CHAPTER 3

Corporate Governance

Chapter Objectives

- To define corporate governance
- To describe the history and practice of corporate governance
- To examine key issues to consider in designing corporate governance systems
- To describe the application of corporate governance principles around the world
- To provide information on the future of corporate governance

Chapter Outline

Corporate Governance Defined

History of Corporate Governance

Corporate Governance and Social Responsibility

Issues in Corporate Governance Systems

Corporate Governance Around the World

Future of Corporate Governance

OPENING CASE

Fannie Mae and Freddie Mac: Poor Decisions Contributed to Crisis

Fannie Mae and Freddie Mac will go down in history as major players in the mortgage crisis. Fannie Mae is a stockholder-owned corporation created to purchase and securitize mortgages so funds are available to institutions that lend money to homebuyers. Freddie Mac buys and sells mortgages and resells them as mortgage-backed securities. This increases the money available for mortgage lending and home purchases. Both companies were encouraged by President Clinton and Congress to buy loans from banks that made higher-interest mortgage loans to low-income families (known as subprime loans). Yet with a lack of proper oversight, the companies mismanaged the situation and the government had to intervene during the 2008 mortgage crisis.

Before 2008, Fannie Mae and Freddie Mac guaranteed about half of the $12 trillion in the mortgage market. Yet with the economy in decline homeowners increasingly could not afford the mortgage payments on their houses. The shares of Fannie and Freddie plummeted as more houses were foreclosed on and fewer people were in the market to buy.

As early as 1999, the *New York Times* predicted that giving out subprime loans could cause trouble during an economic downturn, requiring government intervention. Yet the companies appeared to ignore these warnings. They donated large amounts to lawmakers sitting on committees that regulated their industry; and as late as 2007, the government passed new rules saying that Fannie Mae and Freddie Mac could buy $200 billion more in subprime loans. The prophetic warnings of critics came true during the next economic downturn, forcing the companies to regret their poor decisions.

However, Fannie Mae's situation went beyond bad decision making. The company was also under investigation for accounting errors. Civil charges had already been filed against Fannie Mae's CEO, CFO, and the former controller, who allegedly manipulated earnings to increase their bonuses.

Similarly, in 2003 Freddie Mac announced that it had underreported earnings by over $5 billion, which was the largest corporate restatement in financial history. Three years later, it was forced to pay $3.8 million after it was revealed the company had been making illegal campaign contributions between 2000 and 2003.

In 2008, James Lockhart of the Federal Housing Finance Agency (FHFA) announced that Fannie Mae and Freddie Mac would be put into a conservatorship of the FHFA, using funds from the U.S. Treasury, as part of the government efforts to stem the hemorrhaging in the mortgage industry. CEOs Daniel Mudd and Ryan Syron were investigated for allegedly lying to investors about earnings, portraying Fannie Mae and Freddie Mac as being more stable than they were. Bad decisions and managerial misconduct clearly contributed to these companies' downfall and to the financial crisis of 2008–2009.[1]

Business decisions today are increasingly placed under a microscope by stakeholders and the media, especially those made by high-level personnel in publicly held corporations. Stakeholders are demanding greater transparency in business, meaning that company motives and actions must be clear, open for discussion, and subject to scrutiny. Although some organizations have operated fairly independently in the past, recent scandals and the associated focus on the role of business in society have highlighted a need for systems that take into account the goals and expectations of various stakeholders. To respond to these pressures, businesses must effectively implement policies that provide strategic guidance on appropriate courses of action. This focus is part of corporate governance, the system of checks and balances that ensures that organizations are fulfilling the goals of social responsibility.

Governance procedures and policies are typically discussed in the context of publicly traded firms, especially as they relate to corporations' responsibilities to investors.[2] However, the trend is toward discussing governance within many industry sectors, including nonprofits, small businesses, and family-owned enterprises. We believe governance deserves broader consideration because there is evidence of a link between good governance and strong social responsibility. Corporate governance and accountability are key drivers of change for business in the twenty-first century. It is abundantly clear, to experts and nonexperts alike, that corporate governance is in need of immediate attention by a wide range of firms and stakeholders. The corporate scandals at firms such as AIG, Countrywide Financial, and Lehman Brothers represented a fundamental breakdown in basic principles of the capitalist system. Investors and other stakeholders must be able to trust management while boards of directors oversee managerial decisions.

Late 2008 and 2009 marked the beginning of a crisis of confidence in global business, particularly in the financial industry. Some of the nation's oldest and most respected financial institutions teetered on the brink of failure and were either bailed out or acquired by other firms. The 2008–2009 global recession was caused in part by a failure of the financial industry to take appropriate responsibility for its decision to utilize risky and complex financial instruments. Loopholes in regulation and the failures of regulators were exploited. Corporate cultures were built on rewards for taking risks rather than rewards for creating value for stakeholders. The governance systems at many of these companies did not take into account the risks or how to provide adequate oversight to prevent misconduct. In some cases, managers looked for loopholes in the laws or in unregulated areas such as derivatives. Ethical decisions were based more on what is legal rather than what was the right thing to do.

Unfortunately, most stakeholders, including the public, regulators, and the mass media, do not always understand the nature of the financial risks taken on by banks and other institutions to generate profits. The intangible nature of financial products makes it difficult to understand complex financial transactions. Problems in the subprime mortgage market, which deals with giving higher-rate mortgages to people who do not qualify for regular credit, sounded the alarm in the most recent economic downturn.

In this chapter, we define corporate governance and integrate the concept with the other elements of social responsibility. Then, we examine the corporate governance framework used in this book. Next, we trace the evolution of corporate governance and provide information on the status of corporate governance systems in several countries. We look at the history of corporate governance and the relationship of corporate governance to social responsibility. We also examine primary issues that should be considered in the development and improvement of corporate governance systems, including the roles of boards of directors, shareholders and investors, internal control and risk management, and executive compensation. Finally, we consider the future of corporate governance and indicate how strong governance is tied to corporate performance and economic growth. Our approach in this chapter is to demonstrate that corporate governance is a fundamental aspect of social responsibility.

CORPORATE GOVERNANCE DEFINED

In a general sense, the term *governance* relates to the exercise of oversight, control, and authority. For example, most institutions, governments, and businesses are organized so that oversight, control, and authority are clearly delineated. These organizations usually have an owner, president, chief executive officer (CEO), or board of directors that serves as the ultimate authority on decisions and actions. Nonprofit organizations, such as homeowners associations, have a president and board of directors to make decisions in the interest of a community of homeowners. A clear delineation of power and accountability helps stakeholders understand why and how the organization chooses and achieves its goals. This delineation also demonstrates who bears the ultimate risk for organizational decisions. Sarbanes-Oxley and the Federal Sentencing Guidelines put responsibility on top officers and the board of directors.

Although many companies have adopted decentralized decision making, empowerment, team projects, and less hierarchical structures, governance remains a required mechanism for ensuring continued growth, change, and accountability to regulatory authorities. Even if a company has adopted a consensus approach for its operations, there has to be authority for delegating tasks, making tough and controversial decisions, and balancing power throughout the organization. Governance also provides oversight to uncover and address mistakes, risks, and misconduct. Consider the failure of boards at Enron, AIG, and Tyco to address risks and provide internal controls to prevent misconduct.

We define **corporate governance** as the formal system of oversight, accountability, and control for organizational decisions and resources. Oversight relates to a system of checks and balances that limit employees' and managers' opportunities to deviate from policies and codes of conduct. Accountability relates to how well the content of workplace decisions is aligned with a firm's stated strategic direction. Control involves the process of auditing and improving organizational decisions and actions. The philosophy that is embraced by a board or firm regarding oversight, accountability, and control directly affects how corporate governance works.

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"The philosophy that is embraced by a board or firm regarding oversight, accountability, and control directly affects how corporate governance works."

Corporate Governance Framework

The majority of businesses and many courses taught in colleges of business operate under the belief that the purpose of business is to maximize profits for shareholders. In 1919, the Michigan Supreme Court in the case of *Dodge v. Ford Motor Co.*[3] ruled that a business exists for the profit of shareholders, and the board of directors should focus on that objective. On the other hand, the stakeholder model places the board of directors in the central position to balance the interests and conflicts of the various constituencies. External control of the corporation includes government regulation, but also includes key stakeholders such as employees, consumers, and communities, who exert pressures for responsible conduct. Many of the obligations to balance stakeholder interest have been institutionalized in legislation that provides incentives for responsible conduct. The Federal Sentencing Guidelines for Organizations (FSGO) provides incentives for developing an ethical culture and efforts to prevent misconduct. At the heart of the FSGO is the carrot-and-stick approach: By taking preventive action against misconduct, a company may avoid onerous penalties should a violation occur. Sarbanes-Oxley legislation holds top officers and the board of directors legally responsible for accurate financial reporting.

Today, the failure to balance stakeholder interests can result in a failure to maximize shareholders' wealth. General Motors and Chrysler failed to understand customer needs, employee reactions to downsizing, and government regulatory issues. This resulted in both companies failing to achieve shareholder goals. Most firms are moving more toward a balanced stakeholder model, as they see that this approach will sustain the relationships necessary for long-run success.

Both directors and officers of corporations are fiduciaries for the shareholders. Fiduciaries are persons placed in positions of trust who use due care and loyalty in acting on behalf of the best interests of the organization. There is a duty of care, also called a *duty of diligence*, to make informed and prudent decisions.[4] Directors have an obligation to avoid ethical misconduct in their role and to provide leadership in decisions to prevent ethical misconduct in the organization. Directors are not held responsible for negative outcomes if they are informed and diligent in their decision making. Ford's directors can be held responsible for the accuracy of financial reporting, however. Manufacturing cars that lose market share is a serious concern, although it is not a legal issue. This means directors have an obligation to request information and research, use accountants and attorneys, and obtain the services of consultants in matters where they need assistance or advice.

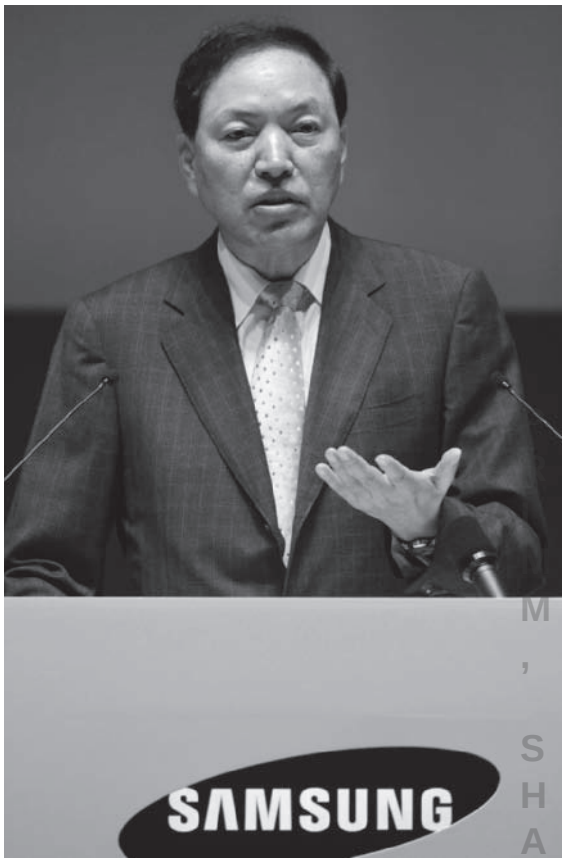
The duty of loyalty means that all decisions should be in the interests of the corporation and its stakeholders. Conflicts of interest exist when a director uses the position to obtain personal gain, usually at the expense of the organization. For example, before the Sarbanes-Oxley Act, directors could give themselves and officers interest-free loans. Scandals at Tyco, Kmart, and WorldCom were all associated with officers receiving personal loans that damaged the corporation. More recently, Texas financier Allen Stanford was also accused of using his banks to give himself over $1.6 million in personal loans.[5] Officer compensation packages challenge directors, especially those on the board and not independent. Directors have an opportunity to vote for others' compensation in return for their own increased compensation. Opportunities to know about the investments, business ventures, and stock market information create issues that could violate the duty of loyalty. Insider trading of a firm's stock is illegal and and violations can result in serious punishment. Former Countrywide Financial CEO Angelo Mozilo was accused of insider trading after emails came to light that showed that he was aware of the riskiness of subprime mortgages granted by his company, even as he was publicly extolling Countrywide's high standards.[6]

The ethical and legal obligations of directors and officers interface with their fiduciary relationships to the company. Ethical values should guide decisions and buffer the possibility of illegal conduct. With increased pressure on directors to provide oversight for organizational ethics, there is a trend toward director training to increase their competence in ethics program development as well as other areas, such as accounting.

Corporate governance establishes fundamental systems and processes for oversight, accountability, and control. This requires investigating, disciplining, and planning for recovery and continuous improvement. Effective corporate governance creates compliance and values so that employees feel that integrity is at the core of competitiveness.[7] Even if a company has adopted a consensus approach to decision making, there should be oversight and authority for delegating tasks, making difficult and sometimes controversial decisions, balancing power throughout the firm, and maintaining social responsibility. Governance also provides mechanisms for identifying risks and planning for recovery when mistakes or problems occur.

The development of stakeholder orientation should interface with the corporation's governance structure. Corporate governance is also part of a firm's corporate culture that establishes the integrity of all relationships. A governance system that does not provide checks and balances creates opportunities for top managers to put their own self-interests before those of important stakeholders. Luxury retailer Saks Inc. voted to hold annual board member elections, as opposed to every three years, and that directors must receive a majority of votes to win. The change is part of an effort to improve accountability at the company, which, along with many other retailers, suffered a serious decline in share prices over the course of 2008 and 2009.[8]

Concerns about the need for greater corporate governance are not limited to the United States. Reforms in governance structures and issues are occurring all over the world.[9] In many nations, companies are being pressured to implement



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Samsung Vice-Chairman and CEO maintains a commitment to corporate governance

stronger corporate governance mechanisms by international investors; by the process of becoming privatized after years of unaccountability as state companies; or by the desire to imitate successful governance movements in the United States, Japan, and the European Union.[10] As the business world becomes more global, standardization of governance becomes important in order for multinational and international companies to maintain standards and a level of control.

Table 3.1 lists examples of major corporate governance issues. These issues normally involve strategic-level decisions and actions taken by boards of directors, business owners, top executives, and other managers with high levels of authority and accountability. Although these people have often been relatively free from scrutiny, changes in technology, consumer activism, government attention, recent ethical scandals, and other factors have brought new attention to such issues as transparency, executive pay, risk and control, resource accountability, strategic direction, stockholder rights, and other decisions made for the organization.

Table 3.1 Corporate Governance Issues

Shareholder rights
Executive compensation
Composition and structure of the board of directors
Auditing and control
Risk management
CEO selection and termination decisions
Integrity of financial reporting
Stakeholder participation and input into decisions
Compliance with corporate governance reform
Role of the CEO in board decisions
Organizational ethics programs

HISTORY OF CORPORATE GOVERNANCE

"Reforms in governance structures and issues are occurring all over the world."

In the United States, a discussion of corporate governance draws on many parallels with the goals and values held by the U.S. Founding Fathers.[11] As we mentioned earlier in the chapter, governance involves a system of checks and balances, a concept associated with the distribution of power within the executive, judiciary, and legislative branches of the U.S. government. The U.S. Constitution and other documents have a strong focus on accountability, individual rights, and the representation of broad interests in decision making and resource allocation.

In the late 1800s and early 1900s, corporations were headed by such familiar names as Carnegie, DuPont, and Rockefeller. These "captains of industry" had ownership investment and managerial control over their businesses. Thus, there was less reason to talk about corporate governance because the owner of the firm was the same individual who made strategic decisions about the business. The owner primarily bore the consequences—positive or negative—of decisions. During the twentieth century, however, an increasing number of public companies and investors brought about a shift in the separation of ownership and control. By the 1930s, corporate ownership was dispersed across a large number of individuals. This raised new questions about control and accountability for organizational resources and decisions.

One of the first known anecdotes that helped shape our current understanding of accountability and control in business occurred in the 1930s. In 1932, Lewis Gilbert, a stockholder in New York's Consolidated Gas Company, found his questions repeatedly ignored at the firm's annual shareholders' meeting. Gilbert and his brother took the problem to the federal government and pushed for reform, which led the creation of the U.S. Securities and Exchange Commission (SEC), which requires corporations to allow shareholder resolutions to be brought to a vote of all stockholders. Because of the Gilbert brothers' activism, the SEC formalized the process by which executives and boards of directors respond to the concerns and questions of investors.[12]

Since the mid-1900s, the approach to corporate governance has involved a legal discussion of principals and agents to the business relationship. Essentially, owners are "principals" who hire "agents," the executives, to run the business. A key goal of businesses is to align the interests of principals and agents so that organizational value and viability are maintained. Achieving this balance has been difficult, as evidenced by these business terms coined by media—*junk bonds, empire building, golden parachute,* and *merger madness*—all of which have negative connotations. In these cases, the long-term value and competitive stance of organizations were traded for short-term financial gains or rewards. The results of this short-term view included workforce reduction, closed manufacturing plants, struggling communities, and a generally negative perception of

corporate leadership. In our philosophy of social responsibility, these long-term effects should be considered alongside decisions designed to generate short-run gains in financial performance.

The Sarbanes-Oxley Act provided the most significant piece of corporate governance reform since the 1930s. Under these rules, both CEOs and CFOs are required to certify that their quarterly and annual reports accurately reflect performance and comply with requirements of the SEC. Among other changes, the act also required more independence of boards of directors, protected whistle-blowers, and established a Public Company Accounting Oversight Board. The New York Stock Exchange (NYSE) and NASDAQ also overhauled the governance standards required for listed firms. Business ethics, director qualifications, unique concerns of foreign firms, loans to officers and directors, internal auditing, and many other issues were part of the NYSE and NASDAQ reforms.[13]

The 2008–2009 Financial Meltdown

The U.S. financial system collapsed in late 2008. The cause was pervasive use of instruments like credit default swaps, risky debt like subprime lending, and corruption in major corporations. The government was forced to step in and bail out many financial companies. Later on, because of the weak financial system and reduced consumption, the government also had to step in to help major automotive companies GM and Chrysler. The U.S. government is now a majority shareholder in GM, an unprecedented move. Not since the Great Depression and President Franklin Delano Roosevelt has the United States seen such widespread government intervention and regulation—something that most deem necessary, but is nevertheless worrisome to free market capitalists. The basic assumptions of capitalism are under debate as countries around the world work to stabilize markets and question those that have managed the money of individual corporations and nonprofits. The financial crisis caused many to question government institutions that provide oversight and regulation. As changes are made, there is a need to address issues related to law, ethics, and the required level of compliance necessary for government and business to serve the public interest.

Financial Crisis and Corporate Governance Reforms

In response to the financial crisis and recession, President Obama very quickly began to work on legislation that would reform corporate governance and provide additional oversight. The federal government has become a "reluctant shareholder" to a degree not seen since the 1930s in the likes of General Motors and AIG, among others, as the giant corportions seek to regain financial liquidity and competitiveness. Previously loosely regulated areas such as hedge funds and brokers are facing new laws that will constrain their behavior. For example, President Obama's regulatory policy requires brokers to put their clients' interests ahead of their own.[14] For firms that received government rescue funds under TARP, the government became a shareholder and helped to

select new members of the board of directors. AIG, for example, was one of the largest insurance companies in the world. It suffered a liquidity crisis and received over $180 billion from the government in exchange for stock warrants that gave 80-percent ownership to the U.S. Federal Reserve Bank. Most of the nation's top banks suddenly became partners with the federal government, and the government became involved in corporate governance. All firms that received TARP bailout money must pay back that money before they can return to full control of their firms.

The lack of effective control and accountability mechanisms prompted a strong interest in corporate governance. Beyond the legal issues associated with governance, there has also been interest in the board's role in social responsibility and stakeholder engagement. Table 3.2 provides *Fortune*'s assessment of the best and worst companies for social responsibility. The board of directors should provide leadership for social responsibility initiatives. The ten worst firms should examine their corporate governance, board of directors' leadership, and the cause of their low rating. It is apparent that some boards have been assuming greater responsibility for strategic decisions and have decided to focus on building more effective social responsibility, as indicated by the ten best companies in Table 3.2.

"The board of directors should provide leadership for social responsibility initiatives."

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CORPORATE GOVERNANCE AND SOCIAL RESPONSIBILITY

Corporate social responsibility can be a difficult concept to define. While there is broad agreement among professionals, academics, and policy makers that being socially responsible does pay, corporate social responsibility always involves trade-offs, and most businesses have yet to formulate an idea of what social responsibility really entails for their organization.[15] Interpreted narrowly, a company can consider itself socially responsible if it generates returns for shareholders and provides jobs for employees (called the *shareholder* model). A broad definition of social responsibility interprets the corporation as a vehicle for stakeholders and for public policy (called the *stakeholder* model). A company that takes the latter view would be more concerned with the public good as well as with profitability and shareholder return. Because most firms have so many potential stakeholders, a key to developing a socially responsible agenda involves determining which of these groups are most important for your business. Social responsibility should seek to help a firm's principle stakeholders. For example, a line of high-end organic soaps might seek to source its ingredients from sustainable sources, avoid products that have been tested on animals, and to hire workers at living wages.

To understand the role of corporate governance in business today, it is also important to consider how it relates to fundamental beliefs about the purpose of business organizations. Some people believe that as long as a company is maximizing shareholder wealth and profitability, it is fulfilling its core responsibility. Although this must be accomplished in accordance with legal and ethical standards, the primary focus is on the economic dimension of social responsibility. Thus, this belief places the philanthropic dimension beyond the scope of business. Other people, however, take the view that a business is an important member, or citizen, of society and must assume broad responsibilities. This view assumes that business performance is reflexive, meaning it both affects and is influenced by internal and external factors. In this case, performance is often considered from a financial, social, and ethical perspective. From these assumptions, we can derive two major conceptualizations of corporate governance: the shareholder model and the stakeholder model.

shareholder model of corporate governance model that bases management decisions toward what is in the best interests of investors; founded in classic economic precepts, including the maximization of wealth for investors and owners

The **shareholder model of corporate governance** is founded in classic economic precepts, including the maximization of wealth for investors and owners. For publicly traded firms, corporate governance focuses on developing and improving the formal system of performance accountability between top management and the firms' shareholders.[16] Thus, the shareholder orientation should drive management decisions toward what is in the best interests of investors. Underlying these decisions is a classic agency problem, where ownership (i.e., investors) and control (i.e., managers) are separate. Managers act as agents for investors and their primary goal is to generate value for shareholders. However, investors and managers are distinct parties with unique insights, goals, and values with respect to the business. Managers, for example, may have motivations beyond shareholder value, such as market share, personal compensation, or attachment to particular products and projects. Because of these potential differences, corporate

governance mechanisms are needed to ensure an alignment between investor and management interests.

For example, a former Qwest Communications International Inc. chief financial officer, Robin Szeliga, pleaded guilty to one count of insider trading. She was accused of improperly selling 10,000 shares of Qwest stock, earning a net profit of $125,000, when she knew that some business units would fail to meet revenue targets. Szeliga, former CEO Joseph Nacchio, and five other former executives were accused of orchestrating a financial fraud that forced Qwest Communications to restate billions of dollars in revenue. The SEC sought repayment and civil penalties from all of the accused.[17] After being convicted of nineteen counts of insider trading, Joseph Nacchio was finally ordered to prison to serve a six-year sentence. Szeliga pleaded guilty to one count of insider trading and testified against Nacchio in exchange for a sentence of six months' home detention, two years' probation, and a $250,000 fine.[18] Because of these potential differences, corporate governance mechanisms are needed to align investor and management interests. The shareholder model has been criticized for its somewhat singular purpose and focus because there are other ways of "investing" in a business. Suppliers, creditors, customers, employees, business partners, the community, and others also invest their resources in the success of the firm.

In the **stakeholder model of corporate governance**, the purpose of business is conceived in a broader fashion. Although a company has a responsibility for economic success and viability, it must also answer to other parties, including employees, suppliers, government agencies, communities, and groups with which it interacts. This model presumes a collaborative and relational approach to business and its constituents. Because management time and resources are limited, a key decision within the stakeholder model is to determine which stakeholders are primary. Once primary groups have been identified, appropriate corporate governance mechanisms are implemented to promote the development of long-term relationships.[19] As we discussed in Chapter 2, primary stakeholders include stockholders, suppliers, customers, employees, the government, and the community. Governance systems that consider stakeholder welfare in tandem with corporate needs and interests characterize this approach. After years of bad publicity regarding environmental damage and its poor treatment of workers, Wal-Mart appears to have realized the importance of corporate social responsibility to a company's bottom line. Over 92 percent of Wal-Mart associates now have health insurance, and Wal-Mart has been working hard to improve diversity as well. In 2008 alone, Wal-Mart received thirty-seven separate awards and distinctions for its diversity efforts. The company has taken strides toward being more sustainable as well—by doing everything from introducing low-emissions vehicles to its shipping fleet and installing solar panels on store rooftops. Wal-Mart has even stated a goal to be zero-waste.[20]

stakeholder model of corporate governance model that sees management as having a responsibility to its stakeholders in addition to its responsibility for economic success; based on a collaborative and relational approach to business and its constituents

Although these two approaches seem to represent ends of a continuum, the reality is that the shareholder model is often a precursor to the stakeholder model. Many businesses have evolved into the stakeholder model as a result of government initiatives, consumer activism, industry activity, and other external forces. In the aftermath of corporate scandals it became clear how the economic accountability of corporations could not be detached from other responsibilities and stakeholder concerns. Although this trend began with large, publicly held firms,

"Many businesses have evolved into the stakeholder model as a result of government initiatives, consumer activism, industry activity, and other external forces."

