In Support of Values-Based Compliance

By Veronica T. Stork, JD

We all believe that we work with good, ethical people, and in the vast majority of cases that's true. The Bernie Madoffs of the world are few and far between. Yet public trust in financial services seems to be improving only slowly over the past few years; it remains one of the least trusted industries. Across sectors within financial services, advisors and asset managers score the lowest levels of trust. A decade of Securities and Exchange Commission (SEC) required compliance procedures and codes of ethics apparently has not been enough to overcome the doubt caused by repeated scandals, and suspicion falls on all firms—even those that haven’t been the subject of prosecution or ugly headlines. To survive, even thrive, in such an environment, a firm has to go further to earn and keep the trust of its clients.

Avoiding Enforcement Isn’t Enough

Rule 204A-1 under the Advisers Act requires registered investment advisors to adopt a code of ethics that sets standards of behavior for its supervised persons consistent with the advisor's fiduciary duty and compliance with federal securities laws. But if a firm does no more than meet the minimum requirements, it stays embedded in a compliance-based mind-set—one based on enforcing rules and punishing rule-breakers. Indeed, the purpose of an SEC-mandated compliance program is to prevent breaches of regulations. After the financial crisis of 2008, the SEC introduced enterprise-wide risk management, which goes beyond mere compliance with regulations. However, this still focuses on avoiding and correcting problems, whether or not they constitute a violation of law.

Yet there’s a gap between not breaking the rules and doing the right thing. “It is not an adequate ethical standard to aspire to get through the day without being indicted.” Limiting focus to mere compliance does little to inspire employees to follow procedures. In the absence of belief in the inherent morality of rules, the threat of punishment doesn’t generally have much influence on whether people comply with them, and it must be a significant threat to have any influence.

Setting Higher Standards

One primary force that helps companies build trust is integrity, which requires more than merely following the rules. In fact, investors rate ethical behavior and transparency as more important to building investor trust in investment managers than performance history or fee structure.

An integrity-based approach to ethics and compliance is based on management responsibility for ethical behavior, which includes concern for complying with laws and regulations but doesn’t stop there. In this type of program, the company operates based on values set forth by management. When values drive policies and procedures, following the rules becomes the right thing to do rather than just bureaucracy. And, although regulations concerning a firm’s relationship with its clients get the most attention, a robust program also will address the relationship between employees and the firm, as well as with each other. This creates a stronger social connection within the firm, which itself encourages members to obey the rules.

Once defined, company values should drive the design of firm policies, systems, programs, and decision-making throughout the firm. Once values have been articulated, they need to be translated into expected actions. Such expectations create a motivating link between values and behavior, clarify values, and guide employees on how to act when values seem to conflict. For example, a firm that chooses respect as a value will implement expectations differently if it also values entrepreneurial spirit. In an entrepreneurial firm, employees may expect to work longer hours, take phone calls during non-office hours, and respond to e-mail on vacation. A firm with a less entrepreneurial culture may decide that respect for employees’ personal time takes precedence unless there is a true emergency.

Without a clear statement of expectations, there are likely to be problems. An employee who doesn’t attend to firm business on personal time may resent being chastised for it if the expectations were never made clear. Similarly, an employee who is available at all hours will expect to be rewarded for that extra effort. If that doesn’t happen, the employee will be unhappy; if it does happen, other employees may feel resentful, as if they weren’t told of unwritten expectations. Because legitimacy and fairness of rules are key to motivating people to comply with rules, either of the above scenarios will undermine a compliance program. And if employees behave based on mistaken understandings of how the values are expected to function, the culture can evolve in ways that aren’t welcoming.

Creating a Values-Driven Culture

Despite investors’ belief that increased government regulation can help bolster trust in financial advisors, there will always be some people who intentionally break the rules. However, major company
embarrassments are caused more often by an error in judgment than intentional criminal behavior. Witness the numerous SEC enforcement actions based on misleading or omitted information in sales and offering documents. In how many of those cases do you think one or more people made an intentional decision to leave out clearly required information? More often, the drive to get a deal done or to make a convincing argument for the sale affects judgment about what should be included in the documents. To limit the potential for such errors, employees need solid grounding in applying values and management must create an atmosphere that fosters adherence to company standards.

Most financial services firms provide formal training for new recruits about their codes of ethics and other policies, and then periodically repeat the training for existing employees. Attestations to having read codes and various manuals and agreeing to abide by them are commonly completed by employees at least annually. But to get employees to take on the firm’s values, they must understand how to use them in making day-to-day decisions.

Values can be tied explicitly to policies and procedures to demonstrate how they apply in routine circumstances. They also must be a regular part of discussions, including department and committee meetings, one-on-one conversations, planning and strategy sessions, and crisis response. When employees see firm values put into action this way, they gain a deeper understanding of how the values function in practice and an appreciation for the firm’s commitment to those standards.

