
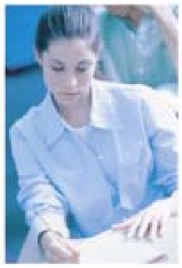

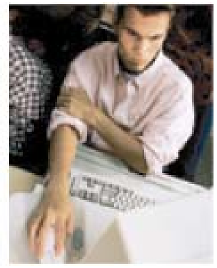

The Kaplan eGuide to Ethics and the Legal Environment

Chapter 6

This mandatory weekly reading assignment is designed to supplement your online coursework and help you to understand the basic concepts behind ethics and philosophical arguments.

In This Chapter

eGuide to Ethics and the Legal Environment

"Whoever has the gold, wins." Most people have heard this cliché, yet some managers, in the race for profit, recognize it as a mantra. Even with the potential for billion-dollar gains and losses for investors and companies in a single day, businesses should still abide by laws and rules of ethics. The Enron scandal illustrates that greed and poor ethics can destroy a company as well as the financial health of corporate stockholders. The resultant legislation demonstrates the legislature's and the public's interest in encouraging accountability. In this climate, it is essential for managers to understand securities laws.

Case Study: Telwhy Corporation

Jonathon is the brother of a founding member of TelWhy Corporation, a publicly traded telecommunications firm. He recently started dating a young, ambitious stock analyst, Jennifer, who works for a powerful New York brokerage firm. During dinner one evening, Jonathon told her that something wonderful was happening at TelWhy Corporation and that he wanted to celebrate. Jennifer watched in silence as Jonathon ordered a $300 bottle of champagne and then treated her to an extravagant and very expensive meal. Jennifer asked Jonathon to explain to her, but he stated that it was better if he didn't say anything just yet. He emphasized that they should just celebrate and enjoy their evening. After the champagne, Jonathon was slightly inebriated and began saying things such as: "I'm glad I bought the stocks when I did" and "I'm going to be richer than Donald Trump."

The next morning, Jennifer arrived at work and began asking other analysts what they knew about TelWhy. No one had heard of any major deals, but Jennifer told them about her dinner with Jonathon and that she believed something big was about to happen. They told Jennifer to keep looking into it, and Jennifer promised to do so.

Later that day in the financial markets news, TelWhy stock was marked a strong "buy" based on the recommendations of senior analysts from Jennifer's firm. By the next morning, the stock had nearly doubled in value in anticipation of "something big happening."

The following day, Jonathon sold his TelWhy shares for more than three times what he paid for them. By exploiting Jennifer's youth and eagerness to make a name for herself, he had duped her into believing that something big was happening at TelWhy. In fact, he simply needed a way to raise the value of his stocks so that he could sell them to pay off his large gambling debt.

The following week, the SEC launched a full investigation into the TelWhy stock debacle and charged the founding members who were also on the board of directors with fraud and misrepresentation. The TelWhy executives claimed no knowledge of the scam. However, one of the founding members knew exactly what happened, but did not reveal his secret. Jack, Jonathon's brother, once told his troubled sibling just how easy it would be to scam the market. Jack was sick with guilt and concern for his brother, who Jack was certain was behind it.

WHY MUST A MANAGER BE CONCERNED WITH THE SHAREHOLDER?

Shareholders are unique stakeholders because they are the actual owners of the corporation. Through their investments and stock purchases, they own the corporation but are not involved in its management or direction. The business, and therefore the manager, is caught in the interesting situation of assuring the public, government agencies, and their specific industry that all financial dealings are legal and ethical, while honoring the fiduciary relationship between the business and the stockholders. To do any less can bring the company to financial ruin, as seen in the Enron scandal, which led to corporate bankruptcy and criminal charges against Enron executives.

The Securities Acts

If a business is publicly traded, it falls under the regulation of the two main securities acts, the Securities Act of 1933 and the Securities Exchange Act of 1934. Congress enacted both pieces of legislation in response to the stock market crash of 1929 and the resultant Great Depression. Prior to the 1929 crash, securities markets were not federally regulated. The crash caused shareholders to lose money they had invested; it also caused banks, which had invested heavily in the market, to lose large sums of money. Depositors, concerned that they might not be able to withdraw money from their accounts, started a run on the banking system that caused many banks to collapse. The purpose of both acts was to structure and oversee the offering, selling, and trading of securities in ways that would protect investors.