WalMart addresses concerns over the cost and availability of health care by offering basic health services at select stores

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its aftereffects are being felt in many types of organizations and industries. Public hospitals, for example, have experienced a transition to the more holistic approach to corporate governance. Although public hospitals serve as a "safety net" for local governments' ability to provide health care, some experts object to the influence of government officials on these hospitals' boards of directors and operations. A new model of governance has emerged that calls for fewer government controls, more management autonomy and accountability, formal CEO and board evaluation systems, and more effective community involvement.[21]

The shareholder model focuses on a primary stakeholder—the investor—whereas the stakeholder model incorporates a broader philosophy toward internal and external constituents. According to the World Bank, a development institution whose goal is to reduce poverty by promoting sustainable economic growth around the world, corporate governance is defined by both internal (i.e., long-term value and efficient operations) and external (i.e., public policy and economic development) factors.[22] We are concerned with the broader conceptualization of corporate governance in this chapter.

In the social responsibility model that we propose, governance is the organizing dimension for keeping a firm focused on continuous improvement, accountability, and engagement with stakeholders. Although financial return, or economic viability, is an important measure of success for all firms, the legal dimension of social responsibility is also a compulsory consideration. The ethical and philanthropic dimensions, however, have not been traditionally mandated through regulation or contracts. This represents a critical divide in our social responsibility model and associated governance goals and systems because there are some critics who challenge the use of

EARTH IN THE BALANCE

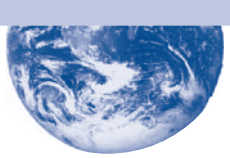
Bank of America Stakeholders Support Sustainability

Along with many other U.S. banks, Bank of America faced a difficult financial situation in 2008–2009. In the midst of a global banking crisis, BofA was faced with the choice of either possible failing or of accepting a $20 billion government rescue—the bank chose the latter option. Because of the bank's poor performance and highly controversial acquisitions of the failing financial institutions Merrill Lynch and Countrywide Financial, shareholders were concerned about the quality of decision making at BofA. A scandal had also emerged regarding $3.6 billion in bonuses paid to Merrill executives after the bank had failed and had been acquired by BofA. Many viewed it as wrong that executives of a failing bank would be rewarded, and approved a proposal to split the positions of chair of the board and CEO. They also called for an overhaul of the board by replacing six directors.

However, all of the negative press obscured the environmentally friendly choices the bank has made. BofA has long focused on energy efficiency, reducing emissions, and limiting waste, in addition to addressing concerns over its financial performance, a stance shareholders support, even in the wake of its financial meltdown-related troubles. The company offers customers eco-friendly products and services such as the Brighter Planet™ Visa® and online banking to reduce paper waste. BofA is active in communities promoting energy efficiency and environmental responsibility. The company committed $20 billion over ten years to aid businesses addressing global climate change, to create loans for companies developing renewable energy, and to create new jobs. BofA won California's 2008 Governor's Environmental and Economic Leadership Award (GEELA) for its focus on melding environmental stewardship with long-term company management. BofA won this award because of its involvement in solar school initiatives, the creation of Clean Renewable Energy Bonds, and the preservation of redwood forests.

Although BofA admits that its focus on protecting the environment is for profit and economic growth, it also acknowledges it is the responsible stance to take. BofA intends to maintain its sustainability efforts no matter what the economic climate. In fact, BofA has performed so well that Citigroup even told its clients to invest in BofA stock, as it is the strongest performing bank.[24]

NASA



organizational resources for concerns beyond financial performance and legalities. This view was summarized in an editorial in *National Journal*, a nonpartisan magazine on politics and government: "Corporations are not governments. In the everyday course of their business, they are not accountable to society or to the citizenry at large. . . . Corporations are bound by the law, and by the rules of what you might call ordinary decency. Beyond this, however, they have no duty to pursue the collective goals of society."[23] This type of philosophy, long associated with the shareholder model of corporate governance, prevailed throughout the twentieth century. However, as the consequences of neglecting the stakeholder model of corporate social responsibility have become clearer, fewer parties adhere to such a narrow view anymore.

ISSUES IN CORPORATE GOVERNANCE SYSTEMS

Organizations that strive to develop effective corporate governance systems consider a number of internal and external issues. In this section, we look at four areas that need to be addressed in the design and improvement of governance mechanisms. We begin with boards of directors, which have the ultimate responsibility for ensuring a governance focus. Then, we discuss the role of shareholders and investors, internal control and risk management, and executive compensation within the governance system. These issues affect most organizations, although individual businesses may face unique factors that create additional governance questions. For example, a company operating in several countries will need to resolve issues related to international governance policy.

Boards of Directors

Members of a company's board of directors assume responsibility for the firm's resources and legal and ethical compliance. The board appoints top executive officers and is responsible for providing oversight of their performance. This is also true of a university's board of trustees, and there are similar arrangements in the nonprofit sector. In each of these cases, board members have a fiduciary duty, which was discussed earlier in this chapter. These responsibilities include acting in the best interests of those they serve. Thus, board membership is not designed as a vehicle for personal financial gain; rather, it provides the intangible benefit of ensuring the success of the organization and the stakeholders affected and involved in the fiduciary arrangement.

For public corporations, boards of directors hold the ultimate responsibility for their firms' ethical culture and legal compliance. This governing authority is held responsible by the 2004 and 2007 amendments to the Federal Sentencing Guidelines for creating an ethical culture that provides leadership, values, and compliance. The members of a company's board of directors assume legal responsibility for the firm's resources and decisions, and they appoint its top executive officers. In an effort to revamp the company after the 2008–2009 financial crisis, Citigroup appointed new directors to its board. This overhauled board now includes financial experts from government, the banking industry, and academia—all in an effort to increase transparency and accountability.[25]

The traditional approach to directorship assumed that board members managed the corporation's business. Research and practical observation have shown that boards of directors rarely, if ever, perform the management function.[26] Because boards meet usually four to six times a year, there is no way that time allocation would allow for effective management. In small nonprofit organizations, the board may manage most resources and decisions. The complexity of large organizations requires full attention on a daily basis. Today, boards of directors are concerned primarily with monitoring the decisions made by managers on behalf of the company. This includes choosing top executives, assessing their performance, helping to set strategic direction, evaluating company performance, developing CEO succession plans, communicating with stakeholders, maintaining legal and ethical practices, ensuring that control and accountability

mechanisms are in place, and evaluating the board's own performance. In sum, board members assume the ultimate authority for organizational effectiveness and subsequent performance.

Independence Just as social responsibility objectives require more of employees and executives, boards of directors are also experiencing increasing accountability and disclosure mandates. The desire for independence is one reason that a few firms have chosen to split the powerful roles of chair of the board and CEO. Although the practice is common in the United Kingdom and activists have called for this move for years, the idea is newer to U.S. and Canadian firms. Chubb Corporation, Midas, Pathmark Stores, Toronto Dominion Bank, and Closure Medical are companies that have made the transition. In addition to independence concerns, it is unlikely that one person can devote the time and energy it takes to be effective in both roles. The National Association of Corporate Directors is in favor of splitting the roles, whereas other experts suggest that a "presiding" chair take over most of the chair's and CEO's duties with respect to the board. Finally, opponents believe the new rules and practices emerging from governance reform may negate the role-split debate by improving other aspects of the board's membership and impact.[27]

Traditionally, board members were retired company executives or friends of current executives, but the trend since the corporate scandals associated with Enron, WorldCom, and more recently Countrywide Financial and AIG has been toward "outside directors," who have valuable expertise yet little vested interest in the firm before assuming the director role. Thus, directors today are more likely chosen for their competence, motivation, and ability to bring enlightened and diverse perspectives to strategic discussions. Outside directors are thought to bring more independence to the monitoring function because they are not bound by past allegiances, friendships, a current role in the company, or some other matter that may create a conflict of interest. However, independent directors who sit on a board for a long time may eventually lose some of the outsider perspective. While they are more likely to be impartial, independent directors are not always guaranteed to avoid conflict of interest issues. For example, the Indian IT business Satyam Computer Services has independent directors on its board. The chair of Satyam, Ramalinga Raju, admitted to committing massive financial fraud and inflating earnings and assets by billions of dollars for years. Although independent directors served on the board, they are also under investigation for being complicit in the crime.[28] Directors have to avoid "group think" and be competent enough to understand risks. They must also be willing to ask for information relevant to avoiding organizational misconduct.

Quality Finding board members who have some expertise in the firm's industry or who have served as chief executives at similar-sized organizations is a good strategy for improving the board's overall quality. Directors with competence and experiences that reflect some of the firm's core issues should bring valuable insights to bear on discussions and decisions. Directors without direct industry or comparable executive experience may bring expertise on important issues, such

as auditing, executive compensation, succession planning, and risk management, to improve decision making.

Board members must understand the company's strategy and operations; this suggests that members should limit the number of boards on which they serve. Directors need time to read reports, attend board and committee meetings, and participate in continuing education that promotes strong understanding and quality guidance. For example, directors on the board's audit committee may need to be educated on new accounting and auditing standards. Experts recommend that fully employed board members sit on no more than four boards, whereas retired members should limit their memberships to seven boards. Directors should be able to attend at least 75 percent of the meetings. Thus, many of the factors that promote board quality are within the control of directors.[29]

Performance An effective board of directors can serve as a type of insurance against the business cycle and the natural highs and lows of the economy. A company with a strong board free from conflicts of interest and with clearly stated corporate governance rules will be more likely to weather a storm if something bad does happen.[30] As federal regulations increase and the latitude afforded boards of directors shrinks, boards are going to be faced with greater responsibility and transparency.

Board independence, along with board quality, stock ownership, and corporate performance, is often used to assess the quality of corporate boards of directors. Many CEOs have lost their jobs because the board of directors is concerned about performance, ethics, and social responsibility. The main reason for this is the boards' fear of losing their personal assets. This fear comes from lawsuits by shareholders who sued the directors of financial firms over their roles in the collapse on Wall Street. Both settlements called for the directors to pay large sums from their own pockets.[31] These events make it clear that board members are accountable for oversight.

Just as improved ethical decision making requires more of employees and executives, so too are boards of directors feeling greater demands for ethics and transparency. Directors today are increasingly chosen for their expertise, competence, and ability to bring diverse perspectives to strategic discussions. Outside directors are also thought to bring more independence to the monitoring function because they are not bound by past allegiances, friendships, a current role in the company, or some other issue that may create a conflict of interest. The chair of the board audit committee must be an outside independent director with financial expertise.

Many of the corporate scandals uncovered in recent years might have been prevented if each of the companies' boards of directors had been better qualified, more knowledgeable, and less biased. The U.S. Treasury Secretary, Timothy Geithner, is trying to change how the government goes about overseeing risk-taking in financial markets. He is pushing for stricter rules on financial management and controls on hedge funds and money-market mutual funds. He believes that the United States needs greater openness and transparency, greater oversight and enforcement, as well as clearer, more commonsense language in the financial

system.[32] Board members are being asked to understand changes in regulations and participate in providing better oversight on risk-taking in their firms.

Rules promulgated by the Sarbanes-Oxley Act and various stock exchanges now require a majority of independent directors on the board; regular meetings between nonmanagement board members; audit, compensation, governance, and nominating committees either fully made up of or with a majority of independent directors; and a financial expert on the audit committee. The governance area will continue to evolve as corporate scandals are resolved and the government and companies begin to implement and test new policies and practices. Regardless of the size and type of business for which boards are responsible, a system of governance is needed to ensure effective control and accountability. As a corporation grows, matures, enters international markets, and takes other strategic directions, it is likely that the board of directors will evolve to meet its new demands. Sir Adrian Cadbury, former president of the Centre for Board Effectiveness at the Henley Business School in Reading, England, and an architect of corporate governance changes around the world, has outlined responsibilities of strong boards:

- Boards are responsible for developing company purpose statements that cover a range of aims and stakeholder concerns.
- Annual reports and other documents need to include more nonfinancial information.
- Boards are required to define their role and implement self-assessment processes better.
- Selection of board members will become increasingly formalized, with less emphasis on personal networks and word of mouth.
- Boards need to work effectively as teams.
- Serving on boards will require more time and commitment than in the past.[33]

"Regardless of the size and type of business for which boards are responsible, a system of governance is needed to ensure effective control and accountability."

These trends are consistent with our previous discussion of social responsibility. In all facets of organizational life, greater demands are being placed on business decisions and people. Many of these expectations emanate from those who provide substantial resources in the organization—namely, shareholders and other investors.

Shareholders and Investors

Because they have allocated scarce resources to the organization, shareholders and investors expect to grow and reap rewards from their investments. This type of financial exchange represents a formal contractual arrangement and provides

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WalMart announces plans to buy back $15 billion in stock at their annual shareholders meeting in Bentonville, Arkansas

the capital necessary to fund all types of organizational initiatives, such as new product development and facilities construction. A shareholder is concerned with his or her ownership investment in publicly traded firms, whereas *investor* is a more general term for any individual or organization that provides capital to a firm. Investments include financial, human, and intellectual capital.

Shareholder Activism Shareholders, including large institutional ones, have become more active in articulating their positions with respect to company strategy and executive decision making. *Activism* is a broad term that can encompass engaging in dialog with management, attending annual meetings, submitting shareholder resolutions, bringing lawsuits, and other mechanisms designed to communicate shareholder interests to the corporation. Table 3.3 lists characteristics of effective shareholder activism campaigns.

Shareholder resolutions are nonbinding, yet important, statements about shareholder concerns. A shareholder that meets certain guidelines may bring one resolution per year to a proxy vote of all shareholders at a corporation's annual meeting. Recent resolutions brought forward relate to auditor independence, executive compensation, independent directors, environmental impact, human rights, and other social responsibility issues. In some cases, the company will modify its policies or practices before the resolution is ever brought to a vote. In other situations, a resolution will receive less than a majority vote, but the media attention, educational value, and other stakeholder effects will cause a firm to reconsider, if not change, its original position to meet the resolution's proposal. The accounting scandals prompted many resolutions about executive compensation among shareholders who believe that improper compensation structures are often a precursor

Table 3.3 Characteristics of a Successful Shareholder Activism Campaign

Alliances with social movements or public interest groups, where shareholder concerns and activity mesh with and play a part in a larger, multifaceted campaign
Grass-roots pressure, such as letter writings or phone-ins to public investors to generate support for the resolution
Communications: media outreach, public and shareholder education, etc.
High-level negotiations with senior decision makers
Support and active involvement from large institutional investors
A climate that makes it difficult for the company not to make the "right decision." For example, if you have a plainly compelling financial argument, you have a better chance of getting company management and other shareholders on board with your proposal.
Persistence. Shareholders don't go away. They own the company and have a right to be heard. Often shareholder activists stick with issues for years.

Source: "Characteristics of a Successful Shareholder Activism Campaign," Friends of the Earth, http://www.foe.org/international/shareholder/characteristics.html, accessed April 25, 2006. Courtesy Friends of the Earth © 2006.

to accounting mismanagement.[34] The resolution process is regulated by the SEC in the United States and by complementary offices in other countries; some claim this is more favorable to the corporation than to shareholders.

Although labor and public pension fund activities have waged hundreds of proxy battles in recent years, they rarely have much effect on the target companies. Now shareholder activists are attacking the process by which directors themselves are elected. After poor performance during the 2008 financial crisis on Wall Street, Bank of America shareholders voted to oust six board members. The move got rid of entrenched directors with possible conflicts of interest and replaced them with qualified financial experts.[35] Although shareholders and investors want their resources used efficiently and effectively, they are increasingly willing to take a stand to encourage companies to change for reasons beyond financial return.

Social Investing Many investors assume the stakeholder model of corporate governance, which carries into a strategy of social investing, "the integration of social and ethical criteria into the investment decision-making process."[36] Roughly three-quarters of U.S. investors take social responsibility issues into account when choosing investment opportunities. Twelve percent indicate they are willing to take a lower rate of return if the company is a strong performer in the social responsibility area.[37] Most social investors do not have to worry about a poor return on their investments. Socially conscious firms are strong performers for many of the reasons we discussed in Chapter 1. There remains a large gap between the recognition that social responsibility is important and the actual implementation of social responsibility programs in firms. While nearly three-quarters of top executives identify corporate social responsibility as something that must be a business priority, only 39 percent include social responsibility in their business planning, and an even smaller number (29 percent) have written CSR policies in place.[38]

"There remains a large gap between the recognition that social responsibility is important and the actual implementation of social responsibility programs in firms."

While social investing has traditionally been conducted through managed mutual funds, like those with Domini Social Investments, TIAA-CREF, Vanguard, and Calvert Group, some individual investors are using Web-based research to venture on their own. Websites such as FOLIOfn, SocialFunds.com, Morningstar, Inc., and others provide information and services to help the socially conscious investor in decision making.[39] Thus, there are a number of opportunities for individuals to demonstrate an active strategy with respect to investing and social responsibility. Whereas a passive investor is mainly concerned with buying and selling stock and receiving dividends, social investors are taking a variety of stakeholder issues into account when making investment decisions. A social investor takes the social responsibility of "ownership" seriously because a firm in which he or she invests implements plans and strategies on behalf of its owners. It could be argued that the dishonest actions of a firm were carried out on behalf of shareholders; thus, an investor in the firm would also be responsible. Conversely, it could be argued that a firm implementing a strong social responsibility strategy and agenda is doing so on behalf of its owners.[40] Shareholder activism is the strategy for ensuring that owners' perspectives on social responsibility are included on the corporate agenda.

Although social investing has received strong media attention over the last few years, the idea has a long history. For example, the Quakers, a religious group, applied social investment criteria in the seventeenth century when they refused to invest in, patronize, or partner with any business involved in the slave trade or military concerns.[41] Investors today use similar screening criteria in determining where to place their funds and resources. On the whole, investments tied to environmental causes and to community advocacy have grown rapidly in the 2000s. Many people, for example, now look at the types of investments included in mutual funds when deciding where to put their money; and institutional investors and money managers are including criteria (e.g., related to the crisis in Darfur) into their portfolio management as a way to signal an interest in humanitarian causes, and therefore the greater good.[42] Despite its subjective nature, professionally managed social investments total more than $2.71 trillion in the United States—an increase of 324 percent since 1995.[43] This means that about 11 percent of all money under professional investment in the United States is used for socially responsible investing. Not only do these social investments help individuals and institutions meet their social responsibility goals, but they also provide strong financial returns.

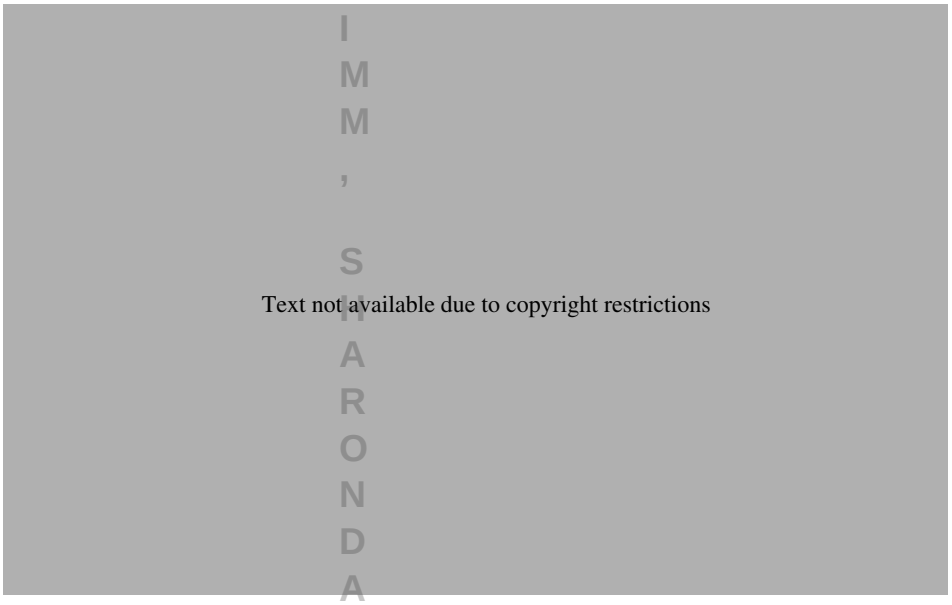
Shareholder activism and social investing are especially prevalent in the United States and United Kingdom, two countries that score relatively high on various corporate governance indexes. Several other European countries are also experiencing increasing rates of activism and social investing. Most activism and investing take place on an organizational level through mutual funds and other institutional arrangements, but some individual investors have affected company strategy and policy. Robert Monks, a leading corporate governance activist, once described Warren Buffett, the legendary investor from Omaha, Nebraska, as "epitomizing the kind of monitoring shareholder whose involvement enhances the value of the whole enterprise." Warren Buffett and his company Berkshire Hathaway command significant respect from investors because of their track record of financial returns and the integrity of their organizations. Buffett says, "I want employees to ask themselves whether they are willing to have any contemplated act appear the next day on the front page of their local paper—to be read by their spouses, children and friends—with the reporting done by an informed and critical reporter." The high level of accountability and trust Buffett places in his employees translates into investor trust and confidence.[44] Although few investors have Buffett's financial clout and respect, he serves as a role model by paying attention to the control and accountability mechanisms of the companies in which he invests.

Investor Confidence Shareholders and other investors must have assurance that their money is being placed in the care of capable and trustworthy organizations. These primary stakeholders are expecting a solid return for their investment, but as illustrated earlier, they have additional concerns about social responsibility. When these fundamental expectations are not met, the confidence that investors and shareholders have in corporations, market analysts, investment houses, stockbrokers, mutual fund managers, financial planners, and other economic players and institutions can be severely tested. In Chapter 1, we discussed the importance of investor trust and loyalty to organizational and societal performance. Part of this trust relates to the perceived efficacy of corporate governance. Figures 3.1 and 3.2 demonstrate the extent to which strong governance is now considered an investment criterion and reason for a premium price.

Bankruptcies and financial misconduct in the early 2000s shook investor confidence. The same thing happened during the subprime mortgage crisis, Wall Street financial sector crash, and recession of 2008–2009. People felt that they could no longer trust large financial firms and banks, which added to the financial tailspin. CEOs, whom many stakeholders felt should be blamed for their firms' losses, were accused of misconduct. People such as Bernard Madoff, who ran the world's largest Ponzi scheme, were given harsh jail sentences. Madoff was sentenced to 150 years for his crimes. Nevertheless, people's retirement and investment accounts dwindled. The federal government took quick action to stop the fiscal hemorrhaging, pumping nearly $1 trillion into the nation's banks. The collapses in the United States were echoed in other markets around the world. People around the world began to question their nations' regulatory systems and whether businesses truly had their stakeholders' best interests in mind. Essentially, stakeholders were calling for boards of directors and others with access to financial records and the power to demand accountability to tighten the control and risk environment in companies today

Figure 3.1 Corporate Governance Challenges Related to the Global Financial Crisis

- Improve public confidence and trust in the financial soundness of the organization
- Communicate the complexity of financial products and the risk to the organization and consumers
- Develop a position on financial regulation to protect all participants in the financial system
- Develop improved transparency in financial decisions for all stakeholders
- Demonstrate participation of shareholders in all corporate governance discussions
- Maintain ethics and compliance oversight to address key areas of risk



Internal Control and Risk Management

Controls and a strong risk management system are fundamental to effective operations, as they allow for comparisons between the actual performance and the planned performance and goals of the organization. Controls are used to safeguard corporate assets and resources, protect the reliability of organizational information, and ensure compliance with regulations, laws, and contracts. Risk management is the process used to anticipate and shield the organization from unnecessary or overwhelming circumstances, while ensuring that executive leadership is taking the appropriate steps to move the organization and its strategy forward.

Internal and External Audits Auditing, both internal and external, is the linchpin between risk and controls and corporate governance. Boards of directors must ensure that the internal auditing function of the company is provided with adequate funding, up-to-date technology, unrestricted access, independence, and authority to carry out its audit plan. To ensure these characteristics, the internal audit executive should report to the board's audit committee and, in most cases, the chief executive officer.45

The external auditor should be chosen by the board and must clearly identify its client as the board, not the company's chief financial officer. Under Sarbanes-Oxley, the board audit committee should be directly responsible for the selection, payment, and supervision of the company's external auditor. The act also prohibits an external auditing firm from performing some non-audit work for the same public company, including bookkeeping, human resources, actuarial services, valuation services, legal services, and investment banking. However, even with regulations in place many auditors failed to properly do their jobs in years leading up to the 2008–2009 recession. For example, trustees of New Century Financial Corporation sued its auditor, KPMG, for "reckless and grossly negligent audits" that hid the company's financial problems and sped its collapse. New Century was one of the early casualties of the subprime mortgage crisis, but was once one of the country's largest mortgage lenders to those with poor credit histories. After it disclosed accounting errors not discovered by KPMG, the company collapsed.[46] Part of the problem relates to the sheer size and complexity of organizations, but these factors do not negate the tremendous responsibility that external auditors assume.