It’s important that the values a company adopts be given equal importance with achieving results. Returning to the earlier example of sales and offering documents, if transparency has been adopted as a standard for the firm, it must be treated as at least equally as important, if not more important, than closing the deal. Judgment calls about what gets included in materials should more often favor inclusion, which in turn will reduce the risk of enforcement. The ethical culture is undermined, however, if it becomes clear in the process of creating materials that effort is made to limit disclosure of potential risks only to what is strictly necessary or if potential conflicts are dismissed as not material so that they don’t have to be included. Every firm has the right to make a profit, but the public will not trust those firms that do so by compromising ethics.

In addition, a firm that discounts or ignores standards when standards get in the way of achievement or become simply inconvenient may fall prey to the “normalization of deviance.” It begins with a single instance of a rule being broken without negative consequences. Perhaps to get quarterly reports mailed by the firm’s deadline, the reports are completed and sent out before receiving a second review of performance numbers. Because following the rules often takes extra time and effort, and might prevent achieving a goal in some circumstances, it becomes attractive to ignore the rule. The more frequently the rule is ignored without consequences, the more it becomes the norm to ignore the rule. When no consequences arise from skipping the second review of performance results, it becomes easier to skip that step the next time, and soon it becomes standard practice. But when something finally does go wrong, even something that would not have been prevented had the procedures been followed, what might otherwise be looked upon as simple human error is magnified. The fact that rules were ignored in itself is likely to increase the reputational if not financial damage.

Violation of rules can become standard practice in this way even when the potential consequences are known to be severe. It was normalization of deviance that contributed to the two space shuttle catastrophes. Both the O-ring problem that led to the Challenger explosion on take-off, and the falling insulation foam that caused Columbia to burn up on re-entry, had been noticed multiple times from the earliest days of the shuttle program. These were design violations, but even with the lives of the astronauts at stake the problems were ignored in the face of an urgency to keep the shuttle flying because it had not met the frequency and cost goals originally promised. In addition, in the case of Columbia, key managers dismissed the requests of several engineers to get photos of the foam impact site—photos that might have shown the extent of the problem and allowed a potential rescue mission with another shuttle. Those who become used to violation without consequences may remain confident even when the risk is called to their attention.

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For this reason, it is important that employees feel safe reporting violations of the firm’s policies and standards. When the moral imperative of following procedures isn’t enough, stopping rule violation early is a firm’s best protection against an embarrassing and possibly expensive mistake. Employees need to know that reports will be considered seriously and that there will be no repercussions for reporting. It isn’t enough to merely not fire a whistleblower; there must be no subtle consequences, such as being passed over for prime assignments, being frozen out of meetings, or lack of promotion opportunity.

Although fear of punishment isn’t sufficient to encourage compliance with values and policies, consequences for violations are necessary. In addition to acting as a deterrent, imposing consequences on those who don’t live up to firm values sends a clear message that management is serious about them. To work, punishment must be applied appropriately and consequences for violations are necessary. In addition to acting as a deterrent, imposing consequences on those who don’t live up to firm values is a serious message that management is serious about them. To work, punishment must be applied equally to all personnel. Incorporating a discussion of the firm’s values and standards into personnel reviews, including impacts on promotion and compensation decisions, sends a strong message. Rewarding star performers and favored employees who don’t live up to firm values sends an equally strong message that can undermine the whole program.

A Win-Win Effort
Creating an integrity-based ethics and compliance program, and creating and maintaining a culture that supports it, takes time and effort for any firm, but the effort can pay off in more than one way. Increased adherence to rules can reduce the risk of investigation and litigation by reducing potential errors. The effort that goes into clarifying values and making employees buy into them creates a unified workforce and may reduce expensive turnover. Finally, as noted at the outset, creating a culture driven by shared values can help build investor trust in a firm, despite a broader mistrust of the industry.

At a time when every firm is facing increasing costs of compliance, the extra effort put into establishing and fostering a values-based ethics and compliance program can pay off in dollars saved and dollars earned. The added peace of mind is just a bonus.

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Endnotes
3. This was set as a minimum standard, and the SEC pointed out in the adopting release that advisors were free to set higher standards. SEC Release IA-2256, Federal Register 69, no. 131, Friday, July 9, 2004, 41696–41709 (41697).
5. Although Rule 206(4)-7 specifically states an advisor must adopt policies and procedures “reasonably designed to prevent violation” of the Advisers Act and associated rules, the SEC made clear in the adopting release that it also expected programs to detect and correct any violations. SEC Release IA-2204, Federal Register 68, no. 247, Wednesday, December 24, 2003, 74174–74179 (74176).
6. Managing for Organizational Integrity, cited above, quoting former SEC Chairman Richard Breeden.
10. Managing for Organizational Integrity, cited above.
14. Managing for Organizational Integrity, cited above.
16. Detailed discussion of how this happened is found in Riding Rockets, cited above.