and policies in the criminal justice system. “We joined Prof. Sally Simpson (University of Maryland) who led the corporate crime deterrence review and found – remarkably – that there is essentially no evidence that the policies, practices and programs that have been put in place to deter corporations from wrongdoing actually work,” Laufer notes. “It is very fair to say that we sit, quite uncomfortably, at the nascent stage of an understanding of compliance.”

Laufer notes that a huge challenge for the future will be with justifying compliance expenditures. Spending large sums of money on compliance cannot simply be used as a signal that a company takes compliance seriously; it is not just a matter of adding another million dollars’ worth of compliance expenditures or another 1,000 compliance professionals. “Firms over time will be asked to provide evidence that the compliance programs and practices actually impact behavior,” Laufer says. “And for that, we have to start measuring the extent to which the compliance and training programs are effectively integrated throughout the organization.”

A case in point is HSBC, the financial services giant, Laufer notes. “HSBC was criminally investigated for laundering drug cartel proceeds in Mexico. Before it entered into negotiations with the Department of Justice, corporate-wide HSBC was spending more than \$500 million a year on compliance. After the deferred prosecution pro-

gram was put in place, part of that agreement was that HSBC would spend another several hundred million – above the \$500 million – on its compliance and risk systems. The last time I looked, HSBC was spending more than \$850 million – that is a significant compliance spend, coupled with more than 7,000 compliance professionals. What effect does this spend have on operating expenses and, ultimately, profit?”

Laufer is concerned that corporations are spending vast sums on compliance and risk programs and policies that may or may not work and, thus, “risk wasting shareholder resources.” The standard refrain with any significant threat of a criminal investigation seems to be that firms should spend more. “This refrain benefits law firms, a cottage industry of ethics consultants, accounting firms, and consulting firms,” he says. “It is no longer surprising to see compliance budgets for large financial institutions exceed several billion dollars.”

The question of whether firms are spending too much on compliance programs of questionable value is not just a U.S. problem; it is a global problem. Countries such as Brazil, India and Mexico are looking at the regulatory experiences of the U.S., according to Laufer. New legislation has been introduced around the world that allows for criminal liability for corporations. “The question has come up in Latin America, Asia and throughout the European Union about how we handle of the risk of cosmetic compliance,” he says. According to Laufer, “Countries look to the U.S. as an example of how to encourage effective self-regulation while, at the same time, hoping to avoid our twenty year experiment in compliance spending without evidence.”

Answers will inevitably come from more systematic research. A recent study by Laufer and his fellow researchers – including Danielle Warren, a professor of

management and global business at Rutgers University in New Jersey, and Joseph Gaspar, a professor of management at Quinnipiac University in Connecticut – explored the response of bank employees to ethics training. Their findings were published in *Business Ethics Quarterly* in January 2014 in a paper titled, “Is Formal Ethics Training Merely Cosmetic? A Study of Ethics Training and Ethical Organizational Culture.”

Lessons from an Ethics Training Program

Warren explains that the researchers’ goal in their paper was to study the impact of formal ethics training at an unidentified bank, which was a component of a larger compliance program. “We studied an organization that had not had formal ethics training. They decided to implement a four-hour, face-to-face ethics training session for all employees. They are in multiple countries, so they orchestrated this training throughout the various locations with small groups of employees, 30 people at a time,” she says.

After surveying the organization before the training, the researchers conducted two follow-up studies. The first was conducted nine months after the training, and the second, two years later. “We found that the four-hour, face-to-face session that had specific content relating to values and compliance had a long-lasting effect on the employees’ attitude and the behaviors that they were seeing in the workplace,” Warren notes.

Warren says that the study documented the effectiveness of a formal training program in a way that has never been studied before. “It gave some credibility or some empirical evidence to support some of the pushes that we’ve seen from the U.S. government in terms of sentencing guidelines and various programs that were being promoted to promote more ethical conduct within organizations,” she says. “This was strong evidence into how this plays out in a real organization.” Warren was surprised at the effectiveness of the training program, considering that it lasted just four hours, and that two years later, it had a “statistically significant effect on multiple aspects of the organization’s culture.”