Control Systems The area of internal control covers a wide range of company decisions and actions, not just the accuracy of financial statements and accounting records. Controls also foster understanding when discrepancies exist between corporate expectations and stakeholder interests and issues. Internal controls effectively limit employee or management opportunism or the use of corporate assets for individualistic or nonstrategic purposes. Controls also ensure the board of directors has access to timely and quality information that can be used to determine strategic options and effectiveness. For these reasons, the board of directors should have ultimate oversight for the integrity of the internal control system.47 Although board members do not develop or administer the control system, they are responsible for ensuring that an effective system exists. The need for internal controls is rarely disputed, but implementation can vary. As Figure 3.3 shows, the CEO or chair appears to be the key decision maker relating to public and political debates that have an impact on shareholder value. Thus, internal control represents a set of tasks and resource commitments that require high-level attention.

Although most large corporations have designed internal controls, smaller companies and nonprofit organizations are less likely to have invested in a complete system. For example, a small computer shop in Columbus, Ohio, lost thousands of dollars due to embezzlement by the accounts receivable clerk. Because of the clerk's position and role in the company, she was able to post

Figure 3.3 Leadership is the Key to Shareholder Value: Who takes the lead in large companies when managing sociopolitical issues?

Chief Executive Officer or Chair	56%
Public or Corporate Affairs Department	14%
Other Executive Members of the Board	10%
Core Business Divisions	5%
Department of Corporate Social Responsibility	5%
Human Relations Department	2%
Strategy Department	1%

Source: The McKinsey Global Survey of Business Executives: Business and Society. *The McKinsey Quarterly,* The Online Journal of McKinsey & Co., January 2006.

credit card payments due her employer to her own account and later withdraw the income. Although she faced felony theft charges, her previous employer admitted feeling ashamed and did not want his business associated with a story on employee theft.[48] Such crime is common in small businesses because they often lack effective internal controls. Simple, yet proven, control mechanisms that can be used in all types of organizations are listed in Table 3.4. These techniques are not always costly, and they conform to best practices in the prevention of ethical and legal problems that threaten the efficacy of governance mechanisms.

The 2004 and 2007 amendments to the Federal Sentencing Guidelines for Organizations make it clear that a corporation's governing authority must be well informed about its control systems with respect to implementation and effectiveness. This places the responsibility squarely on the shoulders of the firm's leadership, usually the board of directors. The board must ensure that there is a high-ranking officer accountable for the day-to-day operational responsibility of the control systems. The board must also provide for adequate authority, resources, and access to the board or an appropriate subcommittee of the board. The guidelines further call for confidential mechanisms whereby the organization's employees and agents may report or seek guidance about potential or actual misconduct without fear of retaliation. Finally, the board is required to oversee the discovery of risks and to design, implement, and modify approaches to deal with those risks. Thus, the board of directors is clearly accountable for discovering risks associated with a firm's specific industry and assessing the firm's ethics program to ensure that it is capable of uncovering misconduct.[49]

Risk Management A strong internal control system should alert decision makers to possible problems, or risks, that may threaten business operations, including worker safety, company solvency, vendor relationships, proprietary

Table 3.4 Internal Control Mechanisms for Small Businesses and Nonprofits

Develop and disseminate a code of conduct that explicitly addresses ethical and legal issues in the workplace.
Rotate and segregate job functions to reduce the opportunity for opportunism (e.g., the person reconciling bank statements does not make deposits or pay invoices).
Screen employment applicants thoroughly, especially those who would assume much responsibility if hired.
Watch new employees especially carefully until they have gained knowledge and your trust.
Require all employees to take at least one week of vacation on an annual basis.
Limit access to valuable inventory and financial records. Use technology to track inventory, costs, human resources, finances, and other valuable business processes.
Implement unannounced inspections, spot checks, or "tests" of departments, systems, and outcomes.
Keep keys and pass codes secure and limit their duplication and distribution.
Insist that operating statements are produced on at least a monthly basis.
Ask questions about confusing financial statements and other records.

Sources: *Curtailing Crime: Inside and Out,* Crime Prevention Series, U.S. Small Business Administration, http://www.sba.gov/library/pubs/cp-2.doc, accessed May 9, 2006; "Protecting Against Employee Fraud," *Business First–Western New York,* June 14, 1999, p. 31; Kathy Hoke, "Eyes Wide Open," *Business First–Columbus,* August 27, 1999, pp. 27–28.

information, environmental impact, and other concerns. As we discussed in Chapter 2, having a strong crisis management plan is part of the process for managing risk. The term *risk management* is normally used in a narrow sense to indicate responsibilities associated with insurance, liability, financial decisions, and related issues. Kraft General Foods, for example, has a risk management policy for understanding how prices of commodities, such as coffee, sugar, wheat, and cocoa, will affect its relationships throughout the supply chain.[50]

Most corporate leaders' greatest fear is discovering serious misconduct or illegal activity somewhere in their organization. The fear is that a public discovery can immediately be used by critics in the mass media, competitors, and skeptical stakeholders to undermine a firm's reputation. Corporate leaders worry that something will be uncovered outside their control that will jeopardize their careers and their organizations. Fear is a paralyzing emotion. Of course, maybe even executives like Bernie Madoff, Alan Stanford,

"The board of directors is clearly accountable for discovering risks associated with a firm's specific industry and assessing the firm's ethics program to ensure that it is capable of uncovering misconduct."

and Angelo Mozilo experienced fear as they participated in misconduct. The former chair of Satyam Computer Services, Ramalinga Raju, said it was a terrifying experience to watch a small act of fudging some numbers snowball out of control. He compared knowingly engaging in misconduct for years to "riding a tiger, not knowing how to get off without being eaten."[51] These leaders were the captains of their respective ships, and they made a conscious decision to steer their firms into treacherous waters with a high probability of striking an iceberg.[52]

Corporate leaders do fear the possibility of reputation harm, financial loss, or a regulatory event that could potentially end their careers and even threaten their personal lives through fines or prison sentences. Indeed, the whole concept of risk management involves recognizing the possibility of a misfortune that could jeopardize or even destroy the corporation.[53] Organizations face significant risks and threats from financial misconduct. There is a need to identify potential risks that relate to misconduct that could devastate the organization. If risks and misconduct are discovered and disclosed, they are more likely to be resolved before they become front-page news.

Risk is always present within organizations, so executives must develop processes for remedying or managing its effects. A board of directors will expect the top management team to have risk management skills and plans in place. There are at least three ways to consider how risk poses either a potentially negative or positive concern for organizations.[54] First, risk can be categorized as a hazard. In this view, risk management is focused on minimizing negative situations, such as fraud, injury, or financial loss. Second, risk may be considered an uncertainty that needs to be hedged through quantitative plans and models. This type of risk is best associated with the term *risk management,* which is used in financial and business literature. Third, risk also creates the opportunity for innovation and entrepreneurship. Just as management can be criticized for taking too much risk, it can also be subject to concerns about not taking enough risk. All three types of risk are implicitly covered by our definition of corporate governance because there are risks for both control (i.e., preventing fraud and ensuring accuracy of financial statements) and accountability (i.e., innovation to develop new products and markets). For example, the Internet and electronic commerce capabilities have introduced new risks of all types for organizations. Privacy, as we discuss in Chapter 10, is a major concern for many stakeholders and has created the need for policies and certification procedures. A board of directors may ensure that the company has established privacy policies that are not only effective but also can be properly monitored and improved as new technology risks and opportunities emerge in the business environment.[55]

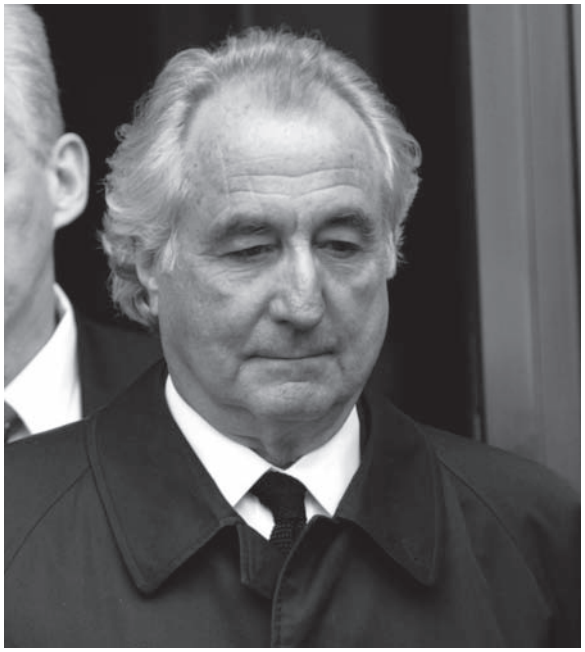
Financial Misconduct

The failure to understand and manage ethical risks played a significant role in the financial crisis and recession of 2008–2009. While there is a difference between bad business decisions and business misconduct, there is also a thin line between the ethics of using only financial incentives to gauge performance and the use of holistic measures that include ethics, transparency, and responsibility to stakeholders. From CEOs to traders and brokers, lucrative financial incentives existed for performance in the financial industry.

Ethics issues emerged early in the arena of subprime lending, with loan officers receiving commissions on securing loans from borrowers with no consequences if the borrower defaulted on the loan. Some appraisers provided inflated home values in order to increase the loan amount. In other instances consumers were asked to falsify their incomes to make the loan more attractive to the lending institution. The opportunity for misconduct was widespread. Top managers, boards of directors, and even CEOs were complacent about the wrongdoings as long as profits were good. Congress and President Clinton encouraged Fannie Mae and Freddie Mac to support home ownership among low-income people by giving out home mortgages. Throughout the early 2000s, in an economy with rapidly increasing home values, the culture of unethical behavior was not apparent to most people. When home values started to decline and individuals were "upside down" on their loans (owing more that the equity of the home), the failures and unethical behavior of lending and borrowing institutions became more obvious.

Derivatives, a financial trading instrument, can pose high amounts of risk for small or inexperienced investors. Because derivatives offer the possibility of large rewards, they offer an attraction to individual investors. But the basic premise of derivatives is to transfer risk among parties based on their willingness to assume additional risk, or hedge against it. Warren Buffett, a well known investor, has stated that he regards derivatives as, "financial weapons of mass destruction." Derivatives have been used to leverage the debt in an economy, sometimes to a massive degree. When something unexpected happens, an economy will find it very difficult to pay its debts, thus causing a recession or even depression. This is why corporate governance systems must have contingency plans for unexpected events.

Because derivatives are so complex, Wall Street turned to mathematicians and physicists to create models and computer programs that could analyze these exotic instruments. It has become apparent that the use of derivatives such as credit default swaps became so profitable that traders and managers lost sight of anything but their incentives for selling these instruments. In other words, financial institutions sold what could be called defective products because the true risk of these financial instruments was not understood or disclosed to the customer. In some cases these defective products were given to traders to sell without any due diligence from the company as to the level of risk. Better corporate


© AP Photo/Louis Lanzano

External investigations and audits by the Securities and Exchange Commission failed to uncover Bernard Madoff's massive pyramid scheme and investor fraud

governance of financial divisions dealing in risky instruments, combined with compensation packages that do not encourage excessive risk-taking, may help to minimize the widespread problems experienced in the financial industry before the 2008 meltdown.

In hindsight, the enormous risks taken by traders and companies seem to be unwise and unfair to stakeholders. An ethical issue relates to the level of transparency that exists in using complex financial instruments to create profits. Irresponsible derivatives trading with limited regulatory oversight gave traders almost unlimited opportunities to manipulate the use of derivatives. In many financial institutions, there is no doubt that a number of key decision makers not only pushed the limits of legitimate risk-taking, but also engaged in manipulation and, in some cases, fraud to deceive shareholders by lying about the company's true financial condition. The federal government has worked to increase government regulation of the financial industry, but it is also clear that internal corporate governance is important in reducing misconduct as well. Additionally, the amount and types of compensation offered to employees should minimize the temptations to take risks, not encourage risk-taking.

"The federal government has worked to increase government regulation of the financial industry, but it is also clear that internal corporate governance is important in reducing misconduct as well."

Executive Compensation

Executive compensation has been a topic rife with controversy in the aftermath of the 2008–2009 recession. While major companies had to turn to the government for help to stay afloat, and while regular people lost their life savings, top executives continued to receive incredibly high bonuses. Top executives at Merrill Lynch were awarded $3.6 billion in bonuses shortly before its merger with Bank of America in 2008. A combined $121 million went to four top executives. This was done in spite of the fact that Merrill Lynch had to be rescued by the government to save it from bankruptcy. Two ethics issues are at play: first, paying out the bonuses at all; and second, rushing their distribution in order to complete the job before Bank of America's takeover. Risk management in the financial industry is a key concern, including paying bonuses to executives who have failed in their duties. Regulatory agencies and Congress were not proactive in investigating early cases of financial misconduct and the systemic issues that led to the crisis. The legal and regulatory systems were more focused on individual misconduct rather than systemic ethical failures. AIG received a great deal of criticism after it paid out $165

million in bonuses to executives, even after the company received $180 billion in bailout money. Many feel that large executive bonuses point to a pervasive culture of greed and a sense of entitlement that has caused many of the problems on Wall Street in recent years.[56]

Executive compensation is such an important topic that many boards spend more time deciding how much to compensate top executives than they do ensuring the integrity of the company's financial reporting systems. How executives are compensated for their leadership, organizational service, and performance has become a controversial topic. Because of the large government bailouts of 2008 and 2009, many people are enraged because they feel that the government is sponsoring corporate excess with taxpayer money. Even many boards of directors—which are responsible for setting executive pay—feel that the United States has a problem in that executive pay is not in line with performance or demonstration of stewardship to the company.[57]According to the AFL–CIO, average executive pay is $10.4 million, which is 344 times the pay of the average U.S. worker. Executive bonuses alone are an average of $336,248. Added to this is the fact that companies have received nearly a billion dollars in government bailout money, money which comes from taxpayers.[58]

An increasing number of corporate boards are imposing performance targets on the stock and stock options they include in their CEOs' pay package. The SEC proposed that companies disclose how they compensate lower-ranking employees, as well as top executives. This was part of a review of executive pay policies that addresses the belief that many financial corporations have historically taken on too much risk. The SEC believes that compensation may be linked to excessive risk-taking.[59] Another issue is whether performance-linked compensation encourages executives to focus on short-term performance at the expense of long-term growth.[60] Shareholders today, however, may be growing more concerned about transparency than short-term performance and executive compensation.

Some people argue that because executives assume so much risk on behalf of the company, they deserve the rewards that follow from strong company performance. In addition, many executives' personal and professional lives meld to the point that they are "on call" twenty-four hours a day. Because not everyone has the skill, experience, and desire to become an executive, with the accompanying pressure and responsibility, market forces dictate a high level of compensation. When the pool of qualified individuals is limited, many corporate board members feel that offering large compensation packages is the only way to attract and retain top executives and so ensure that their firms are not left without strong leadership. In an era when top executives are increasingly willing to "jump ship" to other firms that offer higher pay, potentially lucrative stock options, bonuses, and other benefits, such thinking is not without merit.[61]

Executive compensation is a difficult but important issue for boards of directors and other stakeholders to consider because it receives much attention in the media, sparks shareholder concern, and is hotly debated in discussions of corporate governance. One area for board members to consider is the extent to which executive compensation is linked to company performance. Plans that base compensation on the achievement of several performance goals, including profits and revenues, are intended to align the interests of owners with management.

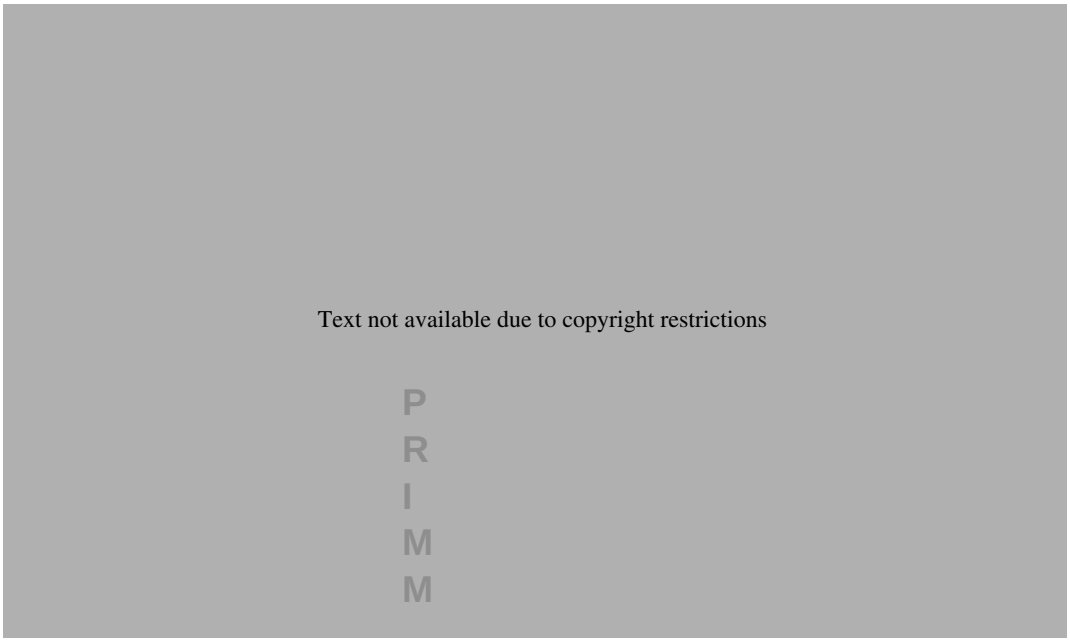


Table 3.5 shows the top CEO compensations at some of the world's largest companies. While still hundreds of times higher than what the average worker makes, overall CEOs did take paycuts for two years in a row in 2007 and 2008—only the second time in U.S. history when that happened. This downward shift may show a slight change in how executives are compensated, or it may represent that firms are listening to stakeholder protests regarding pay. However, those making the most money brought in more than their counterparts did in previous years.

CORPORATE GOVERNANCE AROUND THE WORLD

Increased globalization, enhanced electronic communications, economic agreements and zones, and the reduction of trade barriers have created opportunities for firms around the world to conduct business with both international consumers and industrial partners. These factors are propelling the need for greater homogenization in corporate governance principles. Standard & Poor's has a service called Corporate Governance Scores, which analyzes four macro-forces that affect the general governance climate of a country, including legal infrastructure, regulation, information infrastructure, and market infrastructure. On the basis of these factors, a country can be categorized as having strong, moderate, or weak support for effective governance practices at the company level. Institutional investors are very interested in this measure, as it helps determine possible risk.[62] As financial, human, and intellectual capital crosses borders, a number of business, social, and cultural concerns arise. Institutional investors in companies based in emerging markets claim to be willing to pay more for shares in companies that are well governed. Global shareholders also would like companies in their countries to

disclose more financial data, to adopt CEO pay plans that reward only strong performance, and to use independent boards with no ties to management.

In response to this business climate, the Organisation for Economic Co-operation and Development (OECD), a forum for governments to discuss, develop, and enhance economic and social policy, issued a set of principles intended to serve as a global model for corporate governance.[63] After years of discussion and debate among institutional investors, business executives, government representatives, trade unions, and nongovernmental organizations, thirty OECD member governments signaled their agreement with the principles by signing a declaration to integrate them within their countries' economic systems and institutions. The purpose of the OECD Corporate Governance Principles (see Table 3.6) is to formulate minimum standards of fairness, transparency, accountability, disclosure, and responsibility for business practice. The principles focus on the board of directors, which the OECD says should recognize the impact of governance on the firm's competitiveness. In addition, the OECD charges boards, executives, and corporations with maximizing shareholder value while responding to the demands and expectations of their key stakeholders.

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The OECD Corporate Governance Principles cover many specific best practices, including (1) ensuring the basis for an effective corporate governance framework; (2) rights of shareholders to vote and influence corporate strategy; (3) greater numbers of skilled, independent members on boards of directors; (4) fewer techniques to protect failing management and strategy; (5) wider use of international accounting standards; and (6) better disclosure of executive pay and remuneration. Although member governments of the OECD are expected to uphold the governance principles, there is some room for cultural adaptation.

Best practices may vary slightly from country to country because of unique factors such as market structure, government control, role of banks and lending institutions, labor unions, and other economic, legal, and historical factors. Both industry groups and government regulators moved quickly in the United Kingdom after the Enron crisis was revealed. Because some British bankers were indicted in the scandal, corporate governance concerns increased in that country. Several British reforms resulted, including annual shareowners' votes on board compensation policies and greater supervision of investment analysts and the accounting profession.

Corporate governance, or lack of it, was one of the reasons for the financial crisis that occurred in Southeast Asia in the late 1990s. For example, the government structure of some Asian countries created greater opportunities for corruption and nepotism. Banks were encouraged to extend credit to companies favored by the government. In many cases, these companies were in the export business, which created an imbalance in financing for other types of businesses. The concentration of business power within a few families and tycoons reduced overall competitiveness and transparency. Many of these businesses were more focused on size and expanded operations than profitability. Foreign investors recognized the weakening economies and pulled their money out of investments. An extreme example of growth at all costs was the country of Iceland. In a country with few resources, it became one of the fastest-growing nations in the world during the 2000s because of heavy involvement in the financial sector. In fact, the entire country nearly went bankrupt in the fallout of the failure of the global financial markets in 2008–2009, and the nation's leading banks were nationalized. Iceland's governments and corporations failed to install reasonable checks and balances until the entire country was hugely overleveraged.[64]

FUTURE OF CORPORATE GOVERNANCE

As the issues discussed in the previous section demonstrate, corporate governance is primarily focused on strategic-level concerns for accountability and control. Although many discussions of corporate governance still revolve around responsibility in investor-owned companies, good governance is fundamental to effective performance in all types of organizations. As you have gleaned from history and government classes, a system of checks and balances is important for ensuring a focus on multiple perspectives and constituencies; proper distribution of resources, power, and decision authority; and the responsibility for making changes and setting direction.

To pursue social responsibility successfully, organizations must consider issues of control and accountability. As we learned earlier, the concept of corporate governance is in transition from the shareholder model to one that considers broader stakeholder concerns and inputs to financial performance. A number of market and environmental forces, such as the OECD and shareholder activism,

have created pressures in this direction. This evolution is consistent with our view of social responsibility. Although some critics deride this expanded focus, a number of external and internal forces are driving business toward the stakeholder orientation and the formalization of governance mechanisms. One concern centers on the cost of governance. However, the failure of the financial sector, the subprime mortgage crisis, and the recession in 2008 and 2009 have taught us that not instilling good governance can be immensely more costly. For example, companies like Nike and Wal-Mart, which have had problems in the past and have implemented strong ethics and compliance systems, survived comparatively well during the more recent recession. However, many of the largest firms on Wall Street, which were overleveraged and did not have strong ethics and compliance programs in place, either failed or had to be bailed out in order not to fail.[65]

Most businesspeople and academicians agree that the benefits of a strong approach to corporate governance outweigh its costs. However, the positive return on governance goes beyond organizational performance to benefit the industrial competitiveness of entire nations, something we discussed in Chapter 1. For example, corrupt organizations often fail to develop competitiveness on a global scale and can leave behind financial ruin, thus negating the overall economic growth of the entire region or nation. At the same time, corrupt governments usually have difficulty sustaining and supporting the types of organizations that can succeed in global markets. Thus, a lack of good governance can lead to insular and selfish motives because there is no effective system of checks and balances. In today's interactive and interdependent business environment, most organizations are learning the benefits of a more cooperative approach to commerce. It is possible for a company to retain its competitive nature while seeking a "win-win" solution for all parties to the exchange.[66] Further, as nations with large economies embrace responsible governance principles, it becomes even more difficult for nations and organizations that do not abide by such principles to compete in these lucrative and rich markets. There is a contagion effect toward corporate governance among members of the global economy, much like peer pressure influences the actions and decisions of individuals. Portugal is a good example of this effect.

Because governance is concerned with the decisions made by boards of directors and executives, it has the potential for far-reaching positive—and negative—effects. A recent study by the OECD found that stronger financial performance is the result of several governance factors and practices, including (1) large institutional shareholders that are active monitors of company decisions and boards; (2) owner-controlled firms; (3) fewer mergers, especially between firms with disparate corporate values and business lines; and (4) shareholders', not board of directors', decisions on executive remuneration.[67]

"The positive return on governance goes beyond organizational performance to benefit the industrial competitiveness of entire nations."