WHAT DO THE SECURITIES ACTS MEAN TO THE SHAREHOLDER?

Congress enacted the Securities Act of 1933 in order to ensure that investors receive needed information about securities that are being offered for public sale. The act also prohibits fraud in the sale of those securities by requiring that securities sold in this country be registered. The registration forms filed by companies selling publicly traded securities must provide a description of the company's properties and business, a description of the security to be offered for sale, information about the management of the company, and financial statements certified by independent accountants. All of this information keeps the investor informed and protects the investor from fraud and deception.

With the Securities Exchange Act of 1934, Congress created the Securities and Exchange Commission (SEC) and gave it the power to register, regulate, and oversee brokerage firms, transfer agents, clearing agencies, and securities self-regulatory organizations. This oversight responsibility is meant to give the investor confidence and prevent another collapse in the system.

WHAT DO THE SECURITIES ACTS MEAN TO THE MANAGER?

Astute managers are well aware of the two Securities Acts (as well as the power of the SEC) and abide by all laws and regulations.

The 1933 act prohibits certain types of conduct and gives the SEC disciplinary powers over entities regulated by the act. Pursuant to the act, the SEC may require periodic reporting of information by companies with publicly traded securities. For example, SEC regulations require companies with more than $10 million in assets and securities that are held by more than 500 owners to file annual and other periodic reports electronically so that the public has access to the reports.

The SEC requires that companies submit certain documents for review, including: registration statements for newly offered securities, annual and quarterly filings, proxy materials, annual reports to shareholders, documents concerning tender offers, and filings related to mergers and acquisitions.

Both the Security Act of 1933 and the Security Exchange Act of 1934 prohibit fraudulent activities in connection with the offer, purchase, or sale of securities. These fraudulent activities include insider trading (an illegal breach of fiduciary duty when a person trades a security while in possession of material nonpublic information), misrepresentation of disclosure information, manipulation of securities market prices, stealing funds or securities, and sale of securities without proper registration.

Ethics Application

Example: Candice is in an office elevator when she overhears three employees of a different company discussing the not-yet-public sale of one of their subsidiaries. Candice recognizes that if she were to buy stock in the parent corporation, she could stand to gain a substantial return on her investment. Insider trading law does not typically cover individuals outside the company who innocently overhear of a "tip." Candice decides to use the private information for her own gain.

Activity: Ask yourself the following questions:

1. Who are the stakeholders in this case? What are their needs?

2. Is the action of Candice legal? Is her action ethical based on your gut reaction?

3. How does the answer to the above question change if you apply a rights approach to the case? A justice approach? A categorical imperative approach? A utilitarian approach?

4. Where would you rank Candice in Kohlberg's Levels of Moral Development?

The Sarbanes-Oxley Act

Toward the end of 2001, the Enron Corporation admitted to accounting errors that had inflated earnings by almost $600 million over the previous seven years. Less than a month after making that admission, Enron filed the largest bankruptcy case in the history of the country, causing many of its employees to lose their life savings and tens of thousands of investors to lose billions of dollars. Several parties contributed to Enron's fall, including Enron's top management and audit committee, its outside law firm, the auditors at Arthur Andersen, and Enron's investment advisors. The company and its advisors were alleged to have engaged in several questionable and/or illegal practices such as participating in insider trading, using aggressive accounting procedures to hide debt, knowingly falsifying financial documents, and shredding subpoenaed documents.

WHAT DOES THE SARBANES-OXLEY ACT MEAN TO SHAREHOLDERS?

In response to the Enron debacle and others subsequent corporate scandals, President George W. Bush signed the Sarbanes-Oxley Act of 2002 into law. The purpose of the act is to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to SEC laws, by enhancing corporate responsibility, and by ending corporate and accounting fraud. It remains to be seen whether the act has lead to a restoration of investor confidence, but the intent is to protect the shareholder and restore the image of stock purchases as investments worth the risk.

WHAT DOES THE SARBANES-OXLEY ACT MEAN TO THE MANAGER?