Warren notes that banks such as the one featured in the study have clear incentives to implement ethics training programs. Most significantly, “the guidelines reduce the fines associated with corporate wrongdoing based on the various programs that have been put in place by the organizations to protect against such wrongdoing,” she

“Enron had an ethics program – and yet they had horrible behavior in the organization.”
–Danielle Warren

explains. “So if you are an organization that has an ethics program, if you have the same level of misconduct in your organization as another one that does not have an ethics program, you will receive a lower fine. In other words, it’s the same wrongdoing. But if you have an ethics program, your fine will be lower.” Warren adds that various attributes of ethics programs can lead to further reduction in fines. “There was a 2004 amendment to the sentencing guidelines that said that if you could demonstrate you have an ethical culture in your organization, that you would receive a lower fine,” she says.

According to Warren, regulations are ambiguous or unclear about what it takes to have an ethical culture. “For instance, Enron had an ethics program – and yet they had horrible behavior in the organization. That brought to light the fact that you could have an ethics program in place but not have a culture that reflects that ethics program. Scams such as the one uncovered at Enron are what prompt critics to argue that ethics programs – and many compliance efforts overall – might be cosmetic. If companies are unable to prevent corporate malfeasance because of their culture, they could choose to try and lighten their punitive burden by implementing an ethics program. Its impact, though, would remain largely cosmetic.”

Warren says that was the reason why their study decided to focus on the impact of ethics training on the bank’s culture. “We didn’t just use some global measure of ethical culture or ethical climate,” she notes. “We actually measured components or attributes of the culture.” In addition to looking at specific behaviors, researchers asked questions such as “What do you think of the values of various groups within the organization – your supervisor, upper management, your co-workers?” Warren and her colleagues tried to “unpack what organizational culture is and measure all the various attributes separately to

see if there was an effect.” The researchers found an improvement on most dimensions – except for one. “The only thing in two-and-a-half years that dropped off was a perception of values. That went back to pre-training levels,” Warren says.

Warren believes that thorough training can have an impact on culture. “I think we have evidence of that in our study, but there is also broader evidence within organizational behavior research about how you may shift an organization’s culture – and not necessarily just along the ethical dimension. It could also be something like innovation. Training is one of the ways in which you can try and shift the culture. I most certainly believe that you can shift the culture so that people start to think about ethical issues.”

According to Warren, ethics training helps change the culture by raising awareness. “There may have been a series

of behaviors that were commonplace in your office that you didn’t realize were ethically questionable,” she says. “One aspect of ethics training – that adds value in terms of shifting the culture – is to just raise awareness about what an unethical practice is in your workplace. People may be giving gifts to one another that are worth more than \$100, without realizing this was problematic or against the rules. People may have been saying inappropriate things to one other. This might have become commonplace. Ethics training brings about some level of awareness of such problems. That is just the first step in shifting a culture.”

As the study by Warren and her colleagues shows, implementing an ethics program did have an impact at the bank – limited as it may have been. The great challenge that firms face, however, is not just how to ensure compliance; it is of building an ethical culture. ■

Corporate Governance and Corporate Culture

Peter Drucker once said (as reported by a Ford executive) that culture eats strategy for breakfast. Whether or not Drucker actually spoke the words that have been attributed to him, this statement is a striking way of emphasizing that no strategy – no matter how brilliant – can succeed if an organization’s culture rejects it. Strategic initiatives, like plants, need hospitable soil to thrive. This is also true of efforts that firms make to go beyond compliance – or obeying rules that regulators expect them to follow – and to build organizations with an ethical culture, where doing the right thing becomes second nature and part of the air that everyone breathes. As Wharton’s Donaldson says, Johnson & Johnson would hardly have been able to sustain its ethical true north over decades had the principles of its credo not become a living part of the company’s culture.

If that is true, a critical question to answer is: How do firms create an ethical culture? Training undoubtedly needs to be among the first steps, as Rutgers University’s Warren says. But what else should firms do?

They could do many things, notes Warren, who views ethics training as a small but integral part of a broader ethics program. “Ethics programs typically have several features,” she says. “They may have a system that people can use for reporting wrongdoing. There may be hotlines or departments where employees can seek guidance when they encounter ethically questionable behavior or practices. Other ways in which you can influence culture is by having a formal, clear statement about the organization’s values [such as the J&J credo]. If an organization is explicit in its statement about belief in and support of integrity, this can be a strong guiding force in employees’ everyday work.”