The authors of the study note that these practices may not hold true for strong performance in all countries and economic systems. However, they also point out that a consensus view is emerging, with fewer differences among OECD countries than among all other nations. Similarities in organizational-level accountability and control should lead to smoother operations between different companies and countries, thereby bolstering competitiveness on many levels.

The future of corporate governance is directly linked to the future of social responsibility. Because governance is the control and accountability process for achieving social responsibility, it is important to consider who should be involved in the future. First and most obviously, business leaders and managers will need to embrace governance as an essential part of effective performance. Some of the elements of corporate governance, particularly executive pay, board composition, and shareholder rights, are likely to stir debate for many years. However, business leaders must recognize the forces that have brought governance to the forefront as a precondition of management responsibility. Thus, they may need to accept the "creative tension" that exists among managers, owners, and other primary stakeholders as the preferable route to mutual success.[68]

Second, governments have a key role to play in corporate governance. National competitiveness depends on the strength of various institutions, with primacy on the effective performance of business and capital markets. Strong corporate governance is essential to this performance, and thus, governments will need to be actively engaged in affording both protection and accountability for corporate power and decisions. Just like the corporate crises in the United States, the Asian economic crisis discussed earlier prompted companies and governments around the world to consider tighter governance procedures. Finally, other stakeholders may become more willing to use governance mechanisms to influence corporate strategy or decision making. Investors—whether shareholders, employees, or business partners—have a stake in decisions and should be willing to take steps to align various interests for long-term benefits. Many investors and stakeholders are willing to exert great influence on underperforming companies.

Until recently, governance was one area in the business literature that had not received the same level of attention as other issues, such as environmental impact, diversity, and sexual harassment. Over the next few years, however, corporate governance will emerge as the operational centerpiece to the social responsibility effort. The future will require that business leaders have a different set of skills and attitudes, including the ability to balance multiple interests, handle ambiguity, manage complex systems and networks, create trust among stakeholders, and improve processes so leadership is pervasive throughout the organization.[69]

In the past, the primary emphasis of governance systems and theory was on the conflict of interests between management and investors.[70] Governance today holds people at the highest organizational levels accountable and responsible to a broad and diverse set of stakeholders. Although top managers and boards of directors have always assumed responsibility, their actions are now subject to greater accountability and transparency. A *Wall Street Journal* writer put the shift succinctly, indicating, "Boards of directors have been put on notice." A key issue going forward will be the board's ability to align corporate decisions with various stakeholder interests.[71] Robert Monks, the activist money manager and leader on corporate governance

issues, wrote that effective corporate governance requires understanding that the "indispensable link between the corporate constituents is the creation of a credible structure (with incentives and disincentives) that enables people with overlapping but not entirely congruent interests to have a sufficient level of confidence in each other and the viability of the enterprise as a whole."[72] We will take a closer look at some of these constituents and their concerns in the next few chapters.

SUMMARY

To respond to stakeholder pressures that companies be more accountable for organizational decisions and policies, organizations must implement policies that provide strategic guidance on appropriate courses of action. Such policies are often known as corporate governance, the formal system of accountability and control for organizational decisions and resources. Accountability relates to how well the content of workplace decisions is aligned with the firm's stated strategic direction, whereas control involves the process of auditing and improving organizational decisions and actions.

Both directors and officers of corporations are fiduciaries for the shareholders. Fiduciaries are persons placed in positions of trust who use due care and loyalty in acting on behalf of the best interests of the organization. There is a duty of care, also called a duty of diligence, to make informed and prudent decisions. Directors have a duty to avoid ethical misconduct in their director role and to provide leadership in decisions to prevent ethical misconduct in the organization. Directors are not held responsible for negative outcomes if they are informed and diligent in their decision making. The duty of loyalty means that all decisions should be in the interests of the corporation and its stakeholders. Conflicts of interest exist when a director uses the position to obtain personal gain, usually at the expense of the organization.

There are two major conceptualizations of corporate governance. The shareholder model of corporate governance focuses on developing and improving the formal system of performance accountability between top management and the firm's shareholders. The stakeholder model of corporate governance views the purpose of business in a broader fashion in which the organization not only has a responsibility for economic success and viability but also must answer to other stakeholders. The shareholder model focuses on a primary stakeholder—the investor—whereas the stakeholder model incorporates a broader philosophy that focuses on internal and external constituents.

Governance is the organizing dimension for keeping a firm focused on continuous improvement, accountability, and engagement with stakeholders. Although financial return, or economic viability, is an important measure of success for all firms, the legal dimension of social responsibility is also a compulsory consideration. The ethical and philanthropic dimensions, however, have not been traditionally mandated through regulation or contracts. This represents a critical divide in our social responsibility model and associated governance goals and systems because there are some critics who challenge the use of organizational resources for concerns beyond financial performance and legalities.

In the late 1800s and early 1900s, corporate governance was not a major issue because company owners made strategic decisions about their businesses. By the

1930s, ownership was dispersed across many individuals, raising questions about control and accountability. In response to shareholder activism, the Securities and Exchange Commission required corporations to allow shareholder resolutions to be brought to a vote of all shareholders. Since the mid-1900s, the approach to corporate governance has involved a legal discussion of principals (owners) and agents (managers) in the business relationship. The lack of effective control and accountability mechanisms in years past has prompted a current trend toward boards of directors playing a greater role in strategy formulation than they did in the early 1990s. Members of a company's board of directors assume legal responsibility and a fiduciary duty for organizational resources and decisions. Boards today are concerned primarily with monitoring the decisions made by managers on behalf of the company. The trend today is toward boards composed of outside directors who have little vested interest in the firm. Shareholder activism is helping to propel this trend, as they seek better representation from boards that are less likely to have conflicts of interest.

Shareholders have become more active in articulating their positions with respect to company strategy and executive decision making. Many investors assume the stakeholder model of corporate governance, which implies a strategy of integrating social and ethical criteria into the investment decision-making process. Although most activism and investing take place on an organizational level through mutual funds and other institutional arrangements, some individual investors have affected company strategy and policy.

Another significant governance issue is internal control and risk management. Controls allow for comparisons between actual performance and the planned performance and goals of the organization. They are used to safeguard corporate assets and resources, protect the reliability of organizational information, and ensure compliance with regulations, laws, and contracts. Controls foster understanding when discrepancies exist between corporate expectations and stakeholder interests and issues. A strong internal control system should alert decision makers to possible problems or risks that may threaten business operations. Risk can be categorized as (1) a hazard, in which case risk management focuses on minimizing negative situations, such as fraud, injury, or financial loss; (2) an uncertainty that needs to be hedged through quantitative plans and models; or (3) an opportunity for innovation and entrepreneurship.

How executives are compensated for their leadership, service, and performance is another governance issue. Many people believe the ratio between the highest-paid executives and median employee wages in the company should be reasonable. Others argue that because executives assume so much risk on behalf of the organization, they deserve the rewards that follow from strong company performance. One area for board members to consider is the extent to which executive compensation is linked to company performance.

The financial meltdown on Wall Street, the subprime mortgage crisis, and the recession of 2008–2009 have all shown stakeholders and regulators that the system still carries a lot of risk. This is in spite of actions taken after the events of the early 2000s involving companies like Enron and Worldcom. Increased government regulation of industries is not sufficient to ensure good corporate governance and reasonable risk-taking. Companies must take actions to implement ethics and compliance programs, to strengthen the accountability of their boards, and to align employee incentives with stakeholder interests. Better corporate

governance across industries will not be attained without internal controls and risk management working in tandem with external government laws.

The Organisation for Economic Co-operation and Development has issued a set of principles from which to formulate minimum standards of fairness, transparency, accountability, disclosure, and responsibility for business practice. These principles help guide companies around the world and are part of the convergence that is occurring with respect to corporate governance.

Most businesspeople and academicians agree that the benefits of a strong approach to corporate governance outweigh its costs. Because governance is concerned with the decisions taken by boards of directors and executives, it has the potential for far-reaching positive, and negative, effects. The future of corporate governance is directly linked to the future of social responsibility. Business leaders and managers will need to embrace governance as an essential part of effective performance. Governments also have a role to play in corporate governance. National competitiveness depends on the strength of various institutions, with primacy on the effective performance of business and capital markets. Other stakeholders may become more willing to use governance mechanisms to affect corporate strategy or decision making.

RESPONSIBLE BUSINESS DEBATE

Vasella Steers Novartis Away from the Pack

ISSUE: Are pharmaceutical profits more important than curing disease?

Most businesses have a CEO and board of directors that operate under the conviction that their purpose is to maximize profits for the shareholders. They are trusted to make decisions that will grow the company and increase profits, without failing to conduct due diligence. No matter what the social interests of a company are, profits must be the most important consideration. Without earning profits, a company will not be successful in the long run and likely will not survive long enough to pursue stakeholder interests.

Novartis is a pharmaceutical company that is trying to responsibly grow profits while also maintaining a balanced stakeholder model. CEO Dan Vasella is a former doctor who knows the pharmaceutical industry from the manufacturer and the consumer side. Because of his medical background, Vasella holds the belief that Novartis's core stakeholders are the patients who use the company's drugs, not the shareholders who demand high returns.

While competitors focus on so-called "blockbuster" drugs, like those for depression or impotence, that hold the potential for enormous profits, Vasella wants Novartis to focus on curable diseases that may not hold as much profit potential. For example, employees at Novartis are pushing Vasella to spend hundreds of millions on an Alzheimer's vaccine. Although an Alzheimer's drug could net the company billions in profits, the disease is so complex that a cure is not yet within reach.

Vasella, on the other hand, wants to focus on targeted diseases, such as the inflammatory disease Muckle-Wells syndrome that affects a few thousand people worldwide. The genetics behind this disease are better understood and a cure is reasonably within reach—only a drug has never been developed because most pharmaceutical companies do not think it is profitable enough. Vasella, however, thinks it is a worthwhile disease on which to spend research and development (R&D) money because Novartis could cure a devastating disease, and he hopes that what the company learns from developing the drug could be applied to other similar diseases

such as type 2 diabetes and arthritis. While not all shareholders understand his approach, Vasella has the support of the board and nine senior executives who make up what is called the Innovation Board. While Novartis is definitely taking a different approach to pharmaceutical development, Vasella's ideas have the potential to distinguish Novartis from the pack. Only time will tell if this stakeholder model maximizes profits for shareholders.

There Are Two Sides to Every Issue:

1. The Novartis stakeholder model will maximize profits in the long run.
2. Competitors that focus on an alternative financial return model (that emphasizes blockbuster drugs over curing more obscure diseases) will maximize profits in the long run.

Sources: Karry Capell, "Novartis: Radically Remaking Its Drug Business," *BusinessWeek*, June 22, 2009, pp. 30–35; "Comprehensive Compliance Program," Novartis Diagnostics, http://www.novartisdiagnostics.com/ethics/compliance.shtml, accessed July 10, 2009; "Lifesaving Research Rewarded," Novartis Newsroom, http://www.novartis.com/newsroom/news/2009-05-20_european-inventor.shtml, accessed July 10, 2009.

KEY TERMS

corporate governance (p. 85)
shareholder model of corporate governance (p. 92)
stakeholder model of corporate governance (p. 93)

DISCUSSION QUESTIONS

1. What is corporate governance? Why is corporate governance an important concern for companies that are pursuing the social responsibility approach? How does it improve or change the nature of executive and managerial decision making?
2. Compare the shareholder and stakeholder models of corporate governance. Which one seems to predominate today? What implications does this have for businesses in today's complex environment?
3. What role does executive compensation play in risk-taking and accountability? Why do some people partially blame compensation for the failures of the subprime mortgage and financial industries in 2008–2009?
4. What is the role of the board of directors in corporate governance? What responsibilities does the board have?
5. What role do shareholders and other investors play in corporate governance? How can investors effect change?
6. Why are internal control and risk management important in corporate governance? Describe three approaches organizations may take to managing risk.
7. Why is the issue of executive compensation controversial? Are today's corporate executives worth the compensation packages they receive?
8. In what ways are corporate governance practices becoming standardized around the world? What differences exist?
9. As corporate governance becomes a more important aspect of social responsibility, what new skills and characteristics will managers and executives need? Consider how pressures for governance require managers and executives to relate and interact with stakeholders in new ways.

EXPERIENTIAL EXERCISE

Visit the website of the Organisation for Economic Co-operation and Development (http://www.oecd.org). Examine the origins of the organization and its unique role in the global economy. After visiting the site, answer the following questions:

1. What are the primary reasons that OECD exists?
2. How would you describe OECD's current areas of concern and focus?
3. What role do you think OECD will play in the future with respect to corporate governance and related issues?

WHAT WOULD YOU DO?

The statewide news carried a story about Core-Tex that evening. There were rumors swirling that one of the largest manufacturers in the state was facing serious questions about its social responsibility. A former accountant for Core-Tex, whose identity was not revealed, made allegations about aggressive accounting methods and practices that overstated company earnings. He said he left Core-Tex after his supervisor and colleagues did not take his concerns seriously. The former accountant hinted that the company's relationship with its external auditor was quite close, since Core-Tex's new CFO had once been on the external auditing team. Core-Tex had recently laid off 270 employees—a move that was not unexpected in these turbulent financial times. However, the layoff hit some parts of the site's community pretty hard. Finally, inspectors from the state environmental protection agency had just issued a series of citations to Core-Tex for improper disposal and high emissions at one of its larger manufacturing plants. A television station had run an exposé on the environmental citations a week ago.

CEO Kelly Buscio clicked off the television set and thought about the company's next steps. Core-Tex's attorney had cautioned the executive group earlier that week about communicating too much with the media and other constituents. The firm's vice president for marketing countered the attorney by insisting that Core-Tex needed to stay ahead of the rumors and assumptions that were being made about the company. The vice president of marketing said that suppliers and business partners were starting to question Core-Tex's financial viability. The vice president of information technology and the vice president of operations were undecided on the proper next steps. The vice president of manufacturing had not been at the meeting. Buscio rubbed her eyes and wondered what tomorrow could bring.

To her surprise, the newspapers were pretty gentle on Core-Tex the next day. There had been a major oil spill, the retirement of a *Fortune* 500 CEO, and a major league baseball championship game the night before, so the reporters were focused on those stories. The company's stock price, which averaged around $11.15, was down $0.35 by midmorning. Her VP of marketing suggested that employees needed to hear from the CEO and be reassured about Core-Tex's strong future. Her first call after lunch came from a member of the firm's board of directors. The director asked Buscio what the board could do to help the situation.

What would you do?

CHAPTER 4

Legal, Regulatory, and Political Issues

Chapter Objectives

- To understand the rationale for government regulation of business
- To examine the key legislation that structures the legal environment for business
- To analyze the role of regulatory agencies in the enforcement of public policy
- To compare the costs and benefits of regulation
- To examine how business participates in and influences public policy
- To describe the government's approach for legal and ethical compliance

Chapter Outline

Government's Influence on Business

Business's Influence on Government and Politics

The Government's Strategic Approach for Legal and Ethical Compliance

OPENING CASE

Bear Stearns: Deceit and Derivatives Cause Destruction

Bear Stearns was an American institution that survived the Great Depression, but it met its ruin in 2008. Bear Stearns was the fifth largest investment bank and was one of the early institutions to fall during the financial crisis. Many see it as having kicked off the string of subsequent business failures and bailouts. While not as large and esteemed as Goldman Sachs or Morgan Stanley, it was among a group of large, trusted institutions that many people had previously thought were too big to fail.

Two things caused the doom of this eighty-five-year-old company: subprime mortgages and derivatives. Like many financial institutions, Bear Stearns, a global investment bank and securities brokerage firm, invested heavily in subprime mortgages. However, Bear Stearns misrepresented information to achieve its success. The company had inaccurately reported client information on some loan applications to make them appear less risky.

After securing the loans, Bear Stearns sold the debt to other institutions in the form of a financial instrument known as a derivative. In other words, Bear Stearns agreed to insure the debt that it sold to other companies. The derivatives were supposed to be backed by cash flows from the loans. This allowed Bear Stearns to move the risk onto investors. In November 2007, Bear Stearns had $13.4 trillion in derivatives. There was just one problem. When the economic downturn hit, the cash flows from the loans dried up and the bank could not make good on its promise to "bail out" investors.

After the firm fell, top executives made claims that they did not understand how risky the securities were in which they were investing. While this may be true to a certain extent, comments like this set off a rally of public outcry asking for justice. Stakeholders were rightfully enraged that top financial executives were gambling investors' money without disclosing or even knowing the risks involved.

The situation was made worse by the misconduct of executives Ralph Cioffi and Matthew Tannin. As the company's hedge funds were failing, the executives deceived investors by portraying the funds as great investments. A month later, the funds collapsed, losing $1.6 billion in investor assets. Although the U.S. government attempted to save Bear Stearns, the damage was irrevocable. JP Morgan purchased the firm for $10 a share, a far cry from its previous fifty-two-week high of $133.20 per share. Cioffi and Tannin were arrested, but this does little to recover the billions in investor assets they helped lose.[1]

The government has the power through laws and regulations to structure how businesses and individuals achieve their goals. The purpose of regulating firms is to create a fair competitive environment for businesses, consumers, and society. All stakeholders need to demonstrate a commitment to social responsibility through compliance with relevant laws and proactive consideration of social needs. The law is one of the most important business subjects in terms of its effect on organizational practices and activities. Thus, compliance with the law is an important foundation of social responsibility. Because the law is based on principles, norms, and values found within society, the law is the foundation of responsible decision making.

This chapter explores the complex relationship between business and government. First, we discuss some of the laws that structure the environment for the regulation of business. Major legislation relating to competition and regulatory agencies is reviewed to provide an overview of the regulatory environment. We also consider how businesses can participate in the public policy process through lobbying, political contributions, and political action committees. Finally, we offer a framework for a strategic approach to managing the legal and regulatory environment.

GOVERNMENT'S INFLUENCE ON BUSINESS

The government has a profound influence on business. Most Western countries have a history of elected representatives working through democratic institutions to provide the structure for the regulation of business conduct. For example, one of the differences that have long characterized the two major parties of the U.S. political system involves the government's role with respect to business. In general terms, the Republican Party tends to favor smaller central government with less regulation of business, while the Democratic Party is more open to government oversight, federal aid program, and sometimes higher taxes. From the start, President Obama worried some businesspeople, as he has promised more oversight of many different areas of the economy. For example, he has promised to be tough on antitrust violations and has followed through by reversing a Bush-era policy that made it more difficult for the government to pursue antitrust violations. The Bush administration brought a historically low number of antitrust cases to trial, a tactic that the Obama administration reversed.[2]

President Obama has brought U.S. policy regarding antitrust cases more in line with Europe's model, which marks a return to a historic norm after eight years of Bush's noninterventionism.[3] Third-party and independent candidates typically focus on specific business issues or proclaim their distance from the two major political parties. However, the power and freedom of big business have resulted in conflicts among private businesses, government, private-interest groups, and even individuals as businesses try to influence policy makers.

In the United States, the role that society delegates to government is to provide laws that are logically deduced from the Constitution and the Bill of Rights and to enforce these laws through the judicial system. Individuals and businesses,

therefore, live under a rule of law that protects society and supports an acceptable quality of life. Ideally, by controlling the limitation of force by some parties, the overall welfare and freedom of all participants in the social system will be protected.

The provision of a court system to settle disputes and punish criminals, both organizational and individual, provides for justice and order in society. Both Intel and Microsoft have been hit with enormous fines for alleged antitrust activity in Europe, where the companies have been accused of engaging in behavior that prevents smaller companies from competing. The European Commission fined Intel a record-setting $1.45 billion after it was found guilty of taking anticompetitive measures against smaller competitor Advanced Micro Devices. Competitors in Europe have accused Microsoft of contractual tying because the company has been preloading its own Internet Explorer as part of the Windows operating system. Due to pressures from the Commission, Microsoft has agreed that it will now release a new version of Windows without a browser.[4] The European Union is famous for being tough on companies suspected of antitrust cases, igniting the ire of many multinational corporations that feel as if they are being punished for being successful. Being aware of antitrust laws is important for all large corporations around the world, no matter what the country, because judicial systems can punish businesses that fail to comply with laws and regulatory requirements.

The legal system is not always accepted in some countries as insurance that business will be conducted in a legitimate way. For example, after generations of being known for its top-secret bank accounts, Swiss banks were ordered by the U.S. Internal Revenue Service to disclose information about some of their clients because of concerns over illegal activities. In many places around the world, the business climate has become less tolerant of illegal and immoral actions, and countries like Switzerland, Liechtenstein, and Luxembourg now are being pressured to share information on potential tax dodgers with government agencies like the IRS. One bank alone, UBS, may harbor the secret bank accounts of 52,000 American tax dodgers.[5] The Swiss government ordered UBS not to divulge the U.S. clients' information on the grounds that it violated Swiss privacy laws.[6] This case illustrates the complexity of complying with international business laws.

While many businesses may object to regulations aimed at maintaining ethical cultures and preserving stakeholder welfare, businesses' very existence is based on laws permitting their creation, organization, and dissolution. From a social perspective, it is significant that a corporation has the same legal status as a "person" who can sue, be sued, and be held liable for debts. Laws may protect managers and stockholders from being personally liable for a company's debts, but individuals as well as organizations are still responsible for their conduct. Because corporations have a perpetual life, larger companies like ExxonMobil, Ford, and Sony take on an organizational culture, including social responsibility values, that extends beyond a specific time period, management team, or geographical region. Organizational culture plays an important role in the ability of corporations to outlive individual executives—it sets the tone for the business and allows for continuity even during times of leadership turnover.

Most, generally smaller, companies are owned by individual proprietors or operated as partnerships. However, large incorporated firms like those just mentioned often receive more attention because of their size, visibility, and impact on so many aspects of the economy and society. In a pluralistic society, diverse stakeholder groups such as business, labor, consumers, environmentalists, privacy advocates, and others attempt to influence public officials who legislate, interpret laws, and regulate business. The public interest is served though open participation and debate that result in effective public policy. Because no system of government is perfect, legal and regulatory systems are constantly evolving and changing in response to changes in the business environment and social institutions. For example, increasing use of the Internet for information and business created a need for legislation and regulations to protect the owners of creative materials from unauthorized use and consumers from fraud and invasions of privacy. The line between acceptable and illegal activity on the Internet is increasingly difficult to discern and is often determined by judges and juries.

"The public interest is served though open participation and debate that result in effective public policy."

In response, the Better Business Bureau (BBB) offers an Online Accredited Business certification to 55,020 retailers, which certifies their high ethical standards and safety for online shoppers. The BBB lists the companies on its website and directs consumers to approved businesses' websites.[7] More than a million times a month, web users click on the BBB*OnLine* seals to check a firm's credibility and high standards.[8]

Companies that adopt a strategic approach to the legal and regulatory system develop proactive organizational values and compliance programs that identify areas of risks and include formal communication, training, and continuous improvement of responses to the legal and regulatory environment.

In the next section, we take a closer look at why and how the government affects businesses through laws and regulation, the costs and benefits of regulation, and how regulation may affect companies doing business in foreign countries.

The Rationale for Regulation

The United States was established as a capitalist system, but the prevailing capitalistic theory has changed over time. Adam Smith published his critical economic ideas in *The Theory of Moral Sentiments* and *Inquiry into the Nature and Causes of the Wealth of Nations,* which are still considered important today. Smith observed the supply and demand, contractual efficiency, and division of labor of various companies within England. Smith's writings formed the basis of modern economics. Smith's idea of *laissez-faire,* or "the invisible hand," is critical to capitalism in that it assumes the market, through its own inherent mechanisms, will keep commerce in equilibrium.

A second form of capitalism gained support at the beginning of the Great Depression. During the 1930s John Maynard Keynes argued that the state could stimulate economic growth and improve stability in the private sector—through, for example, controlling interest rates, taxation, and public projects.[9]

Keynes argued that government policies could be used to increase aggregate demand, thus increasing economic activity and reducing unemployment and deflation. He argued that the solution to depression was to stimulate the economy through some combination of a reduction in interest rates or government investment in infrastructure. President Franklin D. Roosevelt employed Keynesian economic theories to pull the United States out of the Great Depression, as President Obama is now trying to do with the 2008–2009 economic recession.

The third and most recent form of capitalism was developed by Milton Friedman, and represented a swing to the right on the political spectrum. Friedman had lived through the Great Depression but rejected the Keynesian conclusion that the market sometimes needs some intervention in order to function most efficiently. Friedman instead believed in deregulation because he thought that the system could reach equilibrium without government intervention.[10] Friedman's ideas were the guiding principles for government policy making in the United States, and increasingly throughout the world, starting in the second half of the twentieth century, especially during the presidencies of Presidents Ronald Reagan, George H. W. Bush, and George W. Bush.

Although the view of which form of capitalism is best has changed over time, the federal and state governments in the United States have always stepped in to enact legislation and create regulations to address particular issues and restrict the behavior of business in accordance with society's wishes. Many of the issues used to justify business regulation can be categorized as economic or social.