Effective managers should never put profit ahead of principle. The Sarbanes-Oxley Act speaks directly to the principle of corporate responsibility.

The act requires both the principal executive officer and the principal financial officer of a company to certify in each annual or quarterly report that the following procedures have occurred:

1. The signing officers have reviewed the report and the report is a true, complete, and fair presentation of the financial condition of the company.
2. The signing officers have designed internal controls to ensure that material information is made known to them.
3. The signing officers have disclosed to the auditors all significant deficiencies in the design or operation of their company's internal controls and any fraud that involves management with respect to those internal controls.

The Sarbanes-Oxley Act also prohibits publicly held companies from making personal loans to their senior officers and provides for more detailed financial disclosures, stricter conflict of interest standards, and disclosures of transactions involving management and principal stockholders.

In addition, and perhaps of immediate importance to the manager, is that the act requires each publicly traded company to adopt a code of ethics for senior financial officers that is designed to promote honest and ethical conduct.

Finally, the act makes it a crime for any person to destroy corporate audit records or to destroy, alter, or falsify records pertaining to federal investigations or bankruptcy proceedings.

Ethics Application

Example: The Banker's Association is a nonprofit corporation. However, each year, they do in fact make a substantial profit. Under nonprofit corporation law, the organization's profit cannot be distributed to directors or officers. The law also states that nonprofits cannot have investors, so it is illegal to distribute profits to investors. However, each year, the directors vote in substantial increases in their own per diem pay rate and give money to other nonprofits whose work they support. When they seek outside financing from banks, they typically do not report the increases to the directors' pay rates, nor do they disclose the "cash grants" to other nonprofits. The 2002 Sarbanes-Oxley law does not cover specifically the situation of a nonprofit corporation.

Activity: Ask yourself the following questions:

1. Who are the stakeholders in this case? What are their needs?

2. Is the action of the directors legal? Is the action of the directors ethical based on your gut reaction?

3. How does the answer to the above question change if you apply a rights approach to the case? A justice approach? A categorical imperative approach? A utilitarian approach?

4. Where would you put the directors in Kohlberg's Levels of Moral Development?

Chapter Summary

Recall the case study at the beginning of this chapter, TelWhy Corporation. In this case, there are both legal and ethical issues that must be addressed by managers.

It appears that in this case, the brother, Jonathon, has manipulated securities prices of TelWhy stock. He accomplished this by pretending to be aware of big changes at the corporation, spending lavishly, and making statements regarding his future stock riches.

However, Jonathon is not an employee of the corporation, nor does it appear that his involvement with the company extends beyond common stock ownership. The company itself played no part in the manipulation of the stock prices. The fact that a founding member of the corporation once spoke about how to complete a stock manipulation does not bring legal liability to the corporation. This information was shared in a conversation and was never intended to be used for such a manipulation.

Jennifer also played a role in the manipulation, yet her intent was only to make a name for herself as an analyst with legal inside information. Her reliance on the inebriated Jonathon's veiled comments probably shows poor judgment, but does not amount to legal liability.

However, the effective manager knows that the evaluation continues beyond the legal analysis and explores possible ethical issues. In this case, Jonathon's action, as an outsider of the corporation, is clearly unethical. The corporation itself does not appear to have violated any ethical codes. Jack, who inadvertently told his brother how to achieve the stock price manipulation, is probably guilty of poor judgment. However, it is difficult to say without more information whether Jack committed an ethical breach. And Jennifer, although young and naïve, might be held responsible under an ethical analysis based on her lack of research into the words and actions of Jonathon. Jennifer's reliance on the accuracy of Jonathon's dinner conversation hurt many shareholders.

In conclusion, effective managers should not only recognize their corporate responsibilities to shareholders and the larger market but also guard against outsiders who would use the corporation for stock gains through illegal or unethical means.

References and Recommended Readings

The Laws That Govern the Securities Industry (2003). U.S. Securities and Exchange Commission. http://www.sec.gov/about/whatwedo.shtml#laws. (12 Dec 2003).

The Changing Accounting Regulatory Landscape (2003). American Institute of Certified Public Accountants. http://www.aicpa.org/info/index.htm. (12 Dec 2003).