One of the best ways to cultivate an ethical culture, suggests Warren, is for companies to walk the talk. In other words, it is not enough simply to have a framed statement on the wall expressing high ethical standards; these standards and values must be reflected in everyday decisions. “If an organization decides to disclose that there is an issue with one of its products – without being forced to do so by regulators – and gets out in front of the problem, discloses it to the public and lets people know how it will be fixed, that is how the firm can make a strong statement about honesty and integrity,” she says. “The company can

practice what it preaches. That can reinforce a shift toward an ethical culture.”

Warren says instances of management decisions reflecting integrity can be reinforced during training sessions. “You can give positive examples where the organization is living up to what it says its values are during a training session. You can also use instances of people being punished because they did not live by those standards, or were deceitful, or failed to act with integrity. You can use examples of people who were suspended or asked to leave the organization because of ethically questionable behavior.” All this further reinforces an ethical culture, she notes.

Leadership plays a critical role in nurturing an ethical culture (see the next section for a more detailed discussion on leadership and the role of boards). According to Warren, leadership sets the tone for organizational culture. Decisions to implement ethics training as part of a broader program, crafting a values statement, creating a reporting process that allows employees to report wrongdoing – all these are choices that leaders need to make in order to nurture and reinforce an ethical culture.

One of the hallmarks of an ethical culture is openness, an environment where people not only feel encouraged to do the right thing, but also speak up about things that may be going wrong. Michael Useem, a professor of management at Wharton and director of the school’s Center for Leadership and Change Management, notes that one of the most visible hallmarks of an ethical culture is when leaders help create an environment where people at all levels of the organization feel safe to “speak truth to power” – a phrase whose origin is attributed to an old Quaker saying – without fear of punishment. Trust is the glue that binds organizations together. Trust withers when truth-tellers are victimized for speaking up when they feel they must.

According to Useem, the notion of speaking truth to power – or telling leaders what they need to hear rather than what they may want to hear – is “one of those conditions that does not come from heaven. Some things we think are just natural; we are endowed that way. It’s how people are – a sort of natural condition. Speaking truth to power is extremely unnatural. You have to turn things upside down.” Given how challenging it is for bad news

“One of the most visible hallmarks of an ethical culture is when people at all levels of the organization feel safe to speak truth to power without fear of punishment.”

–Michael Useem

to travel upwards within firms – a condition that is critical to creating an ethical culture – he explains that the best management teams have created devices to encourage that process.

Useem tells a story from the American Civil War to explain how leaders encourage open communication. “My favorite example comes from the armed services, where as you know we salute senior officers,” he says. “On the eve of Pickett’s Charge [during the Battle of Gettysburg], on July 2, 1863, the Union commander, Major-General George Meade, was wondering what to do the next day. His forces had been beaten badly by Robert E. Lee’s Confederate forces the prior two days. In his own mind, he had decided there were three options: He could retreat and find a better ground to fight on; he could go on the offensive, or he could stay where his troops were lined up and anticipate that Lee would attack.”

According to Useem, Meade probably knew in his own mind what should be done. But for several reasons, he convened his top seven generals late that night. Though they were all generals, their seniority was determined by the chronology of the time they had been appointed by President Lincoln. Knowing there is a tendency for military officers to defer to senior officers, Meade turned to the junior-most officer and asked what should be done. Having no indication about the “right answer” from any of the others, the officer recommended that the Union forces should stand their ground rather than retreat or attack.

The major general then turned to the second junior-most officer, who recommended the same course of action.

As they went around the room, it was clear that everyone was of the same view – that the Union forces should defend their existing positions. The major general had

already privately reached the same conclusion but by letting the junior-most officers speak first followed by the more senior generals, he created a consensus. Rather than his decision, it was a collective decision – and it turned out to be a historic one. Pickett’s Charge today is regarded as a pivotal point in the history of the Civil War. It helped swing the balance of power in favor of the Union forces.