Economic and Competitive Reasons for Regulation A great number of regulations have been passed by legislatures over the last 100 years in an effort "to level the playing field" on which businesses operate. When the United States became an independent nation in the eighteenth century, the business environment consisted of many small farms, manufacturers, and cottage industries operating on a primarily local scale. With the increasing industrialization of the United States after the Civil War, "captains of industry" like John D. Rockefeller (oil), Andrew Carnegie (railroads and steel), Andrew Mellon (aluminum), and J. P. Morgan (banking) began to consolidate their business holdings into large national trusts. **Trusts** are organizations generally established to gain control of a product market or industry by eliminating competition. Such organizations are often considered detrimental because, without serious competition, they can potentially charge higher prices and provide lower-quality products to consumers. Thus, as these firms grew in size and power, public distrust of them likewise grew because of often-legitimate concerns about unfair competition. This suspicion and the public's desire to require these increasingly powerful companies to act responsibly spurred the first antitrust legislation. If trusts are successful in eliminating competition, a monopoly can result.

trust
an organization established to gain control of a product market or industry by eliminating competition

A **monopoly** occurs when just one business provides a good or service in a given market. Utility companies that supply electricity, natural gas, water, or cable television are examples of monopolies. The government tolerates these monopolies because the cost of supplying the good or providing the service is so great that few companies would be willing to invest in new markets without some protection from competition. Monopolies may also be allowed by patent laws that grant the developer of a new technology a period of time (usually seventeen years) during which no other firm can use the same technology without the patent holder's consent. Patent protections are permitted to encourage businesses to engage in riskier research and development by allowing them time to recoup their research, development, and production expenses and to earn a reasonable profit.

Because trusts and monopolies lack serious competition, there are concerns that they may either exploit their market dominance to restrict their output and raise prices or lower quality to gain greater profits. This concern is the primary rationalization for their regulation by the government. Public utilities, for example, are regulated by state public utility commissions and, where they involve interstate commerce, are subject to federal regulation as well. In recent years, some of these industries have been deregulated with the idea that greater competition will police the behavior of individual firms. However, in areas like utilities it is difficult to develop perfect competition because of the large sunk costs required. Oftentimes deregulation has led to increased costs to stakeholders. For example, Maryland deregulated the state's residential energy market in the late 1990s, and when rate caps came off in 2004 residences were hit with skyrocketing utilities costs. The problem has been market prices—when petroleum costs are high, so are the costs to generate energy. In a deregulated privatized market, these costs are passed on to consumers. The governor has tried numerous tactics to relieve the burden, including a one-time handout, but stakeholders remain concerned.[11]

Related to the issue of regulation of trusts and monopolies is society's desire to restrict destructive or unfair competition. What is considered unfair varies with the standard practice of the industry, the impact of specific conduct, and the individual case. When one company dominates a particular industry, it may engage in destructive competition or employ anticompetitive tactics. For example, it may slash prices in an effort to drive competitors out of the market and then raise prices later. It may conspire with other competitors to set, or "fix," prices so that each firm can ensure a certain level of profit. Other examples of unfair competitive trade practices are stealing trade secrets or obtaining other confidential information from a competitor's employees, trademark and copyright infringement, false advertising, and deceptive selling methods such as "bait and switch" and false representation of products.

Regulation is also intended to protect consumers from unethical business practices. Seniors, for instance, are a highly vulnerable demographic and are often the victims of business scams. New laws have taken aim at financial scams on seniors, such as free-lunch seminars. The state of Arkansas has taken the forefront on this issue, conducting police sweeps of suspected scams, increasing fines, and amending laws to impose increased penalties for those who prey on the elderly. Older people are the most vulnerable group when it comes to financial scams, as they rely on their savings for retirement security.[12]

monopoly
the situation where one business provides a good or service in a given market

Social Reasons for Regulation

Regulation may also occur when marketing activities result in undesirable consequences for society. Many manufacturing processes, for example, create air, water, or land pollution. Such consequences create uncounted "costs" in the form of contamination of natural resources, illness, and so on that neither the manufacturer nor the consumer "pays" for directly, although consumers end up paying for these costs nevertheless. Because few companies are willing to shoulder these costs voluntarily, regulation is necessary to ensure that all firms within an industry do their part to minimize damages and pay their fair share. Likewise, regulations have proven necessary to protect resources, both natural (e.g., forests, fishing grounds, and other habitats) and social (e.g., historical and architecturally or archeologically significant structures). We will take a closer look at some of these environmental protection regulations and related issues in Chapter 11, which covers sustainability.

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Regulations can result from marketing activities that cause negative effects on stakeholders and society

Other regulations have come about in response to social demands for equality in the workplace, especially after the 1960s. Such laws and regulations require that companies ignore race, ethnicity, gender, religion, and disabilities in favor of qualifications that more accurately reflect an individual's capacity for performing a particular job. Likewise, deaths and injuries because of employer negligence resulted in regulations designed to ensure that people can enjoy a safe working environment. The airline industry has become a prime example of tough economic times resulting in overworked, undertrained employees. Many pilots receive low compensation, poor health benefits, and are forced to work long hours—all factors that may have played a part in a tragic crash in Buffalo, New York, that killed all forty-nine passengers and one person on the ground. Even Captain Sully Sullenberger who safely landed a plane on the Hudson River after colliding with some geese confessed that his pay had been cut 40 percent from its high. Because the industry cannot pay for the best and the brightest, significant factors like experience and skill have become less important when hiring new pilots. Many airlines simply hire the best they can afford.[13]

Still other regulations have resulted from special-interest group crusades for safer products. For example, Ralph Nader's *Unsafe at Any Speed,* published in 1965, criticized the automobile industry as a whole, and General Motors specifically, for putting profit and style ahead of lives and safety. Nader's consumer protection organization, popularly known as Nader's Raiders, successfully campaigned for legislation that required automakers to provide safety belts, padded dashboards, stronger door latches, head restraints, shatterproof windshields, and collapsible steering columns in automobiles. As we will see in Chapter 8, consumer

activists also helped secure passage of several other consumer protection laws, such as the Wholesome Meat Act of 1967, the Clean Water Act of 1972, and the Toxic Substance Act of 1976.

Issues arising from the increasing use of the Internet have led to demands for new laws protecting consumers and business. It is estimated that spam levels (unwanted emails) are up 156 percent since 2008. Google Message Security has been recording historically high spam levels, with an average of 194 spam messages blocked per user per day.[14] With an increase in spam comes an increase in viruses and malware programs. Although spam-blocking technology exists, spammers are increasingly finding ways to bypass these programs to reach their targets. For this reason, Internet access services in the past have pressed for tougher federal legislation in a quest to stop illicit commercial email. However, legislators often have difficulty with finding a way to block deceptive spammers without violating their First Amendment rights. Yet stiffer penalties are being enforced for well-known spammers, as evidenced by the conviction of the "Spam King" Sanford Wallace. Sanford Wallace and his partner, whose company sent up to 30 million junk emails per day in the 1990s, was accused by MySpace of sending over 730,000 deceitful spam messages to MySpace members. The pair now owe MySpace approximately $230 million in damages.[15]

As we shall see in Chapter 10, the technology associated with the Internet has generated a number of issues related to privacy, fraud, and copyrights. For instance, creators of copyrighted works such as movies, books, and music are calling for new laws and regulations to safeguard their ownership of these works. In response to these concerns, Congress enacted the Digital Millennium Copyright Act in 1998, which extended existing copyright laws to better protect "digital" recordings of music, movies, and the like. Many other countries have implemented similar measures. However, copyright violations continue to plague many global industries, which to some critics calls into question the effectiveness of legal action. A team of security specialists recommends technological, not legal, solutions as most effective in the fight against piracy and copyright infringement.[16]

"The technology associated with the Internet has generated a number of issues related to privacy, fraud, and copyrights."

Concerns about the collection and use of personal information, especially regarding children, resulted in the passage of the Children's Online Privacy Protection Act of 2000 (COPPA). The Federal Trade Commission (FTC) enforces the act by levying fines against noncomplying website operators. For example, the FTC imposed the largest COPPA penalty to date on Sony BMG. Sony agreed to pay $1 million to the FTC for collecting and disclosing information on thousands of children under age thirteen without parental consent.[17]

Internet safety among children is a major topic of concern. Research has shown that

Text not available due to copyright restrictions

filtering and age verification are not effective in making the Internet safer—businesses, regulators, and parents are all trying to find answers in how to protect children from dangers ranging from online predators to pornography.[18]

With good reason, consumers are worried about becoming victims of online fraud. According to the Internet Crime Complaint Center (IC3), online fraud contributes to the loss of nearly $300 million a year, with costs escalating every year.[19] Online auction fraud makes up a large percentage of Internet crime. In 2008, one in every four Internet scams reported to the IC3 involved online auction scams.[20] Table 4.1 describes the types of risk that consumers encounter in both in-person and online auctions. It is clear that online auctions present significantly greater risk than in-person transactions, which is linked to the degree of protection that consumers demand or require from the government.

Laws and Regulations

As a result of business abuses and social demands for reform, the federal government began to pass legislation to regulate business conduct in the late nineteenth century. In this section, we will look at a few of the most significant of these laws. Table 4.2 summarizes many more laws that affect business operations.

Sherman Antitrust Act The Sherman Antitrust Act, passed in 1890, is the principal tool employed by the federal government to prevent businesses from restraining trade and monopolizing markets. Congress passed the law, almost unanimously, in response to public demands to curtail the growing power and abuses of trusts in the late nineteenth century. The law outlaws "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce."[21]It also makes a violation of the law a felony crime, punishable by a fine of up to $10 million for corporate violators and $350,000 and/or three years in prison for individual offenders.[22]

Table 4.2 Major Federal Legislation

Act (Date Enacted)	Purpose
Sherman Antitrust Act (1890)	Prohibits contracts, combinations, or conspiracies to restrain trade; establishes as a misdemeanor monopolizing or attempting to monopolize
Clayton Act (1914)	Prohibits specific practices such as price discrimination, exclusive dealer arrangements, and stock acquisitions in which the effect may notably lessen competition or tend to create a monopoly
Federal Trade Commission Act (1914)	Created the Federal Trade Commission (FTC); gives the FTC investigatory powers to be used in preventing unfair methods of competition
Robinson-Patman Act (1936)	Prohibits price discrimination that lessens competition among wholesalers or retailers; prohibits producers from giving disproportionate services of facilities to large buyers
Wheeler-Lea Act (1938)	Prohibits unfair and deceptive acts and practices regardless of whether competition is injured; places advertising of foods and drugs under the jurisdiction of the FTC
Lanham Act (1946)	Provides protections and regulation of brand names, brand marks, trade names, and trademarks
Celler-Kefauver Act (1950)	Prohibits any corporation engaged in commerce from acquiring the whole or any part of the stock or other share of the capital assets of another corporation when the effect substantially lessens competition or tends to create a monopoly
Fair Packaging and Labeling Act (1966)	Makes illegal the unfair or deceptive packaging or labeling of consumer products
Magnuson-Moss Warranty (FTC) Act (1975)	Provides for minimum disclosure standards for written consumer product warranties; defines minimum consent standards for written warranties; allows the FTC to prescribe interpretive rules in policy statements regarding unfair or deceptive practices
Consumer Goods Pricing Act (1975)	Prohibits the use of price maintenance agreements among manufacturers and resellers in interstate commerce
Antitrust Improvements Act (1976)	Requires large corporations to inform federal regulators of prospective mergers or acquisitions so that they can be studied for any possible violations of the law
Trademark Counterfeiting Act (1988)	Provides civil and criminal penalties against those who deal in counterfeit consumer goods or any counterfeit goods that can threaten health or safety
Trademark Law Revision Act (1988)	Amends the Lanham Act to allow brands not yet introduced to be protected through registration with the Patent and Trademark Office
Nutrition Labeling and Education Act (1990)	Prohibits exaggerated health claims and requires all processed foods to contain labels with nutritional information
Telephone Consumer Protection Act (1991)	Establishes procedures to avoid unwanted telephone solicitations; prohibits marketers from using an automated telephone dialing system or an artificial or prerecorded voice to certain telephone lines

Table 4.2 Major Federal Legislation (*continued*)

Act (Date Enacted)	Purpose
Federal Trademark Dilution Act (1995)	Provides trademark owners the right to protect trademarks and requires relinquishment of names that match or parallel existing trademarks
Digital Millennium Copyright Act (1998)	Refined copyright laws to protect digital versions of copyrighted materials, including music and movies
Children's Online Privacy Act (2000)	Regulates the collection of personally identifiable information (name, address, email address, hobbies, interests, or information collected through cookies) online from children under age thirteen
Sarbanes-Oxley Act (2002)	Requires corporations to take responsibility to provide principles-based ethical leadership and holds CEOs and CFOs personally accountable for the credibility and accuracy of their company's financial statements
Emergency Economic Stabilization Act (2008)	Responded to the subprime mortgage crisis by creating the Troubled Assets Recovery Program (TARP), a program that authorized the U.S. Treasury to spend up to $700 billion to purchase troubled assets like mortgage-backed securities
Housing and Economic Recovery Act (2008)	A program lasting until 2011 that offers government insurance to lenders who volunteer to reduce their mortgages by at least 90 percent of the market's current value

Sources: "What Is the Troubled Asset Relief Program," *About.com: US Politics,* http://uspolitics.about.com/od/20072008/a/2008_TARP.htm, accessed July 3, 2009; "Housing and Economic Recovery Act of 2008 FAQ," *U.S. Department of Housing and Urban Development*, August 5, 2008, http://www.hud.gov/news/recoveryactfaq.cfm, accessed July 3, 2009.

The Sherman Antitrust Act applies to all firms operating in interstate commerce as well as to U.S. firms engaged in foreign commerce. The law has been used to break up some of the most powerful companies in the United States, including the Standard Oil Company (1911), the American Tobacco Company (1911), and AT&T (1984). There was also an attempt to break up Microsoft. In the Microsoft case, a U.S. district court judge ruled that the software giant inhibited competition by using unlawful tactics to protect its Windows monopoly in computer operating systems and by illegally expanding its dominance into the market for Internet Web-browsing software. In ordering that the company be split into two independent firms, Judge Thomas Penfield Jackson said that Microsoft had placed "an oppressive thumb on the scale of competitive fortune" by targeting competitors that threatened its Windows software monopoly. However, the ruling to break up Microsoft was appealed, and the order by Judge Jackson was overturned. The Supreme Court refused to hear an appeal by Microsoft that other aspects of its conviction should be overturned. Microsoft agreed to adhere to a consent decree, where it would comply with stricter remedies to prevent noncompetitive business practices through 2010. The Sherman Act remains the primary source of antitrust law in the United States, although it has been supplemented by several amendments and additional legislation.

Clayton Antitrust Act Because the provisions of the Sherman Antitrust Act were vague, the courts have interpreted the law in different ways. To rectify this situation, Congress enacted the Clayton Antitrust Act in 1914 to limit mergers and acquisitions that have the potential to stifle competition.[23] The Clayton Act

also specifically prohibits price discrimination, tying agreements (when a supplier furnishes a product to a buyer with the stipulation that the buyer must purchase other products as well), exclusive agreements (when a supplier forbids an intermediary to carry products of competing manufacturers), and the acquisition of stock in another corporation where the effect may be to substantially lessen competition or tend to create a monopoly. In addition, the Clayton Act prohibits members of one company's board of directors from holding seats on the boards of competing corporations. The law also exempts farm corporations and labor organizations from antitrust laws.

Federal Trade Commission Act In the same year the Clayton Act was passed, Congress also enacted the Federal Trade Commission Act to further strengthen the antitrust provisions of the Sherman Act. Unlike the Clayton Act, which prohibits specific practices, the Federal Trade Commission Act more broadly prohibits unfair methods of competition. More significantly, this law created the Federal Trade Commission (FTC) to protect consumers and businesses from unfair competition. Of all the federal regulatory agencies, the FTC has the greatest influence on business activities.

When the FTC receives a complaint about a business or finds reason to believe that a company is engaging in illegal conduct, it issues a formal complaint stating that the firm is in violation of the law. If the company continues the unlawful practice, the FTC can issue a cease-and-desist order, which requires the offender to stop the specified behavior. For example, Stanley Works, a maker of tools and equipment, was ordered to cease advertising practices that the FTC deemed as misleading with respect to the origin of its products. Stanley was accused of misrepresenting the foreign origin of some of its products. Several years later, the FTC relaunched its probe of Stanley Works and found that the company was not fully compliant with the cease-and-desist order. At this point, Stanley agreed to pay a $205,000 civil penalty for failing to provide accurate country-of-origin information on product labels.[24]

"In response to the 2008–2009 financial crisis, administrative leaders have proposed sweeping reforms to increase consumer protection."

Thus, although a firm can appeal to the federal courts to have the order rescinded, the FTC can seek civil penalties in court, up to a maximum penalty of $10,000 a day for each infraction, if a cease-and-desist order is ignored. The commission can also require businesses to air corrective advertising to counter previous ads the commission considers misleading. For example, the maker of Doan's pills was required by the FTC to run corrective advertising to counter its unproven claim that its product is more effective than other pain relievers at alleviating back pain.[25]

In addition, the FTC helps to resolve disputes and makes rulings on business decisions,

especially in emerging areas such as Internet privacy. For example, the commission approved a settlement that would permit the bankrupt Internet retailer Toysmart.com to sell its customer list as long as the buyer of the list agrees to abide by Toysmart's privacy guarantees.[26] In this case, the FTC helped to reinforce corporate guarantees of consumer privacy on the Internet.

Proposed Financial Reforms In response to the 2008–2009 financial crisis, administrative leaders have proposed sweeping reforms to increase consumer protection. This proposed legislation would be a step away from the deregulation practices of the last several decades, instead giving government a freer hand in regulating the financial industry. The Obama administration proposes giving the Federal Reserve more power over the financial industry and establishing a new Consumer Financial Protection Agency that would help to regulate banks and other financial institutions. More specifically, the agency would monitor financial instruments like subprime mortgages and other high-risk lending practices. Part of the problems leading up to the financial crisis included inaction on the part of federal regulators to protect consumers from fraud and predatory lending practices, lack of responsibility on the part of mortgage brokers taking large risks, conflicts of interest among credit rating industries, and complex financial instruments that investors did not understand.

To prevent these problems from leading to future financial crises, the current administration proposes legislation that would include the following reforms among others: removing some of the FTC's powers and other regulators and creating a Consumer Financial Protection Agency; creating a Financial Services Oversight Council to identify and address key risks to the financial industry; establishing a new National Bank Supervisor to oversee federally chartered lenders; requiring loan bundlers to retain a percentage of what they sell (a proposal also being considered by the EU); new powers for the Securities and Exchange Commission to monitor credit rating industries for objectivity; and requiring complex financial instruments to be traded on a regulated exchange.

The administration believes major changes in the regulatory system are needed. Republicans and other industry groups are against such extensive regulation, fearing that the government would assume too much control over the financial industry and threaten the free market system. Instead, they call for better regulation over more regulation, including holding current regulators and financial institutions more accountable for their actions. Whatever the outcome, one thing is generally agreed upon: reforms of the financial industry are needed to prevent future financial crises.[27]

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U.S. Treasury Secretary Timothy Geithner shares his vision for reshaping financial regulation with the Senate Banking Committee

Enforcement of the Laws Because violations of the Sherman Antitrust Act are felony crimes, the Antitrust Division of the U.S. Department of Justice enforces the act. The FTC enforces antitrust regulations of a civil, rather than criminal, nature. There are many additional federal regulatory agencies (see Table 4.3) that oversee the enforcement of other laws and regulations. Most states also have regulatory agencies that make and enforce laws for individuals and businesses. In recent years, cooperation among state attorneys general, regulatory agencies, and the federal government has increased, particularly in efforts related to the control of drugs, organized crime, and pollution.

The 2008–2009 financial meltdown revealed the need for better enforcement of the financial industry. Institutions took advantage of loopholes in the regulation system to make quick profits. For example, some adjustable mortgage rates offered low "teaser" rates that did not even cover the monthly interest on loans. This ended up increasing the principal balances on mortgages, resulting in debt that many consumers could not pay off. Unethical actions such as these led to the financial crisis. However, since these institutions were not as carefully monitored as other institutions, such as banks, regulators did not catch them until it was too late.[28] Part of the plan is to create a single bank regulator to oversee financial standards, and to establish the Consumer Financial Protection Agency to standardize options for consumer loans. New enforcement aims to require brokers to display a greater fiduciary duty to their clients, requiring them to put their clients' interests above their own and eliminating any conflicts of interest. This could cause them to offer products that are less costly and more tax-efficient for consumers over encouraging products that would benefit their companies at consumers' expense.[29]

In addition to enforcing stricter regulations for financial institutions, the Obama administration also wants to take steps to protect consumers. The Obama administration will encourage consumers to manage credit cards, savings, and mortgages more carefully; provide cardholders with warnings about how long it will take to pay off their debt if they only pay the minimum on their credit cards each month; and possibly prevent certain credit card issuers from offering credit cards to people under the age of twenty-one. Other proposed laws are more controversial. For instance, one plan includes a proposal requiring employers that do not offer retirement savings accounts to automatically enroll workers into individual retirement accounts. Employers would pay for this by taking deposits from employees' paychecks. Another plan proposes sending tax refunds directly into taxpayers' savings accounts instead of sending taxpayers checks in the mail. Although consumers could choose to opt out of these new approaches, opponents have said these proposed changes would create a more authoritarian government and leave room for governmental errors.[30]

In addition to enforcement by state and federal authorities, lawsuits by private citizens, competitors, and special-interest groups are used to enforce legal and regulatory policy. Through private civil actions, an individual or organization can file a lawsuit related to issues such as antitrust, price fixing, or unfair advertising. An organization can even ask for assistance from a federal agency to address a concern. For example, American Express gained the assistance of the Department of Justice's Antitrust Division in accusing Visa and MasterCard

Table 4.3 Federal Regulatory Agencies

Agency (Date Established)	Major Areas Of Responsibility
Food and Drug Administration (1906)	Enforces laws and regulations to prevent distribution of adulterated or misbranded foods, drugs, medical devices, cosmetics, veterinary products, and potentially hazardous consumer products
Federal Reserve Board (1913)	Regulates banking institutions; protects the credit rights of consumers; maintains the stability of the financial system; conducts the nation's monetary policy; and serves as the nation's central bank
Federal Trade Commission (1914)	Enforces laws and guidelines regarding business practices; takes action to stop false and deceptive advertising and labeling
Federal Deposit Insurance Corporation (1933)	Insures deposits in banks and thrift institutions for at least $250,000; identifies and monitors risks related to deposit insurance funds; and limits the economic effects when banks or thrift institutions fail
Federal Communications Commission (1934)	Regulates communication by wire, radio, and television in interstate and foreign commerce
Securities and Exchange Commission (1934)	Regulates the offering and trading of securities, including stocks and bonds
National Labor Relations Board (1935)	Enforces the National Labor Relations Act; investigates and rectifies unfair labor practices by employers and unions
Equal Employment Opportunity Commission (1970)	Promotes equal opportunity in employment through administrative and judicial enforcement of civil rights laws and through education and technical assistance
Environmental Protection Agency (1970)	Develops and enforces environmental protection standards and conducts research into the adverse effects of pollution
Occupational Safety and Health Administration (1971)	Enforces the Occupational Safety and Health Act and other workplace health and safety laws and regulations; makes surprise inspections of facilities to ensure safe workplaces
Consumer Product Safety Commission (1972)	Ensures compliance with the Consumer Product Safety Act; protects the public from unreasonable risk of injury from any consumer product not covered by other regulatory agencies
Commodity Futures Trading Commission (1974)	Regulates commodity futures and options markets; protects market users from fraud and abusive trading practices
Federal Housing Finance Industry (2008)	Combined the agencies of the Office of the Federal Housing Enterprise Oversight, the Federal Housing Finance Board, and the GSE mission office of the Department of Housing and Urban Development to oversee the country's secondary mortgage markets including Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

of antitrust violations.[31] Visa eventually agreed to settle the antitrust lawsuit by settling with American Express for $2.25 billion.[32]

In 2009, antitrust regulators also began investigating Google's intentions to scan millions of books and book titles into an online database. Recently, the company settled a copyright lawsuit with book publishers for $125 million. This settlement could allow Google to make millions of out-of-print books available online. Antitrust regulators are concerned that allowing one company to have rights to millions of books would give it too much power in the marketplace.[33]

Global Regulation

The twentieth century brought a number of regional trade agreements that decreased the barriers to international trade. NAFTA and the EU are two of these agreements that were formed with the intention of enhancing regional competitiveness and decreasing inequalities. The North American Free Trade Agreement (NAFTA), which eliminates virtually all tariffs on goods produced and traded between the United States, Canada, and Mexico, makes it easier for businesses of each country to invest in the other member countries. The agreement also provides some coordination of legal standards governing business transactions among the three countries. NAFTA promotes cooperation among various regulatory agencies to encourage effective law enforcement in the free trade area. Within the framework of NAFTA, the United States and Canada have developed many agreements to enforce each other's antitrust laws. The agreement provides for cooperation in investigations, including requests for information and the opportunity to visit the territory of the other nation in the course of conducting investigations.

The European Union (EU) was established in 1958 to promote free trade among its members and now includes twenty-seven European nations, with more expected to be admitted in coming years.[34] To facilitate trade among its members, the EU standardized business laws and trade barriers, to eliminate customs checks among its members, and introduced the Euro as a standard currency. Moreover, the Commission of the European Communities has entered into an agreement with the United States, similar to NAFTA, regarding joint antitrust laws. The European Union is in favor of tighter financial-market regulation in the wake of the financial crisis. Among the proposals is one by the European Commission establishing new regulatory bodies to oversee the bloc's financial industries. EU countries like France and Germany support such legislation, but the United Kingdom and some eastern European countries oppose a European financial body that would monitor individual financial firms in different countries. Some are concerned that were such a financial body to fail it could doom the entire EU. The UK does not want individual taxpayers to bear the brunt of a bank failure from another country.[35]

A company that engages in commerce beyond its own country's borders must contend with the potentially complex relationship among the laws of its own nation, international laws, and the laws of the nation in which it will be trading, as well as various trade restrictions imposed on international trade. International business activities are affected to varying degrees by each nation's laws, regulatory agencies, courts, the political environment, and special-interest groups. The European Union, for example, has been tough on large businesses, leaving some critics in the

United States to call the EU anticompetitive and anti-innovative. After the 2008–2009 financial crisis, which hit the EU hard, the European Commission has taken a tough stance on risk takers in the financial industry. These standards could place U.S. financial firms at a disadvantage, critics allege, preventing them from selling securities on the European market because of the differences in national legislation. A plan proposed by the European Parliament forces financial firms to maintain a 5 percent stake in asset-backed securities. Financial companies outside the European Union that have agencies to monitor major insurance industries may be exempt from the new rules, but U.S. insurers fear that the United States does not qualify. If not, U.S. firms could be penalized.[36]

These examples demonstrate how companies can experience major barriers when doing business in foreign countries. In addition to stricter regulations, countries can also establish import barriers, including tariffs, quotas, minimum price levels, and port-of-entry taxes that affect the importation of products. Other laws govern product quality and safety, distribution methods, and sales and advertising practices.

Although there is considerable variation and focus among different nations' laws, many countries have laws that are quite similar to those in the United States. Indeed, the Sherman Act has been copied throughout the world as the basis for regulating fair competition. Antitrust issues, such as price fixing and market allocation, have become a major area of international cooperation in the regulation of business.[37] Table 4.4 provides a list of situations and signs that antitrust may become a concern.

Table 4.4 Signs of Possible Antitrust Violation

• any evidence that two or more competing sellers of similar products have agreed to price their products a certain way, to sell only a certain amount of their product, or to sell only in certain areas or to certain customers
• large price changes involving more than one seller of very similar products of different brands, particularly if the price changes are of an equal amount and occur at about the same time
• suspicious statements from a seller suggesting that only one firm can sell to a particular customer or type of customer
• fewer competitors than normal submit bids on a project
• competitors submit identical bids
• the same company repeatedly has been the low bidder on contracts for a certain product or service or in a particular area
• bidders seem to win bids on a fixed rotation
• there is an unusual and unexplainable large dollar difference between the winning bid and all other bids
• the same bidder bids substantially higher on some bids than on others, and there is no logical cost reason to explain the difference

Source: U.S. Department of Justice, "Antitrust Enforcement and the Consumer," http://www.usdoj.gov/atr/public/div_stats/211491.pdf, accessed July 4, 2009.

Costs and Benefits of Regulation

Costs of Regulation Regulation results in numerous costs for businesses, consumers, and society at large. Although many experts have attempted to quantify these costs, it is quite difficult to find an accurate measurement tool. To generate such measurements, economists often classify regulations as economic (applicable to specific industries or businesses) or social (broad regulations pertaining to health, safety, and the environment). One yardstick for the direct costs of regulation is the administrative spending patterns of federal regulatory agencies. The 2009 estimated cost of regulatory activities was over $51 billion, which was up from $48 billion on 2008, $39.5 billion in 2005, and around $3 billion in 1960. Many people in the business world and beyond are concerned about the upward trajectory of regulatory costs. Another way to measure the direct cost of regulation is to look at the staffing levels of federal regulatory agencies. The expenditures and staffing of state and local regulatory agencies also generate direct costs to society. Federal regulatory agency jobs have been on the rise in recent years, to 263,989 full-time jobs in 2009.[38]

Still another way to approach the measurement of the costs of regulation is to consider the burden that businesses incur in complying with regulations. Various federal regulations, for example, may require companies to change their manufacturing processes or facilities (e.g., smokestack "scrubbers" to clean air and wheelchair ramps to make facilities accessible to customers and employees with disabilities). Companies also must keep records to document their compliance and to obtain permits to implement plans that fall under the scope of specific regulatory agencies. Again, state regulatory agencies often add costs to this burden. Regulated firms may also spend large amounts of money and other resources to prevent additional legislation and to appear responsible. Of course, businesses generally pass these regulatory costs on to their consumers in the form of higher prices, a cost that some label a "hidden tax" of government. Additionally, some businesses contend that the financial and time costs of complying with regulations stifle their ability to develop new products and make investments in facilities and equipment. Moreover, society must pay for the cost of staffing and operating regulatory agencies, and these costs may be reflected in federal income taxes. Table 4.5 describes the primary drivers to the cost of regulation, including those associated with administering, enforcing, and complying with the regulation.

Table 4. 5 Cost of Regulation

Type of Cost	Description
Administration and enforcement	Expenditures by government to develop and administer regulatory requirements, including the salaries of government workers, hiring inspectors, purchasing office supplies, and other overhead expenses
Compliance	Expenditures by organizations, both private and public, to meet regulatory requirements, such as hiring personnel, training employees, and monitoring compliance

Benefits of Regulation

Despite business complaints about the costs of regulation, it provides many benefits to business, consumers, and society as a whole. These benefits include greater equality in the workplace, safer workplaces, resources for disadvantaged members of society, safer products, more information about and greater choices among products, cleaner air and water, and the preservation of wildlife habitats to ensure that future generations can enjoy their beauty and diversity.

Companies that fail to respond to consumer desires or that employ inefficient processes are often forced out of the marketplace by more efficient and effective firms. Truly competitive markets also spur companies to invest in researching and developing product innovations as well as new, more efficient methods of production. These innovations benefit consumers through lower prices and improved goods and services. For example, companies such as Apple, IBM, and Dell Computer continue to engineer smaller, faster, and more powerful computers that help individuals and businesses to be more productive.

Regulatory Reform Many businesses and individuals believe that the costs of regulation outweigh its benefits. They argue that removing regulation will allow Adam Smith's "invisible hand of competition" to more effectively and efficiently dictate business conduct. Some people desire complete **deregulation,** or removal of all regulatory authority. Proponents of deregulation believe that less government intervention allows business markets to work more effectively. For example, many businesses want their industries deregulated to decrease their costs of doing business. Many industries have been deregulated to a certain extent since the 1980s, including trucking, airlines, telecommunications (long-distance telephone and cable television), and more recently, electric utilities. In many cases, this deregulation has resulted in lower prices for consumers as well as in greater product choice.

However, the onset of the 2008–2009 crisis has slowed the call for deregulation. After the economy plummeted, the United States and other countries around the world saw the need for greater regulation, particularly of the financial industry, and began to reverse the deregulatory trend of the previous two or three decades. Although the economic crisis stemmed from a variety of factors, many perceived that much of it stemmed from lack of appropriate governmental oversight and a dearth of ethical leadership in businesses. However, governments' reactions have many fearing that governments will assume too much control. There has always been considerable debate on the relative merits and costs of regulation, and these new changes resulting from the worst financial crisis since the Great Depression are not likely to lessen this controversy.

Self-Regulation Many companies attempt to regulate themselves in an effort to demonstrate social responsibility, to signal responsibility to stakeholders, and to preclude further regulation by federal or state government. Often these firms choose to join trade associations that have self-regulatory programs, many of which were established as a preventative measure to stop or delay the development of laws and regulations that would restrict the associations' business practices. Some trade associations establish codes of conduct by which their members must

deregulation
removal of all regulatory authority

"Many companies attempt to regulate themselves in an effort to demonstrate social responsibility, to signal responsibility to stakeholders, and to preclude further regulation by federal or state government."

abide or risk discipline or expulsion from the association.

Perhaps the best-known self-regulatory association is the Better Business Bureau (BBB), an organization supported by member businesses around the country. Founded in 1912, today there are more than 125 bureaus in the United States and Canada. The bureaus currently oversee more than 3 million local and national businesses and charities and resolve problems for millions of consumers and businesses each year.[39] Each bureau also works to champion good business practices within a community, although it usually does not have strong tools for enforcing its business conduct rules. When a company violates what the BBB believes to be good business practices, the bureau warns consumers through local newspapers or broadcast media.

If the offending organization is a member of the BBB, it may be expelled from the local bureau. For example, the membership of Priceline.com was revoked by a Connecticut Better Business Bureau after the online retailer failed to address numerous complaints related to misrepresentation of products, failure to provide promised refunds, and failure to correct billing problems.[40]

Self-regulatory programs like the Better Business Bureau have a number of advantages over government regulation. Establishment and implementation of such programs are usually less costly, and their guidelines or codes of conduct are generally more practical and realistic. Furthermore, effective self-regulatory programs reduce the need to expand government bureaucracy. However, self-regulation also has several limitations. Nonmember firms are under no obligation to abide by a trade association's industry guidelines or codes. Moreover, most associations lack the tools or authority to enforce their guidelines. Finally, these guidelines are often less strict than the regulations established by government agencies.

BUSINESS'S INFLUENCE ON GOVERNMENT AND POLITICS

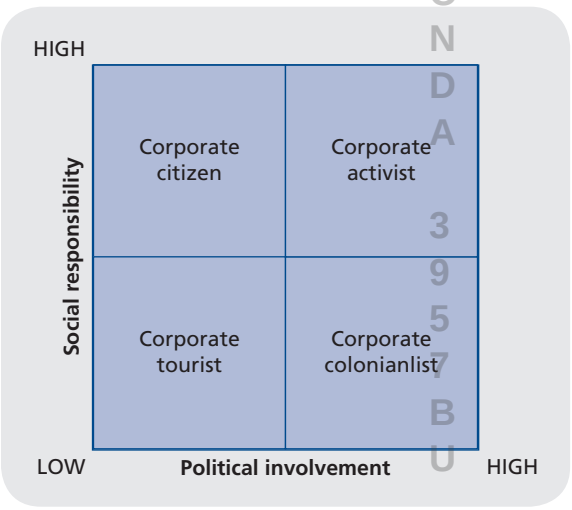
Although the government has a profound effect on business activities, especially through its regulatory actions, business has an equal influence on government, and that influence has grown in recent years as multinationals grow in size and resources. Managing this relationship with government officials while

navigating the dynamic world of politics is a major challenge for firms, both large and small. In our pluralistic society, many participants are involved in the political process, and the economic stakes are high. Because government is a stakeholder of business (and vice versa), businesses and government can work together as both legitimately participate in the political process. For example, the SAFE-BioPharma Association was established by a group of international biopharmaceutical companies and is working with the FDA to create a secure means of conducting business and transferring information electronically for the pharmaceutical industry. The goal of the association is to transform the biopharmaceutical and health-care industries to a completely electronic business environment by 2012. The SAFE-BioPharma Association has worked to develop pilot programs for using digital signatures in the hopes of attaining a fully electronic environment.[41]

Obviously, many people believe that businesses should not be allowed to influence government because of their size, resources, and vested interests. Business participation can either be direct or indirect, positive or negative for society's interest depending not only on the outcome but also on the perspective of various stakeholders.

Figure 4.1 describes four approaches to the relationship between social responsibility and political involvement by companies. Firms with a high level of social responsibility and political involvement are considered corporate activists because they take political actions that may be seen as positive or negative by stakeholder groups. For example, Shell was accused of being anti-activist after the company refused to intervene with the Nigerian government on the execution of the nine leaders of MOSOP, Movement for the Survival of the Ogoni People. Although Shell wrote to government officials asking for human treatment of the MOSOP leaders, the company maintained a policy against involvement in domestic politics.

Figure 4.1 Social Responsibility and Political Involvement



Source: Daniel Malan, "Corporate Citizens, Colonialists, Tourists or Activists? Ethical Challenges Facing South African Corporations in Africa," *Journal of Corporate Citizenship* 18 (Summer 2005): 49–60.

On the other hand, firms that are relatively weak in terms of social responsibility and political involvement may be called corporate tourists. This label implies that, much like tourists, these companies are relatively uninvolved on a social or political level and are able to exit with ease and a low level of consequence.

Good corporate citizens strive for strategic social responsibility but are not overly involved in the political climate of an area or country. In this regard, corporate citizens are focused on the four levels of social responsibility without resorting to aggressive activity in the political and governmental arena. This type of company would consider the needs of primary and secondary stakeholders without granting special privilege or resources to political stakeholders. Finally, firms with low levels of social responsibility but high levels of political interest are considered corporate colonialists. These companies are typically focused on obtaining competitive and economic power, even if it is detrimental to the local culture, environment, economy, or other social element. One example is the British South Africa Company, which was formed with the consent of the British government. The company had its own police force and flew a flag with the motto, "Justice, Commerce, Freedom." The company's founder, Cecil John Rhodes, stated that "Africa awaits us still, and it is our duty to seize every opportunity of acquiring more territory and we should keep this one idea steadily before our eyes. . . ."[42] Before we look at specific tactics businesses use to influence government policy, it is useful to briefly examine the current political environment to understand how business influence has grown.

The Contemporary Political Environment

Beginning in the 1960s, a significant "antiestablishment" public that was growing more hostile to business mounted protests to effect reform. Their increasingly vocal efforts spurred a fifteen-year wave of legislation and regulation to address a number of issues of the day, including product safety, employment discrimination, human rights, energy shortages, environmental degradation, and scandals related to bribery and payoffs. During the Republican-dominated 1980s, the pendulum swung back in favor of business. During the 1990s, economic prosperity driven by technological advances encouraged both the Republican and Democratic Parties to encourage the self-regulation of business while protecting competition and the natural environment. President George W. Bush continued these policies through 2008, with continued self-regulation of industries and the rolling back of environmental laws that businesses deemed detrimental. However, 2009 and the election of President Barack Obama has marked a change back toward more regulation. The onset of the financial crisis created an even greater need for stricter legislation under the Obama administration, such as the Troubled Assets Recovery Program (TARP) that authorized the U.S. Treasury to purchase up to $700 billion of troubled assets like mortgage-backed securities. It has also resulted in support for entirely new regulation and regulatory agencies like President Obama's proposal for a new Consumer Financial Protection Agency. These new regulations will have wide-sweeping effects over the financial industry. Other organizations such as the Environmental Protection Agency and the Food and Drug Administration also began to regulate with the aim of protecting stakeholders with renewed vigor beginning in 2009.

Such changes in the political environment over the last fifty years shaped the political environment in which businesses operate and created new avenues for businesses to participate in the political process. Among the most significant factors shaping the political environment were changes in Congress and the rise of special-interest groups. As the current administration seeks to revive and increase oversight of the finance industry, more companies will hire lobbyists to campaign on behalf of their interests in Washington.

Changes in Congress Among the calls for social reform in the 1960s were pressures for changes within the legislative process of the U.S. Congress itself. Bowing to this pressure, Congress enacted an amendment to the Legislative Reorganization Act in 1970, which ushered in a new era of change for the political process. This legislation significantly revamped the procedures of congressional committees, most notably stripping committee chairpersons of much of their power, equalizing committee and chair assignments, and requiring committees to record and publish all roll-call votes taken in committee. By opening up the committee process to public scrutiny and reducing the power of senior members and committee leaders, the act reduced the level of secrecy surrounding the legislative process and effectively brought an end to an era of autonomous committee chairs and senior members.[43]

Another significant change occurred in 1974 when Congress amended the Federal Election Campaign Act to limit contributions from individuals, political parties, and special-interest groups organized to get specific candidates elected or policies enacted.[44] Around the same time, many states began to shift their electoral process from the traditional party caucus to primary elections, further eroding the influence of the party in the political process. These changes ultimately had the effect of reducing the importance of political parties by decreasing members' dependence on their parties. Many candidates for elected offices began to turn to special-interest groups to raise enough funds to mount serious campaigns and reelection bids.

In 2002, Congress passed the Bipartisan Campaign Reform Act (BRCA), sponsored by Senators John McCain and Russell Feingold. This new act limited the amount of contributions parties could donate to political campaigns and it implemented rules for how corporate and labor treasury funds could be used in federal elections. The act also forbade national party committees from raising or spending unregulated funds. Though the act outraged certain legislators, who appealed to the Supreme Court over its constitutionality, the Supreme Court upheld the act.[45]

Rise of Special-Interest Groups The success of activists' efforts in the 1960s and 1970s marked the rise of special-interest groups. The movements to promote African-American and women's rights and to protest the Vietnam War and environmental degradation evolved into well-organized groups working to educate the public about significant social issues and to crusade for legislation and regulation of business conduct they deemed irresponsible. These progressive groups were soon joined on Capitol Hill by more conservative groups working to further their agendas on issues such as business deregulation, restriction of abortion

and gun control, and promotion of prayer in schools. Businesses joined in by forming industry and trade associations. These increasingly powerful special-interest groups now focused on getting candidates elected who could further their own political agendas. Common Cause, for example, is a nonprofit, nonpartisan organization working to fight corrupt government and special interests backed by large sums of money. Since 1970, Common Cause, with more than 200,000 members, has campaigned for greater openness and accountability in government. Some of its self-proclaimed "victories" include reform of presidential campaign finances, tax systems, congressional ethics, open meeting standards, and disclosure requirements for lobbyists. Table 4.6 lists the dates and subject matter of Common Cause's major accomplishments over the past three decades.

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Corporate Approaches to Influencing Government

Although some businesses view regulatory and legal forces as beyond their control and simply react to conditions arising from those forces, other firms actively seek to influence the political process to achieve their goals. In some cases, companies publicly protest the actions of legislative bodies. More often, companies work for the election of political candidates who regard them positively. Lobbying, political action committees, and campaign contributions are some of the tools businesses employ to influence the political process.

"Lobbying, political action committees, and campaign contributions are some of the tools businesses employ to influence the political process."

Lobbying Among the most powerful tactics business can employ to participate in public policy decisions is direct representation through full-time staff who communicate with elected officials. **Lobbying** is the process of working to persuade public and/or government officials to favor a particular position in decision making. Organizations may lobby officials either directly or by combining their efforts with other organizations.

Many companies concerned about the threat of legislation or regulation that may negatively affect their operations employ lobbyists to communicate their concerns to officials on their behalf. Microsoft, for example, had a Washington office with a staff of fourteen lobbyists and spent $4.6 million to persuade federal officials that breaking up the company for antitrust violations would harm the computer industry and U.S. economy.[46] The company's efforts were successful. However, its lobbyists wield less power internationally and therefore have not been as helpful in fighting its antitrust allegations in the EU.

The financial industry has long employed lobbyists to push for increased deregulation so that it can pursue riskier and more profitable avenues, but under a Democratically-controlled congress, financial industry lobbyists will be working harder than usual. The current administration plans to change compensation practices among bank employees. In the past few years, bank officials have often been awarded for the quantity of business they do, rather than the quality, which encouraged employees to engage in riskier business practices to increase their compensation packages. The administration wants to change bank compensation packages to award a "best practices" pay structure and limit the amount of bonuses top bank officials can receive. Additionally, new Treasury laws would also force banks to better inform borrowers about the costs of certain loans, create greater supervision of bank practices, and even establish a capital surcharge for certain banks. Banks are expected to fight these potential financial reforms through discreet lobbying and industry groups.[47]

Companies may attempt to influence the legislative or regulatory process more indirectly through trade associations and umbrella organizations that represent

lobbying
the process of working to persuade public and/or government officials to favor a particular position in decision making

© Larry Downing/Reuters/Landov

Organizations such as the Pet Food Initiative attempt to protect consumers and in this case testify before a Senate subcommittee on recent pet food recalls

collective business interests of many firms. Virtually every industry has one or more trade associations that represent the interests of their members to federal officials and provide public education and other services for their members. Examples of such trade associations include the National Association of Home Builders, the Tobacco Institute, the American Book-sellers Association, and the Pet Food Institute. Additionally, there are often state trade associations, such as the Hawaii Coffee Association and the Michigan Beer and Wine Wholesalers Association, which work on state- and regional-level issues. Umbrella organizations such as the National Federation of Independent Businesses and the U.S. Chamber of Commerce also help promote business interests to government officials. The U.S. Chamber of Commerce takes positions on many political, regulatory, and economic questions. With more than 200,000 member companies, its goal is to promote its members' views of the ideal free enterprise marketplace.

The cozy relationship between corporations and the government has been a growing concern for years, and was a topic of serious discussion after the 2008–2009 financial industry meltdown. For example, more than one-quarter of the forty-eight members of the House Energy and Commerce Committee own stock in energy, oil, and natural gas companies. Some citizens are concerned that these investments could create a conflict of interest among legislators, as they are at the forefront of climate-change legislation. However, House and Senate ethics do not forbid Congress from having a stake in companies unless they pass a law that would benefit only their own interests.[48]

Political Action Committees Companies can also influence the political process through political action committees. **Political action committees (PACs)** are organizations that solicit donations from individuals and then contribute these funds to candidates running for political office. Companies are barred by federal law from donating directly to candidates for federal offices or to political action committees, and individuals are limited to relatively small donations. However, companies can organize PACs to which their executives, employees, and stockholders can make significant donations as individuals. PACs operate independently of business and are usually incorporated. Labor unions and other special-interest groups, such as teachers and medical doctors, can also establish PACs to promote their goals.

political action committees (PACs) organizations that solicit donations from individuals and then contribute these funds to candidates running for political office

The Federal Election Committee has rules to restrict PAC donations to $5,000 per candidate for each election. However, many PACs exploit loopholes

in these regulations by donating so-called soft money to political parties that do not support a specific candidate for federal office. Under current rules, these contributors can make unlimited donations to political parties for general activities. Even though President Obama refused contributions from PACs during his presidential campaign, a USA Today analysis revealed that 175 members of Congress received at least half of their campaign funds from PACs that year. This amounted to a record $416 million on the federal election. The PAC of the National Association of Realtors alone contributed $4.8 million to the election.[49]

Campaign Contributions Although federal laws restrict direct corporate contributions to election campaigns, corporate money may be channeled into candidates' campaign coffers as corporate executives' or stockholders' personal contributions. Such donations can violate the spirit of corporate campaign laws. A sizable contribution to a candidate may carry with it an implied understanding that the elected official will perform some favor, such as voting in accordance with the contributor's desire on a particular law. Occasionally, some businesses find it so important to ensure favorable treatment that they make illegal corporate contributions to campaign funds. For example, Californian Gladwin Gill admitted to making illegal corporate campaign contributions. He convinced numerous employees and friends to give him funds for campaign contributions, which he put under their names. In exchange, he paid them out-of-pocket or from corporate funds. In total, Gill made approximately $67,000 in illegal contributions to political campaigns between 2003 and 2005.[50]

Although laws limit corporate contributions to specific candidates, it is acceptable for businesses and other organizations to make donations to political parties. Table 4.7 lists selected industry sectors and their contributions to political parties.

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Gatekeepers Provide Oversight for Accountability in the Financial Industry

Gatekeepers are types of "watchdogs" that make sure that certain organizations are behaving ethically toward stakeholders. Dr. John Coffee from Columbia University calls them "intermediaries who provide verification and certification of services to investors." They are especially important in the financial industry. Financial gatekeepers include accountants, who are expected to disclose accurate financial information about companies. Unfortunately, some accountants, like the accounting firm Arthur Andersen, have failed to do so. Arthur Andersen was focused more on company growth than it was on accurate financial reporting. Thus, it looked the other way when faced with questionable accounting practices at Enron. Its negligence eventually led to its destruction. This emphasizes that gatekeepers must exhibit high ethical standards since they are in such an important position of financial trust.

Gatekeepers like Standard & Poor's assess the risks of companies and then express it through a lettering system. "AAA" is the highest rating, whereas "C" means it is a bad investment. In light of the financial crisis, investors must have confidence in financial-rating systems if they are to invest during this troubled time. Regulatory agencies like the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC) also act as gatekeepers. The FDIC guarantees the safety of checking and savings deposits in the bank. The SEC enforces securities laws and oversees financial markets. Both have received recent criticism. As a gatekeeper of banks, the FDIC did not discourage them from engaging in risky subprime mortgages. Additionally, the SEC had received tips that investor Bernie Madoff was operating an illegal scam since 1999, yet they did nothing. The scam lost investors an estimated $65 billion.