How are Meade’s actions relevant to firms that want to create an open and ethical culture today? Useem explains that asking the junior-most officers to speak first has become a military tradition that is used even now and is taught at West Point. “By letting the subordinate officers ‘speak truth to power,’ George Meade reaffirmed his own judgement but he also made each of the seven generals realize that they were part of the high command,” Useem says. “This is a famous example that makes the point that what the top person does matters enormously [in shaping culture]. Do they speak a lot and leave no time for questions? Do they kind of suck the oxygen out of the room? Or do they compliment people for speaking truth to power?” Clearly, a company that wants to build an ethical culture should follow the last course.

Many large, hierarchical structures understandably face a challenge in getting bad news to bubble up to the top. But is the process different for entrepreneurial start-ups, where transparency and trust are perhaps even more critical? David Larcker, a professor of accounting and director of the Corporate Governance Research Initiative at Stanford University’s Graduate School of Business has seen these questions come up at several start-up firms in Silicon Valley. “Out here in the Valley, you run into a lot of unusual organizational forms,” he says. “People say things in open forums, and it seems like the culture is more of an open book. They know they are all in it together, and if things do not work out, they are all in trouble.” Larcker

“If women are thought to be whistle-blowers, they may be left out of decisions or discussions....”
– Sarah Laessig

says it also makes a difference that these are younger companies staffed by younger people. “They don’t have a couple of hundred years of history,” he says.

In addition to start-ups, larger firms, too, have been able to establish a culture of open communication, Larcker notes. For example, Berkshire Hathaway, headed by Warren Buffett, has had “a history of having a lot of trust and minimal internal checking, despite all their different lines of business,” he says. “We have written a little bit about trust in organizations. The question we asked was, ‘What would governance look like if people trusted one another?’ Sometimes it can be Nirvana-like, but it is an interesting thing to think about.”

Larcker notes that different companies have different perspectives on what is acceptable in terms of business practices. For companies that have been in existence for some time and successful, changing the culture and the governance structure can be very difficult. “I would say it is pretty hard without something really awful happening,” he says. For example, when Tyco International’s CEO Dennis Kozlowski and other executives were charged with stealing hundreds of millions of dollars from the company, “they just got crushed in governance,” Larcker says. After a scandal of that magnitude, an organization needs not just a new management team, but also a new board of directors. It is only after such sweeping changes are made that the organization can see a decisive shift in its culture – which is what happened at Tyco. “Clearly it moved from the old style to a more professional style” Larcker says. “But it is hard, unless there is a disaster, for a company to change its focus and culture.”

While Larcker is correct that it often takes a crisis or disaster to bring about a sea-change in an organization’s

culture, such an outcome is hardly desirable for most firms. As a way to identify situations that could potentially lead to a major scandal and to deal with them before they explode all over the news media, companies have another way to ensure ethical behavior in their organizations. It depends on the way they treat those who blow the whistle on bad news.

The Role of Whistleblowers

How do companies treat whistleblowers? The ethical temperature of a corporate culture depends enormously on whether whistleblowers are protected, made to feel safe and their positive contribution is acknowledged. Alternatively, if a firm chooses to ignore, sideline or punish whistleblowers, that can be a telling sign of a culture that is ethically challenged. A lot depends on how firms respond when whistleblowers speak up.

According to Warren, in the U.S. the law does not allow whistleblowers to be punished. “There is a protection for them under Sarbanes-Oxley,” she says. “A number of organizations allow anonymous reporting on hotlines as a way of harnessing whistleblowers and using them for internal purposes in a productive, constructive manner.” The worst-case scenario for an organization is to “have a horrible scandal, then the whistleblower goes outside the organization and blows the whistle, and the organization is potentially blindsided. This happens before the firm has had an opportunity to try and rectify things before it’s blown up in the media, and regulators have come in.”

Warren says when some misconduct occurs in a company, “the ideal situation is that you have another employee who is willing to report that misconduct so that it does not grow. And it does not cause a huge scandal for the organization and potentially cause it to go bankrupt. What organizations are trying to do is create reporting channels where people can speak up as soon as they see an issue. Organizations try to manage these types of situations quickly. That is why hotlines are important, and that channels exist in which people can feel comfortable reporting misconduct. That is very important to having an ethical organizational culture.”