The mistakes of financial gatekeepers in this past decade demonstrate all the more need for efficient gatekeepers in this area. Gatekeepers are what cement the trust between stakeholders and financial organizations. However, critics have accused these risk assessors of giving good ratings to mortgage-backed debt, the debt which helped lead to the financial crisis. When homeowner defaults arose, the risk assessors were slow to lower their ratings. An investigation revealed that conflicts of interest may exist with these risk assessors, as some of their funds come from the very firms they rate. The Securities and Exchange Commission (SEC) found that risk assessors had been putting profits over quality when determining ratings for mortgage-backed securities. This scandal has led the SEC to reevaluate how risk assessors are regulated and consider changing the pay structure to eliminate this conflict of interest.[51]

THE GOVERNMENT'S APPROACH FOR LEGAL AND ETHICAL COMPLIANCE

Thus far, we have seen that, although legal and regulatory forces have a strong influence on business operations, businesses can also affect these forces through the political process. In addition, socially responsible firms strive to comply

with society's wishes for responsible conduct through legal and ethical behavior. Indeed, the most effective way for businesses to manage the legal and regulatory environment is to establish values and policies that communicate and reward appropriate conduct. Most employees will try to comply with an organization's leadership and directions for responsible conduct. Therefore, top management must develop and implement a highly visible strategy for effective compliance. This means that top managers must take responsibility and be accountable for assessing legal risks and developing corporate programs that promote acceptable conduct.

"Top managers must take responsibility and be accountable for assessing legal risks and developing corporate programs that promote acceptable conduct."

Federal Sentencing Guidelines for Organizations

More and more companies are establishing organizational compliance programs to ensure that they operate legally and responsibly, as well as to generate a competitive advantage based on a reputation for responsible citizenship. There are also strong legal incentives to establish such programs. The U.S. Sentencing Commission established the **Federal Sentencing Guidelines for Organizations (FSGO)** in 1991 not only to streamline the sentencing and punishment for organizational crimes but also to hold companies, as well as their employees, responsible for misconduct. Previously, the law punished only those employees responsible for an offense, not the company. Under the FSGO, if a court determines that a company's organizational culture rewarded or otherwise created opportunities that encouraged wrongdoing, the firm may be subject to stiff penalties in the event that one of its employees breaks the law. The guidelines apply to all felonies and Class A misdemeanors committed by employees in association with their work.

The assumption underlying the FSGO is that good, socially responsible organizations maintain compliance systems and internal governance controls that deter misconduct by their employees. Thus, the guidelines focus on crime prevention and detection by mitigating penalties for firms that have implemented such compliance programs in the event that one of their employees commits a crime. To avoid or limit fines and other penalties as a result of wrongdoing by an employee, the employer must be able to demonstrate that it has implemented a reasonable program for deterring and preventing unlawful behavior.

The U.S. Sentencing Commission has delineated seven steps that companies must implement to demonstrate the existence of an effective compliance effort and thereby avoid penalties in the event of an employee's wrongdoing. These steps, which are listed in Table 4.8, are based on the commission's determination to emphasize compliance programs and to provide guidance for both organizations and courts regarding program effectiveness. The steps help companies

Federal Sentencing Guidelines for Organizations (FSGO) established in 1991 to streamline the sentencing and punishment for organizational crimes and to hold companies, as well as their employees, responsible for misconduct

Table 4.8 Seven Steps to Effective Compliance and Ethics Programs

1. Establish codes of conduct (identify key risk areas).
2. Appoint or hire high-level compliance manager (ethics officer).
3. Take care in delegating authority (background checks on employees).
4. Institute a training program and communication system (ethics training).
5. Monitor and audit for misconduct (reporting mechanisms).
6. Enforce and discipline (management implementation of policy).
7. Revise program as needed (feedback and action).

Source: Adapted from Nick Ciancio, "The Seven Pillars of an Effective Ethics and Compliance Program," Health Care Compliance Association, http://www.globalcompliance.com/pdf/the-seven-pillars-of-an-effective-ethics-and-compliance-program.pdf, accessed July 7, 2009.

understand what is required of a compliance and ethics program that is capable of reducing employees' opportunities to engage in misconduct.

To cultivate an effective ethics and compliance program, an organization should first develop a code of conduct that communicates the standards it expects of its employees and identifies key risk areas for the firm. Next, oversight of the program should be assigned to high-ranking personnel in the organization (e.g., an ethics officer, a vice president of human resources, or a general counsel) who are recognized as individuals who abide by the legal and ethical standards of the industry. Authority should never be delegated to anyone with a known propensity to engage in misconduct. An effective compliance program also requires a meaningful communications system, often in the form of ethics training, to disseminate the company's standards and procedures. This system should provide for mechanisms, such as anonymous toll-free phone lines or company ombudsmen, through which employees can report wrongdoing without fear of retaliation. Monitoring and auditing systems designed to detect misconduct are also crucial ingredients for an effective compliance program. If a company does detect criminal behavior or other wrongdoing by an employee, it must take immediate, appropriate, and fair disciplinary action toward all individuals both directly and indirectly responsible for the offense. Finally, if a company discovers that a crime has occurred, it must take steps to prevent similar offenses in the future. This usually involves modifications to the compliance program, additional employee training, and communications about specific types of conduct. In 2007 and 2008, more responsibility was placed on the board and top management to create an ethical organizational culture. This clearly places the responsibility for ethics and compliance on top leadership.[52]

A Supreme Court decision held that the sentences for violations of law were not mandatory but should serve only as recommendations for judges to use in their decisions. Some legal and business experts believe that this decision might weaken the implementation of the FSGO, but most sentences have been in the same range as before the Supreme Court decision. The guidelines remain an important consideration in developing an effective ethics and compliance program.

Table 4.9 Institutionalization of Ethics Through the U.S. Sentencing Guidelines for Organizations

1991	*Law:* U.S. Sentencing Guidelines for Organizations created means for federal prosecutions of organizations. These guidelines provide for just punishment, adequate deterrence, and incentives for organizations to prevent, detect, and report misconduct. Organizations need to have an effective ethics and compliance program to receive incentives in the case of misconduct.
2004	*Amendments:* The definition of an effective ethics program now includes the development of an ethical organizational culture. Executives and board members must assume the responsibility of identifying areas of risk, provide ethics training, create reporting mechanisms, and designate an individual to oversee ethics programs.
2007–2008	*Additional definition of a compliance and ethics program:* Firms should focus on due diligence to detect and prevent misconduct and to promote an organizational culture that encourages ethical conduct. More details are provided encouraging the assessment of risk and appropriate steps to design, implement, and modify ethics programs and training to include all employees, top management, and the board or governing authority. These modifications continue to reinforce the importance of an ethical culture in preventing misconduct.

The most recent amendments to the FSGO extend the ethics training of individuals to members of the board or governing authority, high-level personnel, employees, and the organizations' agents, as illustrated by Table 4.9. This applies not only to oversight, but to mandatory training at all levels of the organization. Merely distributing a code of ethics does not meet the training requirements. The 2007 and 2008 amendments now require most governmental contractors to provide ethics and compliance training. As new FSGO amendments are implemented, more explicit responsibility is being placed on organizations to improve and expand ethics and compliance provisions to include all employees and board members.

A strong program acts as a buffer to keep employees from committing crimes and to protect a company's reputation should wrongdoing occur despite its best efforts. If a firm can demonstrate that is has truly made an effort to communicate to its employees about their legal and ethical responsibilities, the public's response to any wrongdoing may be reduced along with any corporate punishment the courts mete out for the offense. It is important to point out, however, that executives who focus on strict legal compliance are missing part of the picture when it comes to social responsibility. By developing a work environment that supports and expects ethical decision making, management can avoid the perilous situation where employees ask, "Is this legal?" Strong corporate values and ethical standards, which are consistent with and more restrictive than legal standards, should minimize the missteps that are likely to occur in a compliance-driven firm. An effective program must feature ethics and values as the driving force, as we shall see in the next few chapters.

Sarbanes-Oxley Act

During probes into financial reporting fraud at many of the world's largest companies, investigators learned that hundreds of public corporations were not reporting their financial results accurately. Accounting firms, lawyers,

top corporate officers, and boards of directors had developed a culture of deception to attempt to gain investor approval and competitive advantage. The downfall of many of these companies resulted in huge losses to thousands of investors, and employees even lost much of their savings from 401k accounts. The **Sarbanes-Oxley Act (SOX)** was enacted to restore stakeholder confidence and provide a new standard of ethical behavior for U.S. businesses in the wake of Enron and WorldCom in the early 2000s.

The act had almost unanimous support by Congress, government regulatory agencies, and the general public. When President Bush signed the act, he emphasized the need for the standards it provides, especially for top management and boards of directors responsible for company oversight. Table 4.10 details the requirements of the act.

Sarbanes-Oxley Act (SOX) legislation to protect investors by improving the accuracy and reliability of corporate disclosures

The section of SOX that has caused the most concern for companies has been compliance with section 404. Section 404 comprises three central issues: it requires that (1) management create reliable internal financial controls; (2) management attest to the reliability of those controls and the accuracy of financial statements that result from those controls; and (3) an independent auditor further attests to the statements made by management. Because the cost of compliance

Table 4.10 Major Provisions of the Sarbanes-Oxley Act

1. Requires the establishment of an Independent Accounting Oversight Board in charge of regulations administered by the Securities and Exchange Commission
2. Requires CEOs and CFOs to certify that their companies' financial statements are true and without misleading statements
3. Requires that corporate board of directors' audit committees consist of independent members with no material interests in the company
4. Prohibits corporations from making or offering loans to officers and board members
5. Requires codes of ethics for senior financial officers; codes must be registered with the SEC
6. Prohibits accounting firms from providing both auditing and consulting services to the same client
7. Requires company attorneys to report wrongdoing to top managers and, if necessary, to the board of directors; if managers and directors fail to respond to reports of wrongdoing, the attorney should stop representing the company
8. Mandates "whistle-blower protection" for persons who disclose wrongdoing to authorities
9. Requires financial securities analysts to certify that their recommendations are based on objective reports
10. Requires mutual fund managers to disclose how they vote shareholder proxies, giving investors information about how their shares influence decisions
11. Establishes a ten-year penalty for mail/wire fraud
12. Prohibits the two senior auditors from working on a corporation's account for more than five years; other auditors are prohibited from working on an account for more than seven years; in other words, accounting firms must rotate individual auditors from one account to another from time to time

is so high for many companies, some publicly traded companies have even considered de-listing themselves from the U.S. Stock Exchange.

Many company boards failed to provide the necessary oversight of the financial decisions of top officers and executives. This trend of fraud by top company officials contributed to the severity of the 2008–2009 financial crisis. Many top executives were charged with behaving in unethical and illegal ways. For example, the Securities and Exchange Commission (SEC) filed civil fraud and insider trading charges against Countrywide Financial CEO Angelo Mozilo, who was charged with misleading investors about the credit risks Countrywide was taking.[53] The Federal Bureau of Investigation (FBI) also investigated Fannie Mae, Freddie Mac, Lehman Brothers, and American International Group (AIG) for corporate fraud, either for misrepresenting their company's financial well-being or providing extensive compensation packages to company executives when the companies were in the midst of a financial meltdown.[54]

To address fraudulent occurrences such as these, SOX required the creation of the Public Company Accounting Oversight Board, which is supposed to provide oversight of the accounting firms that audit public companies and set standards and rules for the auditors in these firms. The board has investigatory and disciplinary power over accounting firm auditors and securities analysts who issue reports about companies. Specific duties include: (1) registration of public accounting firms; (2) establishment of auditing, quality control, ethics, independence, and other standards relating to preparation of audit reports; (3) inspection of accounting firms; (4) investigations, disciplinary proceedings, and imposition of sanctions; and (5) enforcement of compliance with accounting rules of the board, professionals standards, and securities laws relating to the preparation and issuance of audit reports and obligations and liabilities of accountants.

SOX requires corporations to take more responsibility and to provide principles-based ethical leadership. Enhanced financial disclosures are required, including certification by top officers that audit reports are complete and that nothing material has been withheld from auditors. For example, registered public accounting firms are now required to identify all material correcting adjustments to reflect accurate financial statements. Also, all material off-balance sheet transactions and other relationships with unconsolidated entities that affect current or future financial conditions of a public company must be disclosed in each annual and quarterly financial report. In addition, public companies must also report "on a rapid and current basis" material changes in the financial condition or operations.

SOX sought to hold CEOs and CFOs personally accountable for the credibility and accuracy of their company's financial statements—although the 2008–2009 financial meltdown revealed that even this legislation has loopholes. To prevent future misconduct like that displayed by accounting firm Arthur Andersen, Title VIII of the Sarbanes–Oxley Act, Corporate and Criminal Fraud Accountability, increased the punishment for company fraud. Under the new law, the knowing destruction or creation of documents that "impede, obstruct or influence" any existing or contemplated federal investigation is now a felony. The White Collar Crime Penalty Enhancements Act of 2002 increased the maximum penalty for mail and wire fraud from five to ten years in prison. It also

makes record tampering or otherwise impeding with any official preceding a crime. If necessary, the SEC could freeze extraordinary payments to directors, officers, partners, controlling persons, and agents of employees.

Other provisions of the act include whistle-blower protection and changes in the attorney-client relationship so that attorneys are now required to report wrongdoing to top managers or to the board of directors. Employees of public companies and accounting firms, in general, are also accountable to report unethical behavior. SOX intends to motivate employees through whistle-blower protection that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle-blowers are also granted a remedy of special damages and attorneys' fees. This protection is designed to encourage whistle-blowers to come forward when detecting business misconduct, as much of the fraud that eludes audits or other controls may be detected by employees. According to a 2008 report published by the Association of Certified Fraud Examiners, data compiled on 959 cases of occupational fraud between 2006 and 2008 revealed that 46 percent of the cases were detected by tipsters such as employees or vendors.[55] Actions of retaliation that harm informants, including interference with the lawful employment or livelihood of any person, shall result in fines and/or imprisonment for ten years. Table 4.11 lists the benefits of the act.

There are some concerns with SOX, however. Although a law may help prevent misconduct, it will not stop executives who are determined to lie, steal, manipulate, or deceive for personal gain. We saw this in 2008 and 2009 when the crumbling of Wall Street and the housing market revealed widespread misconduct among executives of major firms. The law requires that accountants and executives do the right thing, but a deep commitment by top company leadership is necessary to create an ethical corporate culture. In addition to these concerns,

Table 4.11 Benefits of Sarbanes-Oxley

1. Greater accountability by top management and board of directors to employees, communities, and society. The goals of the business will be to provide stakeholders with a return on their investment, rather than providing a vehicle for management to reap excessive compensation and other benefits.
2. Renewed investor confidence providing managers and brokers with the information they need to make solid investment decisions, which will ultimately lead to a more stable and solid growth rate for investors.
3. Clear explanations by CEOs of why their compensation package is in the best interest of the company. It will also eliminate certain traditional senior management perks, including company loans, and require disclosures about stock trades, thus making executives more like other investors.
4. Greater protection of employee retirement plans. Employees can develop greater trust that they will not lose savings tied to such plans.
5. Improved information from stock analysts and rating agencies.
6. Greater penalties and accountability of senior managers, auditors, and board members. The penalties now outweigh the rewards of purposeful manipulation and deception.

the implementation of SOX can take a great deal of organizational time and resources.

The national cost of compliance of the Sarbanes–Oxley Act is estimated at $1 million per $1.7 billion in revenues.[56] These costs come from internal costs, external costs, and auditor fees. Whereas very large corporations may be able to hire staff and make other arrangements for implementation, small and medium-sized organizations may have fewer resources at their disposal. Finally, publicly traded multinational companies with operations in the United States must implement SOX in addition to the regulatory requirements of other countries. Since there is no global standard on these responsibilities and accountability mechanisms, this implementation is costly and complicated for such firms.[57] After years of complaints from firms, in spring 2009 the Supreme Court agreed to hear arguments over the constitutionality of Sarbanes-Oxley, which has gained new critics as it failed to detect wrongdoing that led to the subprime mortgage crisis and the meltdown on Wall Street in 2008–2009.[58]

"A deep commitment by top company leadership is necessary to create an ethical corporate culture."

SUMMARY

In a pluralistic society, many diverse stakeholder groups attempt to influence the public officials who legislate, interpret laws, and regulate business. Companies that adopt a strategic approach to the legal and regulatory system develop proactive organizational values and compliance programs that identify areas of risks and include formal communication, training, and continuous improvement of responses to the legal and regulatory environment.

Economic reasons for regulation often relate to efforts to level the playing field on which businesses operate. These efforts include regulating trusts, which are generally established to gain control of a product market or industry by eliminating competition and eliminating monopolies, which occur when just one business provides a good or service in a given market. Another rationale for regulation is society's desire to restrict destructive or unfair competition. Social reasons for regulation address imperfections in the market that result in undesirable consequences and the protection of natural and social resources. Other regulations are created in response to social demands for safety and equality in the workplace, safer products, and privacy issues.

The Sherman Antitrust Act is the principal tool used to prevent businesses from restraining trade and monopolizing markets. The Clayton Antitrust Act limits mergers and acquisitions that could stifle competition and prohibits specific activities that could substantially lessen competition or tend to create a monopoly. The Federal Trade Commission Act prohibits unfair methods of competition and created the Federal Trade Commission (FTC). Legal and regulatory

policy is also enforced through lawsuits by private citizens, competitors, and special-interest groups.

A company that engages in commerce beyond its own country must contend with the complex relationship among the laws of its own nation, international laws, and the laws of the nation in which it will be trading. There is considerable variation and focus among different nations' laws, but many countries' antitrust laws are quite similar to those of the United States.

Regulation creates numerous costs for businesses, consumers, and society at large. Some measures of these costs include administrative spending patterns, staffing levels of federal regulatory agencies, and costs businesses incur in complying with regulations. The cost of regulation is passed on to consumers in the form of higher prices and may stifle product innovation and investments in new facilities and equipment. Regulation also provides many benefits, including greater equality in the workplace, safer workplaces, resources for disadvantaged members of society, safer products, more information about and greater choices among products, cleaner air and water, and the preservation of wildlife habitats. Antitrust laws and regulations strengthen competition and spur companies to invest in research and development. Many businesses and individuals believe that the costs of regulation outweigh its benefits. Some people desire complete deregulation, or removal of regulatory authority.

Because government is a stakeholder of business (and vice versa), businesses and government can work together as both legitimately participate in the political process. Business participation can be a positive or negative force in society's interest, depending not only on the outcome but also on the perspective of various stakeholders.

Changes over the last fifty years have shaped the political environment in which businesses operate. Among the most significant of these changes were amendments to the Legislative Reorganization Act and the Federal Election Campaign Act, which had the effect of reducing the importance of political parties. Many candidates for elected offices turned to increasingly powerful special-interest groups to raise funds to campaign for elected office.

Some organizations view regulatory and legal forces as beyond their control and simply react to conditions arising from those forces; other firms seek to influence the political process to achieve their goals. One way they can do so is through lobbying, the process of working to persuade public and/or government officials to favor a particular position in decision making. Companies can also influence the political process through political action committees, which are organizations that solicit donations from individuals and then contribute these funds to candidates running for political office. Corporate funds may also be channeled into candidates' campaign coffers as corporate executives' or stockholders' personal contributions, although such donations can violate the spirit of corporate campaign laws. Although laws limit corporate contributions to specific candidates, it is acceptable for businesses and other organizations to make donations to political parties.

More companies are establishing organizational compliance programs to ensure that they operate legally and responsibly as well as to generate a competitive advantage based on a reputation for good citizenship. Under the Federal

Sentencing Guidelines for Organizations (FSGO), a company that wants to avoid or limit fines and other penalties as a result of an employee's crime must be able to demonstrate that it has implemented a reasonable program for deterring and preventing misconduct. To implement an effective compliance program, an organization should develop a code of conduct that communicates expected standards, assign oversight of the program to high-ranking personnel who abide by legal and ethical standards, communicate standards through training and other mechanisms, monitor and audit to detect wrongdoing, punish individuals responsible for misconduct, and take steps to continuously improve the program. A strong compliance program acts as a buffer to keep employees from committing crimes and to protect a company's reputation should wrongdoing occur despite its best efforts.

Enacted after many corporate financial fraud scandals, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board to provide oversight and set standards for the accounting firms that audit public companies. The board has investigatory and disciplinary power over accounting firm auditors and securities analysts. The act requires corporations to take responsibility to provide principles-based ethical leadership and holds CEOs and CFOs personally accountable for the credibility and accuracy of their company's financial statements. Ideally, the act will provide for a new standard of ethical behavior for U.S. business, especially for top management and boards of directors responsible for company oversight.

However, the 2008–2009 recession, collapse of the subprime mortgage market, and troubles on Wall Street all pointed to systemic flaws and gaps in the regulatory system. SOX was not able to prevent major financial mishaps that were so large and widespread as to make Enron look benign in comparison. The current administration has a lot of continued work to do to ensure that businesses behave ethically and that stakeholders are protected.

RESPONSIBLE BUSINESS DEBATE

Mark to Market Accounting

ISSUE: Should mark to market accounting in the financial industry stay or go?

One of the problems banks faced in the 2008–2009 financial crisis was an accounting rule called mark to market. This form of accounting was developed to value exchanges on the future market. It requires companies to mark their assets to the market price that existed on that day. Using mark to market in this context makes sense because futures traders buy assets at a fixed future price. When markets are working correctly and there is active trading in the market for financial assets, this rule makes good sense.

However, mark to market accounting has been used in more questionable ways in recent decades and it has been linked with a number of high-profile corporate collapses, including Enron. Enron misused mark to market by tabulating anticipated future profits as real, thereby driving up the company's appearance of profitability. Mark to market works just fine under normal market conditions when trading is steady and assets have agreed-upon market prices. It can be difficult to use this method, however, to value complex or intangible assets, such as those often found in the financial industry. In this case, mark to market

accounting becomes an easy way to commit accounting fraud.

Mark to market also does not work well when trading stops on a good because a market price cannot be determined. When a market dries up, as the mortgage-backed securities market did in late 2008, no active trading occurs and prices do not exist. How do accountants value something that does not have a listed price that day? That was the problem the banks faced in late 2008. Banks had mortgages and other assets and debts that were technically marketable, but investors perceived that there was a high level of risk involved and did not want to invest. Many feared that investors would not make their mortgage payments, and that investors would end up losing money. Because of this fear, there were no buyers for banks' debt. If the banks marked their assets to zero or 20 cents on the dollar, they would be grossly undervaluing these instruments. Unfortunately, banks were forced to write down assets based on the mark to market rule, and wrote off billions of dollars of losses that some argue were not warranted.

To help each of the problems on Wall Street, Congress put pressure on the Securities and Exchange Commission and Federal Accounting Standards Board to relax the mark to market rules. Finally in April of 2009, the rule was relaxed to allow banks and other financial institutions to use discounted cash flow models to value these types of assets. These models allow banks more flexibility in their accounting so that they do not have to mark down valuations as much in times of crisis. Time will tell whether the relaxation of the rule was a good thing.

There Are Two Sides to Every Issue:

1. Defend keeping the mark to market accounting rule. When is this rule useful and why should the government allow the financial industry to continue to use it?
2. Defend doing away with mark to market accounting in the financial industry. Is the potential for committing fraud too high with mark to market accounting?

KEY TERMS

trust (p. 127)
monopoly (p. 128)
deregulation (p. 141)
lobbying (p. 147)
political action committees (PACs) (p. 148)
Federal Sentencing Guidelines for Organizations (FSGO) (p. 151)
Sarbanes-Oxley Act (SOX) (p. 154)

DISCUSSION QUESTIONS

1. Discuss the existence of both cooperation and conflict between government and businesses concerning the regulation of business.
2. What is the rationale for government to regulate the activities of businesses? How is our economic and social existence shaped by government regulations?
3. What was the historical background that encouraged the government to enact legislation such as the Sherman Antitrust Act and the Clayton Act? Do these same conditions exist today?
4. What is the role and function of the Federal Trade Commission in the regulation of business? How does the FTC engage in

proactive activities to avoid government regulation?

5. How do global regulations influence U.S. businesses operating internationally? What are the major obstacles to global regulation?
6. Compare the costs and benefits of regulation. In your opinion, do the benefits outweigh the costs or do the costs outweigh the benefits? What are the advantages and disadvantages of deregulation?
7. Name three tools that businesses can employ to influence government and public policy. Evaluate the strengths and weaknesses of each of these approaches.
8. How do political action committees influence society, and what is their appropriate role in a democratic society?
9. Why should an organization implement the Federal Sentencing Guidelines for Organizations (FSGO) as a strategic approach for legal compliance?
10. What is the significance of Sarbanes-Oxley to business operations in the United States?

EXPERIENTIAL EXERCISE

Visit the website of the Federal Trade Commission (FTC) (http://www.ftc.gov/). What is the FTC's current mission? What are the primary areas for which the FTC is responsible? Review the last two months of press releases from the FTC. On the basis of these releases, what appear to be major issues of concern at this time?

WHAT WOULD YOU DO?