Sarah Laessig is a commissioner of the U.K. Civil Service Commission. A former banker who holds board positions in the commercial as well as non-profit sectors, she believes that the most important priority for companies

should be to have a strongly ethical corporate culture that does not need whistleblowers. “What you want is a culture that engenders positive reinforcement of bringing up problems or issues along the way when they are small or minor to enable the company to change. Obviously, you need a culture and a process for capturing those smaller things.”

Laessig points out that it is difficult to generalize about how whistleblowers are treated –whether they are penalized or protected. Sometimes, attitudes toward whistleblowing can be ambiguous, she notes. “Whistleblowers are seen as a little bit awkward,” Laessig notes. “If you think of an extended family, there may be one family member who tends to state the obvious, but slightly uncomfortable, things that nobody else wants to say. Like, ‘Oh, look, Aunt Janice looks like she’s gained a lot of weight.’ These are things that are, maybe, self-evident, but when you think about that person, do you go out of your way to spend time with them? Do you shun them a little bit? Do you try to walk away from conversation groups where they are? That is a natural way we treat whistleblowers.”

Laessig notes that anecdotally and historically, women have tended to be whistleblowers in a greater ratio than men. “I think that is due to a couple of reasons,” she says. “In the past, and even now in many professions, women tend to be the odd person out; she is different from others in the group because the others are men.” As a result, Laessig explains, the peer pressure that might have been exerted to keep her from blowing the whistle is diminished, because “she already is outside a particular circle of trust.” Moreover, perhaps the idea of “being shunned by her peers is not quite as painful, because she is not part of the inner circle in the first place.”

Laessig believes that being outside the inner circle or the “old-boys club” can have other consequences for senior women executives – of opting out of the corporate world – and she wonders whether that well-recognized phenomenon could be called a form of silent whistleblowing.

“That means they are no longer OK with the corporate culture at their company, or indeed, the business culture of their industry.” Laessig says it is common for people to believe that senior women executives opt out for family reasons, but “if you look at the research, it doesn’t bear that out. It usually has more to do with them being disappointed or frustrated with the corporate culture.”

When women engage in such “silent whistleblowing” as Laessig terms it, they are generally not responding to major unethical practices as Cynthia Cooper of WorldCom or Sherron Watkins of Enron did when these women executives spoke up about corporate corruption at their firms. “It is not usually a single large episode or event, but a series of small frustrations or instances in which they no longer feel comfortable in the corporate culture,” Laessig says. “It can also be a bit of a self-fulfilling prophecy. If women are thought to be whistleblowers more often, they may get left out of decisions or discussions where the rest of the group would feel they might raise a hand and think otherwise. And if they get left out of those decisions, then they are more prone later to blow the whistle on them.”

As a case in point, Laessig points to a controversy last year at California-based Quiksilver, which is one of the world’s biggest manufacturers of surfwear. “The board had a very public spat with the only woman director [Elizabeth Dolan]. She got left out of the decision-making process to oust the CEO because other board members were afraid she would tell the CEO, or break ranks with the board. That was a self-fulfilling prophecy: They thought she might be a whistleblower or let the secret out, so they left her out of the decision. And because they did that, she decided to raise her hand and say, ‘This isn’t right, and I want other people to know that this has gone down that way.’”

The Quiksilver episode highlights the close relationship between whistleblowing, ethical culture and governance. When things go well and even when they do not, the ultimate responsibility generally leads back to the board of directors. ■

Corporate Culture, Leadership and the Role of Boards

In 1989, Jay W. Lorsch, a Harvard professor, published a book titled, *Pawns or Potentates: The Reality of America's Corporate Boards*. Co-authored with Elizabeth MacIver, the book made the case that board members were pawns of management rather than powerful potentates representing the shareholders' interests. In the 26 years since that book appeared, have boards changed their behavior? According to Wharton's Useem, "Lorsch probably wrote the most famous book in corporate governance, period. When he wrote it, I think he was right to say boards were pawns and not potentates. Today, he would be the first to say that it is no longer true."

Useem recalls speaking with Harold Geneen, when he was the CEO of ITT, before the company was broken up. At the time, ITT was a conglomerate active in some 35 lines of business. According to Useem, Geneen told him the board met every three months at a luncheon held at the company's Park Avenue headquarters in New York City. "At the end of the meal, each director would pick up a plate, and under it was a check for \$5,000 – just for showing up. Everyone would say, 'What a great meeting, nice lunch, the management is doing well,' and walk out." It was typical behavior for boards at that time, which earned them the reputation for being pawns of management.