The election of a new governor brings many changes to any state capital, including the shuffling of a variety of appointed positions. In most cases, political appointees have contributed a great deal to the governor's election bid and have expertise in a specific area related to the appointed post. Joe Barritz was in that position when he became assistant agricultural commissioner in January 2003. He was instrumental in getting the governor elected, especially through his fundraising efforts. Joe's family owned thousands of acres in the state and had been farming and ranching since the 1930s. Joe earned a bachelor's degree in agricultural economics and policy and a law degree from one of the state's top institutions. He worked as an attorney in the state's capital city for over eighteen years and represented a range of clients, most of whom were involved in agriculture. Thus, he had many characteristics that made him a strong candidate for assistant commissioner.

After about six months on the job, Joe had lunch with a couple of friends he had known for many years. During that June lunch, they had a casual conversation about the fact that Joe never did have a true "celebration" after being named assistant agricultural commissioner. His friends decided to talk with others about the possibility of holding that celebration in a few months. Before long, eight of Joe's friends were busy planning to hold a reception in his honor on October 5. Two of these friends were currently employed as lobbyists. One represented the beef industry association, and the other worked for the cotton industry council. They asked Joe if they could hold the

celebration at his lake home in the capital city. Joe talked with the commission's ethics officer about the party and learned that these types of parties, between close friends, were common for newly appointed and elected officials. The ethics officer told Joe that the reception and location were fine, but only if his lobbyist friends paid for the reception with personal funds. The state's ethics rules did not allow a standing government official to take any type of gift, including corporate dollars, that might influence his or her decision making. Joe communicated this information to his friends.

During the next few months, Joe was involved in a number of issues that could potentially help or harm agriculture-based industries. Various reports and policy statements within the Agricultural Commission were being used to tailor state legislation and regulatory proposals. The beef and cotton councils were actively supporting a proposal that would provide tax breaks to farmers and ranchers. Staff on the Agricultural Commission were mixed on the proposal, but Joe was expected to deliver a report to a legislative committee on the commission's preferences. His presentation was scheduled for October 17.

On October 5, nearly sixty of Joe's friends gathered at the catered reception to reminisce and congratulate him on his achievements. Most were good friends and acquaintances, so the mood and conversation were relatively light that evening. A college football game between two big rivals drew most people to the big-screen TV. By midnight, the guests were gone. Back at the office the following week, Joe began working on his presentation for the legislative committee. Through a series of economic analyses, long meetings, and electronic discussions, he decided to support the tax benefits for farmers and ranchers. News reports carried information from his presentation.

It was not long before some reporters made a "connection" between the reception in Joe's honor and his stand on the tax breaks for agriculture industries. An investigation quickly ensued, including reports that the beef and cotton industry associations had not only been present but also financially supported the reception on October 5. The small company used to plan and cater the party indicated that checks from the cotton industry council and beef industry association were used to cover some of the expenses. A relationship between the "gift" of the reception and Joe's presentation to the legislative committee would be a breach of his oath of office and state ethics rules. If you were Joe, what would you do?

CASE 5

Coping with Financial and Ethical Risks at American International Group (AIG)

When American International Group (AIG) collapsed in September 2008 and was subsequently saved by a government bailout, it became one of the most controversial players in the 2008–2009 financial crises. The corporate culture at AIG had been involved in a high-stakes risk-taking scheme supported by managers and employees that appeared entirely focused on short-term financial rewards. Out of a firm of 116,000 employees, one unit with around 500 employees, AIG Financial Products, was chiefly to blame. Current CEO Ed Liddy, who was summoned by former Treasury Secretary Hank Paulson, estimates that only twenty to thirty people were directly involved in bringing down the company.

The AIG Financial Products unit specialized in derivatives and other complex financial contracts that were tied to subprime mortgages or commodities. While its dealings were risky, the unit generated billions of dollars of profits for AIG. Nevertheless, during his long tenure as CEO of AIG, Maurice "Hank" Greenberg had been open about his suspicions of the AIG Financial Products unit. However, after Greenberg resigned as chief executive of AIG in 2005, the Financial Products unit became even more speculative in its activities.

Immediately before its collapse, AIG had exposure to $64 billion in potential subprime mortgage losses. The perfect storm formed with the subprime mortgage crisis and a sudden sharp downturn in the value of residential real estate in 2008. Since much of the speculation in the Financial Products unit was tied to derivatives, even small movements in the value of financial measurements could result in catastrophic losses.

In this case, we trace the history of AIG as it evolved into one of the largest and most respected insurance companies in the world, and the more recent events that led to its demise. AIG had a market value of close to $200 billion in 2007, and by 2009 this amount had fallen to a mere $3.5 billion. Only a government rescue of what has amounted to $180 billion in loans, investments, guarantees, and financial injections prevented AIG from facing total bankruptcy in late 2008.

Saving AIG was not meant as a reward, however. The government rescued the company not to keep it from bankruptcy, but to prevent the bankruptcies of many other global financial institutions that depended on AIG as counterparty on collateralized debt obligations. If AIG had been allowed to fail, it is possible that the financial meltdown that occurred in 2008–2009 would have been worse.

This case first examines the events leading up to the 2008 meltdown, including the philosophy of top management and the corporate culture that set the stage for AIG's demise. Then it reviews the events that occurred in 2008, including ethical issues related to transparency and failed internal controls. Finally, the analysis looks at the role of the government and its decision to bail out AIG, taking 79.9 percent ownership in a company that

O.C. Ferrell and John Fraedrich prepared this case with the assistance of Jennifer Jackson. This case was prepared for classroom discussion, rather than to illustrate either effective or ineffective handling of an administrative, ethical, or legal decision by management. All sources used for this case were obtained through publicly available material.

grossly mishandled its responsibility to its stakeholders.

AIG'S HISTORY

The saga of American International Group (AIG) began in 1919 with the U.S.-born Cornelius Vander Starr, who founded a company in Shanghai representing American insurance companies selling fire and marine coverage in Asia. Starr's success in Shanghai quickly led to expansion across Asia, and to the United States in 1926. While AIG began as a representative of American insurance companies abroad, in the United States it provided insurance risk coverage to insurance companies as a way to disperse liabilities. Reinsurers such as AIG were created to remove some of the risk associated with large disasters. Because of AIG and others, insurance companies could grow faster than ever before.

Insurance companies are educated risk takers. When insurance companies feel they have too much risk, they go to their reinsurance companies, such as AIG, to take out insurance so that if something catastrophic happens, they can still pay their clients. AIG utilizes models to determine how much insurance it can sell to insurers and still pay out. To put it simply, AIG charges insurance companies a premium in order to allow them to spread their risk so that they can sell insurance policies and grow more rapidly.

In 1968, Maurice "Hank" Greenberg, a native New Yorker and experienced insurance executive who had been with AIG for many years, took over as CEO. AIG grew exponentially during his tenure. By the end of the 1980s, the company had become the largest underwriter of commercial and industrial coverage in the United States and the leading international insurance organization.

AIG continued to expand throughout the 1990s, led by its return to China as the first foreign insurance organization granted a license by the Chinese authorities to operate a wholly-owned insurance business in Shanghai. AIG later expanded to Guangzhou, Shenzhen, Beijing, and Vietnam. In 2001 AIG established two joint ventures in general insurance and life insurance in India with the Tata Group, the leading Indian industrial conglomerate. New AIG subsidiary companies followed the fall of the Soviet Union into Eastern Europe, with general and life insurance companies formed in Russia, Poland, Hungary, and the Czech Republic, among other emerging markets.

In 2001 AIG purchased American General Corporation, a top U.S. life insurer. This acquisition made AIG a leader in the U.S. life insurance industry and consumer lending. Today, the four principal business areas of AIG are: General Insurance, Life Insurance and Retirement Services, Financial Services, and Asset Management. For the individual consumer, business, financial professional, or insurance professional, AIG provides: Accident and Health Insurance, Auto Insurance, Life Insurance, Banking and Loans, Retirement Services, Travel Insurance, Additional Services, and Annuities. Immediately before its 2008 collapse, AIG had revenues exceeding $110 billion, with total assets of over $1 trillion, and 116,000 employees around the world.

AIG'S CULTURE

Maurice "Hank" Greenberg was the CEO of AIG for 38 years, and was therefore a key player in shaping the modern face and corporate culture of the company. Many considered Greenberg a genius in the insurance business, and arguably he was one of the most successful and influential executives in the business. But critics called him autocratic in his drive to expand the company into an international powerhouse.

During his career, Greenberg championed innovative products that insure almost any type of risk, including Internet identity theft and hijacking. At least four U.S. presidents sought Greenberg's advice on international

affairs and financial markets. And Greenberg was always known for utilizing his contacts and influence to help advance the company. Over the years, Greenberg aggressively lobbied for laws and rulings favorable to AIG. He was very involved with international politics and helped the U.S. government to secure information and develop back-door channels for classified dealings. In return, AIG was given the benefit of the doubt when regulatory agencies came questioning the company's doings. When billions or trillions of dollars are involved, global corporations have powers equal to or greater than those of governments and regulatory agencies.

In spite of Greenberg's active networking, the early 2000s found AIG under investigation by the Securities and Exchange Commission for its "finite insurance" deals—contracts that covered specific amounts of losses rather than unexpected losses of indeterminate size—and what appeared to be loans (since premiums were structured to match policy payouts and eliminate risk) rather than genuine risk allocation vehicles. A federal inquiry later found information that Greenberg might have been personally involved in creating a bogus reinsurance transaction with General Re to fraudulently boost AIG's reserves. New York Attorney General Spitzer subpoenaed Greenberg, who treated the summons far more lightly than he should have. As rumors swirled, AIG's stock began to plummet, and the AIG board started to become concerned.

In 2005, Greenberg was forced out as CEO. Martin Sullivan succeeded him and held the CEO position for three years, followed by Robert Willumstad for three months. Willumstad was forced to step down in 2008 in the wake of the corporation's meltdown. The current CEO is Edward Liddy, the former CEO of The Allstate Corporation. The SEC leveled charges of fraud against Greenberg resulting from the circumstances surrounding his departure. In order to settle the charges that AIG manipulated financial statements in 2005, the company paid the SEC $1.6 billion in 2006, and Greenberg agreed to pay an additional $15 million in 2009.

WHAT HAPPENED AT AIG TO CAUSE ITS DEMISE?

AIG's troubles leading up to the 2008 bailout were, at the heart, caused by a kind of derivative called credit default swaps (CDSs). Credit default swaps are financial products that transfer the credit exposure (risk) of fixed-income products (bonds) between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the creditworthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed-income security to the seller of the swap. One single credit default swap can be valued at hundreds of millions of dollars.

As a reinsurer, AIG used CDSs as a kind of insurance policy on complex collateralized debt obligations (CDOs). The company issued the swaps and promised to pay these institutions, AIG's counterparties, if the debt securities defaulted. However, AIG did not have a large enough safety net to weather the subprime mortgage collapse. These insurance contracts became essentially worthless because many people could not pay back their subprime mortgages and AIG did not have the creditworthiness for the big collateral call.

The government took the drastic step to bail out the company, providing the funds to purchase the CDOs that were being held by banks, hedge funds, and other financial institutions, and in the process ended up with 79.9 percent ownership of AIG. The U.S. government is now the senior partner in a special-purpose entity that will receive interest and share liability in the ownership of these tainted investment instruments. The fear behind this move was that if AIG had been allowed to go bankrupt, many banks throughout the world would have gone bankrupt as well.

Although overall AIG had a diversified insurance business, one unit, AIG Financial Products, was the source of many of the company's woes. Formed more than twenty years ago to trade over-the-counter derivatives, its

creation was timed perfectly to ride the derivatives market boom. By and large, Financial Products was run like a hedge fund out of London and Wilton, Connecticut. Hedge funds are a special type of fund available to a select range of investors. They seek to utilize a wide variety of investment tools to mitigate, or *hedge,* risk—oftentimes the term refers to funds that use short selling as a means of increasing investment returns. Short selling is betting that the stock price of a company will change during a specified period of time. When the stocks move the expected direction, the investor makes money.

AIG Financial Products specialized in derivatives that generated billions of dollars in profits over the years. Derivatives are financial contracts or instruments whose value is derived from something else such as commodities (corn, wheat, soybeans, etc.), stocks, bonds, and even home mortgages. Gains or losses from derivatives come from betting correctly on the movement of these values. The unit also dealt in mortgage securities, a sector that turned rancid with the collapse of the housing bubble. Former New York Attorney General Eliot Spitzer, a champion of financial sector reform, claimed that AIG Financial Products was "the black hole of AIG."

The AIG Financial Products unit was founded in 1987 by Howard Sosin. When Sosin joined AIG he was given an unusual deal: a 20 percent stake in the unit and 20 percent of its profits. While AIG can be described as a conservative global conglomerate selling insurance policies to businesses and individuals, the Financial Products unit was staffed by quantitative specialists with doctorates in finance and math who, it seems, were very willing to take risks. This unit thought it was above the insurance operations, and its employees conducted themselves like investment bankers.

In the late 1990s under the leadership of Joseph Cassano, AIG Financial Products ramped up its business of selling credit default swaps, which were at the heart of the 2008–2009 financial meltdown. AIG Financial Products expanded into writing swaps to cover debt that was backed by mortgages. The unit sold swaps to large institutional investors. These collateralized debt obligations were backed by mortgages, and the swaps issued by AIG backed some $440 billion worth of obligations. To put this in perspective, the entire market worth of AIG was around $200 billion at the time. AIG made millions selling collateralized debt obligations (CDOs) and was able to post modest margin requirements, which is the amount the company keeps as a deposit to protect against the risk of loan defaults or nonpayments. For example, to buy stock on margin, you must have at least 50 percent of the purchase price in your account. AIG was able to make these CDO deals with a very small fraction of actual money on hand. Unfortunately, some of these CDOs were attached to home mortgages.

In spite of the risk, the company involved itself in bad mortgage lending by financial institutions that did not have sufficient capital to cover the loans, which in turn had bought this type of insurance from AIG that created an unstable financial environment. The loans and the CDOs were often sold to people who could not repay their debt. CEO Greenberg became concerned about this unit's derivative dealings and asked a group to shadow its trades. Greenberg was uncomfortable with the results and thought the unit was taking too many risks. However, Greenberg left the company in 2005 because of regulators investigating AIG over its accounting practices.

AIG sold credit protection on CDOs by simply writing pieces of paper that stated that AIG would cover the losses in case these obligations went bad. AIG agreed to either take over the obligations or cover the losses on CDOs. While AIG made billions of dollars in profits and managers received millions of dollars in compensation for selling these so-called insurance policies, it turned out to be a high-risk house of cards. The tools, CDOs and CDSs, were used recklessly and failed to assess systemic risk of counterparties not measuring their own exposures and not paying their obligations. The Financial Products unit

has been under ongoing investigations around the world, including by the United Kingdom's Serious Fraud Office.

Although they have gained notoriety now, before 2008 derivatives were not widely understood by the public, mass media, regulators, and many of the executives who were providing the oversight for their use. AIG could have taken another approach by buying mortgages or CDOs and then having some other party package them into a credit default swap as insurance, but since AIG was an insurer it simply wrote policies on CDOs, thus increasing revenues with the hope that only a few would default. Of course, AIG guessed wrong and became the epicenter of a financial nightmare that has caused many bank failures and a worldwide financial depression.

AIG Lacked Transparency

There is evidence that AIG knew of potential problems in valuing derivative contracts before the 2008–2009 financial meltdown occurred. Outside auditors raised concerns about being excluded from conversations on the evaluation of derivatives. But during this time period, AIG executives Cassano and Sullivan continued to reassure investors and auditors that AIG had accurately identified all areas of exposure to the U.S. residential housing market and stated their confidence in their evaluation methods. PricewaterhouseCoopers (PwC), AIG'S auditor, had a right to know about the models and about market indicators that indicated that the value of AIG swaps should be lowered. If prosecutors find evidence that investors and PwC were misled, it could be considered a criminal fraud.

The market indicators in question came in the form of demands for collateral by AIG trading partners. At a congressional hearing, Sullivan stated that he believed the evaluations to be accurate, based on the information he possessed at the time. This situation is similar to executives at Enron who claimed that they did not know that Enron utilized derivatives and off-the-book balance sheet partnerships that caused its demise. Many Enron executives ended up being found guilty of crimes.

AIG Provided Incentives to Take Risks

What were the factors within the corporate culture of AIG that promoted speculative risk-taking? Part of the problem may have been AIG's incentives. The AIG culture was focused on a reward system that placed little responsibility on executives who made very poor decisions. Although they produced nearly $40 billion in losses in 2008, a number of managers were selected to receive large bonuses. AIG offered cash awards and other perks to thirty-eight executives and a retention program with payments from $92,500 to $4 million for employees earning salaries between $160,000 and $1 million.

After receiving more than $152 billion in federal rescue funds, AIG publicly claimed that it would eliminate some of these bonuses for senior executives while all the time planning to hand out cash awards that doubled or tripled the salaries of some. AIG asserted that these types of payments were necessary to keep top employees at AIG, even as control of the company was being handed over to the government. The ethical ramifications of the rewards doled out in the face of excessive risk-taking and possible misconduct has been highly criticized by most stakeholders.

The central reason AIG was bailed out at all was that the government was seeking to prevent the failure of some of the world's largest banks, thereby potentially causing a global financial catastrophe. AIG's actions reflect an ethical culture that neglects the most important stakeholders that support a business.

The demise of AIG's Financial Products unit, in part, resulted from excessive risk-taking by economists and financial scholars using computer models that failed to take into account real-world market risks. For example, Gary Gorton, a finance professor at the Yale School of Management, was a scholar whose

work was cited in speeches by Federal Reserve Chairman Ben Bernanke. AIG paid him large consulting fees for developing computer models to gauge risk for more than $400 billion in complicated credit default swaps. Remember that a single swap can be valued at hundreds of millions of dollars. AIG relied on Gorton's models to determine which swap deals were low risk. Unfortunately, his models did not anticipate how market forces and contract terms could turn swaps into huge financial liabilities. It was not Gorton's failing, as AIG did not assign him to assess those threats, and therefore his models did not consider them. However, the failure to assess the risk of credit default swaps correctly caused the demise of AIG and pushed the federal government to rescue it and the U.S. banking system.

Like other major firms, AIG entered a very lucrative but perilous new market without truly understanding the sheer complexity of the financial products that it was selling. What the company learned too late is that computers and academic experts cannot determine all of the variables, forces, and weights that cause a high- or low-risk investment to go bad. The blame lies with business placing too much trust in models with faulty assumptions. Models cannot predict with absolute certainty what humans will do because humans are not always rational. Warren Buffett, chief executive of Berkshire Hathaway and a billionaire many times over, said, "All I can say is, beware of geeks … bearing formulas."

AIG ultimately owed Wall Street's biggest firms about $100 billion dollars for speculative trades turned bad; $64 billion of it was tied to losses on subprime mortgages. This debt is particularly challenging because the rescue package for AIG does not include provisions for them. Questions remain about how the insurer will cover these debts. The company allegedly placed billions of dollars at risk through speculation on the movements of various mortgage pools, and the bottom line is that there are no actual securities backing these speculative positions on which AIG is losing money. The losses stem from market wagers that were essentially bets on the performance of bundles of derivatives linked to subprime residential mortgages.

The government rescue of AIG protected many of its policyholders and counterparties from immediate losses on traditional insurance contracts, but these speculative trades by AIG were not a part of the government risk rescue. AIG's activities indicate that managers and traders were focused on financial rewards for assembling high-risk contracts and that the Financial Products division was conducting itself like a gambler in a casino that irrationally expected all bets to pay off. AIG had lost its underlying mission, the importance of strong moral principles, and good compliance programs that respect stakeholders.

The controversies regarding AIG did not end with government ownership. In fact, the problems critics identified regarding the company's culture and reckless spending were put on full display a mere two months after receiving its bailout money. Top AIG executives were spotted holding a lavish conference at a posh Point Hilton Squaw Peak Resort in Phoenix for 150 financial planners and top AIG executives. The three-day event reportedly cost over $343,000. Representatives of the corporation defend the conference, stating that most of the costs were underwritten by sponsors—however, such an episode mere weeks after receiving its government bailout did not sit well with stakeholders. Many believe that it demonstrates how little remorse AIG has for the decisions leading up to the failure, and how little has changed since the company received government money.

AIG'S CRISIS AND BAILOUT

AIG's problems came to a boil in September 2008. Due to the many issues outlined earlier, AIG's stock was downgraded by the rating companies, which caused the stock to drop, causing a run on the reinsurer's liquid assets

(cash on hand) that revealed its lack of liquidity. Simply put, AIG did not have the capital to repay investors asking for their money back.

The federal government came to the rescue—as stated earlier, not out of concern for AIG, but to prevent the string of bank failures that would surely follow an AIG bankruptcy. Over the course of a month, the government doled out over $152 billion of taxpayer money, creating a line of credit for the company and buying up AIG stock. This was a highly controversial decision, particularly since the government did not do the same thing for the other financial giant Lehman Brothers. In March 2009, the government made the controversial decision to dole out another $30 billion in capital to the failing institution. The decision was made even more contentious when it was revealed that $165 million of the bailout money went to bonuses of employees of the failed Financial Products unit.

While the government concluded that it could not get the money back, it did resolve to increase the oversight of new bailout funds. When questioned about the decision to repeatedly bail out AIG, Federal Reserve Chair Ben Bernanke told U.S. lawmakers that "AIG exploited a huge gap in the regulatory system. There was no oversight of the financial products division. This was a hedge fund, basically, that was attached to a large and stable insurance company." He stated that AIG was the single case out of the entire 2008–2009 financial crisis that made him the angriest. However, Bernanke went on to say, "We had no choice but to try to stabilize the system because of the implications that the failure would have had for the broad economic system."

Although the bailouts were massive, they did not cover all that AIG owed and the company has had to sell off numerous assets. Two-thirds of the company needed to be sold in a tough market for sellers, resulting in auctions of dozens of the company's units around the world. Many of these sales resulted in disappointing prices for AIG. For example, Munich Re, the world's biggest reinsurer, agreed to buy AIG Inc.'s Hartford unit for $742 million, about a third less than AIG paid for it eight years before. The company also has given more than 2,000 employees cash incentives to stop them from quitting, saying that the payments are necessary. "Anybody who wants to start an insurance company or beef up their position, they will come to our organization and pick people off," Edward Liddy, the current CEO, said in the interview. "If that happens, we can't maintain the businesses we want to keep and we won't be able to sell them for the kinds of values that we need."

Former CEO Greenberg maintains his innocence, and insists that the company's upper management was the root cause of the collapse after he left. "AIG had a unique culture when I was its CEO, particularly in comparison with the way many large public companies operate today," he said. "Neither I nor other members of my senior management team had employment contracts. I received no severance package in connection with my retirement, and I never sold a single share of AIG stock during the more than 35 years that I served as CEO." Greenberg continues to hold substantial stock in the company. At the end of 2008, he and his firm, Starr International, owned more than 268 million shares, or nearly 10 percent.

In a 2008 interview, Greenberg explained what he sees as the real cause of the financial collapse. He blames low interest rates and excessively easy credit for the reckless risk-taking and poor decisions made within the financial industry. He also cites excessive leveraging and mark-to-market accounting practices as contributing to the meltdown. Mark-to-market is assigning a value to a position held in a financial instrument based on the current market price for the instrument. For example, the final value of a financial contract (grain futures) that expires in nine months will not be known until it expires. If it is marked to market, for accounting purposes, it is assigned the value that it would have at the end of each day. Greenberg believes that all these factors grew out of control to the point where the

entire system had nowhere to go but toward failure.

CONCLUSION

The question remains: Was a bailout really necessary? Some say yes, like Greenberg himself. "You have to have a bailout. But I would call it something else rather than a bailout. That implies the wrong thing. It is really also helping Main Street, not just Wall Street, because if the economy doesn't grow, jobs are going to be lost and we're going to go into a depression rather than a recession. The taxpayer is not going to take a hit long-term because the money involved will be repaid over a period of time."

Others are not so certain. Critics of the AIG and auto industry bailouts, for example, cite lack of accountability in how the funds are used. Many also oppose this level of government intervention in corporations because it seems to be rewarding companies that have blatantly ignored the needs and desires of their stakeholders in favor of enriching themselves in the short term. Even months after the bailout, AIG continued to lose massive amounts of money. The company managed to slow the rate of its losses to $4.35 billion in the first quarter of 2009, but the damage to the company's reputation over this matter has been massive, and some critics wonder if it will ever recover.

The company has also had a difficult time selling off its assets in order to repay its debts, as many of its potential buyers also have been working to recover from the 2008–2009 recession. Without a doubt, the failure of AIG was massive and, bailout or not, its effects have rippled across the globe.

QUESTIONS

1. Discuss the role that AIG's corporate culture played, if any, in its downfall.
2. Discuss the ethical conduct of AIG executives, and how a stronger ethics program might help the company to strengthen the ethics of its corporate culture.
3. What could AIG have done differently to prevent its failure and subsequent bailout?

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