Today, though, "you can't overstate how different it is," Useem notes. "Boards are very tough. In some sessions, they kick all the managers out and sometimes they kick the CEO out as well." A case in point, he says, is AIG. After the insurer was brought to its knees during the financial crisis, the board played a very active role in getting the company back on its feet. The chairman of the board, Harvey Golub, was very tough on Robert Benmosche, who was appointed CEO by regulators to oversee AIG after the bailout. The tension between the two men became so intense that in July 2010, Golub resigned from the board. At that time, *The Wall Street Journal* reported that Benmosche had "chafed under Golub's oversight." According to Useem, "If you were to look at the relationship between Golub and Benmosche, Golub was the opposite of a pawn. Potentate, I think, is the word."

Charles M. Elson, a professor of finance at the University of Delaware and director of the university's John L. Weinberg Center for Corporate Governance, agrees with Useem that boards today are tougher on management than they were two or three decades ago. He adds, though,

that this change has occurred mainly in large cap firms, where "it is an outlier to have a board filled with pawns. In smaller companies, particularly where the founder is still active, this [pawn-like behavior by board members] is more likely to occur," he says. "That is going to have to be the focus of governance going forward."

Elson notes that the improvement in board oversight of large cap companies is a result of changes in the regulatory culture as well as the investor culture. "The demands of investors forced boards to take appropriate action," he says. "In smaller cap companies, you still do see the kind of culture that existed in the large cap firms 20 years ago. That is the vanguard of the governance system. We have to focus on smaller companies and ensure that they act effectively. That is where you see the problem, typically in firms that are founder-dominated." Asked what can be done about this, Elson notes that shareholders and investors will need to drive change in small companies just as they have done in large ones.

Should Boards Monitor or Lead?

One question that is often debated is what the true function of a board of directors is. Should the board simply monitor management's performance and ensure compliance with rules and regulations, or should it play a more proactive role in leading the company? Useem, who co-authored a book titled, *Boards That Lead: When to Take Charge, When to Partner and When to Stay Out of the Way*, with Ram Charan and Dennis Carey, says that oversight is a legal requirement. "The statutes that Congress had passed setting up the regulations for the SEC to enforce, the rules of the New York Stock Exchange, the registration provisions in the state of Delaware – they all say the board is there to monitor," Useem notes. "That means top managers make all of the decisions. Boards make certain that they are good decisions, that all the compass needles are pointed in the same direction and shareholders are protected against risk."

Still, in the book, Useem and his co-authors argue that while the oversight function is undoubtedly important, it "radically underestimates this other function – which is for people in the boardroom to bring what they know to the company leadership." According to Useem, an unanticipated consequence of the efforts that boards made to comply with Sarbanes-Oxley, tougher listing standards at

the New York Stock Exchange and other regulatory moves was to name stronger, more able and more strategic people on to corporate boards. “If you look around the boardroom, you may see the CEO of DuPont, the former CEO of Vanguard, and others like them. If you look at them, you may say to yourself, ‘These guys know a lot about what I am doing – and I really ought to talk with them because I might get some great advice that is going to be a lot cheaper than going to McKinsey.’ So, in an unanticipated kind of way – nobody made it happen – companies have a brain trust in the form of former CEOs of big firms who can provide proactive leadership.”

Elson believes that boards should exercise governance by monitoring as well as leading. “Exercising leadership is a consequence of effective monitoring,” he says. “A good monitor exercises leadership when it is necessary, and when it is not, he stays out of leadership. That is the board’s job, to serve as a circuit breaker. If there is trouble in the leadership, the board has to step forward and replace leadership. For a period of time, the board members may act as leaders, but that is on a temporary basis. Leadership ultimately comes from a management team, but the boards have to ensure that there is good leadership. When there is not, the board has to step in, take the leadership role and replace management. But these are related roles. You cannot separate the two.”

According to Stanford’s Larcker, “The board does two things. It hires and fires the CEO or maybe top management. And then it evaluates, vets and ultimately approves corporate strategy.” In most firms, the management typically develops a strategy in collaboration with the board. The management proposes a strategy; the board debates it, pushes back and makes suggestions; finally, it may or may not approve the strategy. The board also looks at degrees of acceptable risk.

As for the hiring and firing of the CEO, the board has a duty to say, “Here are the goals for the company, and here is how you are doing,” Larcker says. The board evaluates the CEO’s performance and says, “You’re doing well, or not well.” As the board reviews the CEO’s performance and his or her compensation, the line between monitoring and exercising leadership gets blurred, even though the board may not look into every aspect of the company’s operations in great detail. “The board has to monitor and receive the strategy. And it has to monitor and assess whether the right person is leading the company,” Larcker says.

“We always see the governance disasters. We don’t see the governance successes, typically.”
– David Larcker

Larcker compares the role the board plays vis-à-vis management to that of a coach with players on a sports field. “When you play sports, the good coach is the one who knows when to really get after you because you are not doing the right thing, but at the same time provides support and counsel. Boards have that dual role as well,” he says. “Board members assess and evaluate the management, but at the same time they provide a constructive sounding-board and assistance when needed as well.”

Larcker points out that boards often do not get enough credit for good governance though they are generally criticized when problems emerge. “We always see the governance disasters,” he says. “We don’t see the governance successes, typically. The reason probably is that scandals sell papers. But you don’t read a lot of news items that say, ‘A company was going down a bad path, but the board, through the governance process, intervened and stopped the behavior early before it could lead to a full-blown Securities and Exchange Commission investigation.’”

Is a Global Model Emerging for Corporate Governance?

Although the principles of corporate governance may be similar, the structure of firms and the composition of boards varies dramatically across the world. A report titled, “Is One Global Model of Corporate Governance Likely or Even Desirable?,” published in Knowledge@Wharton, notes that in Germany, labor unions have seats on corporate boards. In Japan, loyal managers are rewarded with terms as board members. In China, board members include members of the Communist Party.

Despite this diversity in the composition of boards and systems of governance in different parts of the world, there also are reasons why corporate governance norms

“Capital is the same the world over. No matter where you are in the world, you have to protect capital in the same way.”

– Charles M. Elson

begin to converge. “As business continues to globalize, new pressure from international capital pools and government regulators may diminish the local and national flavor of corporate boards,” the report says. In addition, companies are increasingly seeking funds from global investment firms – and they know that adopting international accounting practices and governance norms could help them compete more effectively for capital.

Will diversity ultimately prevail in corporate governance, or will it be overwhelmed by convergence? According to the University of Delaware’s Elson, “Every part of the world has a different culture, but corporate governance everywhere is about the same thing. The buzzword or the common phrase is ‘investor protection.’” Elson notes that the role of boards all over the world is to protect those who invest in the company. “No matter where you are in the world, when leadership is corrupted or ineffective, you have to change that leadership,” he says. “That is true all over the world. That is the commonality. Capital is the same the world over. No matter where you are in the world, you have to protect capital in the same way.”

Larcker agrees that despite the worldwide diversity in forms of business structures and forms of governance, the world does seem to be converging towards some common principles in certain areas. “Clearly there is a board of directors in virtually every country,” he says. “Whether

they are independent or not and whatever their duties might be, there is some sort of harmonization going on because of international trading.” At the same time, Larcker does not believe that the emergence of common principles will eliminate the real differences that exist in various parts of the world. “I just don’t think there will be 10 golden rules of corporate governance that you will see everywhere. Business cultures are different, and so are legal structures. There also are differences in the way markets operate or fail to operate. These have an impact on how the governance structure works.”

Once you get outside the U.S., Larcker points out, many big companies are controlled by business families. “That introduces another level of complication – it could either make things better or exacerbate the governance problems. I don’t see global convergence happening in corporate governance, though we may see some common elements,” he adds.

Wharton’s Donaldson, too, doubts whether the world is converging toward common standards of corporate governance. “The old time religion of convergence is waning,” he says. “For a while, we wanted to believe that a uniform form of corporate governance was emerging, but we have been disabused of that. Statistics show that it does not seem to be a fact – though we really wanted it to be true.” ■