



Ethics in Globalization

- Moderator: **Rafael M. Di Tella**, *Joseph C. Wilson Professor of Business Administration*
- Panelists: **Robert R. Glauber**, *Adjunct Lecturer, Harvard Kennedy School*
Michael G. Oxley, *Former Congressman and Chairman, House Financial Services Committee*
Daniel L. Vasella, *Chairman and CEO, Novartis AG*

Overview

The current financial crisis has raised questions about the legitimacy of capitalism. Ethical failures certainly played a role. While it remains to be seen whether and how many people blatantly broke the law, there are abundant signs of various forms of potentially unethical behavior. These include greed, unreasonable amounts of leverage, subtle forms of corruption (such as ratings agencies that appear to have had a conflict of interest), complex financial instruments that no one really understood, and herd behavior where people just followed along and failed to exercise independent judgment.

It is difficult or impossible to regulate against greed and against many of the other ethical shortcomings that have been seen. What can be done is to force greater transparency and accountability, a process which began with Sarbanes-Oxley and is expected to continue with new regulations of the financial system.

Context

Drawing upon learnings from their work and experiences, the panelists and moderator exchanged views with the audience on the ethics and legitimacy of business and capitalism in general, and the financial crisis in particular.

Key Takeaways

- **The financial crisis may shift societal views on the legitimacy of business.**

Each panelist offered a different perspective on the issue of ethics and legitimacy in business:

— *The financial crisis has the potential to damage the legitimacy of capitalism (Di Tella)*. Richer nations tend to be more right-wing in their views and have more capitalistic economic systems. The United States is exceptionally right-leaning, even among developed nations.

These attributes are heavily influenced by beliefs regarding the reasons why people are prosperous or poor. Americans tend to see prosperity as a product of effort more than luck; left-leaning nations believe the opposite.

Affecting these beliefs: the number and severity of the shocks a society has weathered; and perceptions regarding the legitimacy of business—i.e., the perceived degree of corruption. America generally perceives that corrupt businesspeople are the exception, and punishes deviants severely. However, this financial crisis holds the potential to shift America leftward since it: 1) is a

major shock that 2) suggests systemic corruption. Both call into some question the legitimacy of U.S. capitalism.

— *It is ethically legitimate for businesses to place the customer's interests above all else, because only through profit comes the freedom to contribute to society (Vasella)*. Business leaders must use their personal moral compasses to make ethical decisions. As for the business's compass, it should be oriented toward satisfying customers above all stakeholders. That is the orientation that allows for the greatest competitive success and profitability. In Mr. Vasella's view, only by making a profit does a company earn the right to pursue social goals; that is why pursuing profit is ethically legitimate. A company's primary responsibility is to produce perpetually improved products/services. Secondarily, it has a duty to contribute to solving social issues. The key ground rule in the pursuit of profit is transparency. Per Mr. Vasella, "We should not do anything which we cannot put on the table and show."

"I feel that we have a right to spend that money [on social issues], but we only get that right if we are successful. The condition to have that freedom . . . is that we make a profit. . . . I strongly believe this is legitimate."

— Daniel L. Vasella

— *A goal of policymakers is to make information more transparent to the investing public (Oxley)*. From 1981 to 2001, the number of Americans owning equities grew from 34% to 54%, due to 401(k)s, IRAs, day trading, and more. Because of this, the Enron and WorldCom scandals and the current financial crisis are not abstract; they are real-world crises that affect most Americans.

In the wake of Enron, it became necessary to change the system to create greater transparency for investors. If a system is transparent, much wrongdoing can be prevented. The strength of Sarbanes-Oxley (SOX) is not as much its punishment side as its transparency aspects. SOX's two pillars are transparency and accountability, which go hand in hand. It was Congress's hope to craft legislation that created an atmosphere of openness and transparency inhospitable to massive frauds taking root. Pulling off fraud is now much more difficult as a result. While in some respects this can be seen as closing the barn door after the horses have left, it is a legitimate attempt by policymakers to create an open and transparent system. (Fortunately, many other governments around the world have followed the United States's lead and have strengthened their own standards.)



"If you have adequate transparency, you can avoid wrongdoing in the first place. . . . The two pillars of the Sarbanes-Oxley Act were transparency and accountability."

— Michael G. Oxley

The current financial crisis will cause Congress to work on much-needed regulatory changes to the financial system. Many of the current regulations were enacted in the 1930s, following the Great Depression. We need a new regulatory structure that befits the 21st century.

- *The financial crisis may weaken market capitalism and increase political intervention in how resources are organized (Glauber).* The financial crisis highlights the fact that markets can't discipline greed and may in fact encourage it. Thus, the crisis may serve to cast doubt on the legitimacy of market-based capitalism.

Greed certainly played a role in the crisis through executive compensation structures which encouraged imprudent amounts of leverage. Monetary policy was also a culprit, as low interest rates encouraged investors to seek higher rates of return, which they convinced themselves could be had with low levels of risk.

Because the financial crisis may undermine confidence in the effectiveness of markets to allocate resources, it may lead to increased political intervention in resource allocation and new forms of intervention, either directly or via regulation.

"I think the most important issue of the financial crisis is how it is going to change perceptions of the effectiveness of markets in allocating resources. . . . To what extent will it undermine confidence in markets? To what extent will it lead to interventions by political forces?"

— Robert R. Glauber

- **Ethical lapses, failures of understanding, herd behavior, self-deception—all contributed to the financial crisis.**

During the Q&A session, participants exchanged views on the factors that precipitated the financial crisis. Some of the ethics-related factors identified were:

- *Shareholder greed.* While much ink is spilled regarding excessive CEO compensation as the symbol of greed, Mr. Vasella suggested that the greed and short-term orientation of many shareholders are to blame. These shareholders don't care about the company; they are looking simply to make a short-term gain.
- *Increased moral ambivalence.* The past 20 years or so, said one participant, "We've cloaked things we used to call 'corrupt' in language that makes it seem okay. We've lost the ability to discern what's really not right."

One example mentioned in the discussion is how credit rating agencies, which seem quite culpable in the current scandal, have gotten into debt advisory businesses. At the very least, this creates a significant appearance of a conflict of interest.

- *Financial instrument complexity.* The complexity of the innovative financial instruments masked conflicts of interest, incapacitated regulation, and facilitated self-delusion—presenting many ways to justify to oneself actions that were morally ambiguous. These products were not created for corrupt reasons (Mr. Glauber pointed out) but did end up facilitating corruption (observed Professor Di Tella).
- *An insufficient emphasis on reasonableness.* CEOs are pressured to push the limits. How much debt can their organization take on? How much can earnings grow in the next quarter? At all times the expectation has been to push the limits, with a razor-thin margin for error. Needed are more reasonableness, more long-term perspective, and acting with decency.
- *Failure of understanding risk.* The lending markets are supposed to identify, call out, and prevent the assumption of unacceptable risk. The reality is that in the past several years, investors have been unable or unwilling to see risk levels for what they really were. Whether self-delusion was at fault or simply a failure of understanding is debatable.

"The marketplace was unwilling to see those as risks; the market just didn't want to understand. One has to try and understand better why it didn't, but it didn't."

— Michael G. Oxley

- *Herd behavior.* This is when everyone appears to suspend judgment because it seems that everyone else has bought into some idea. It is often hard to distinguish between herd behavior, greed, stupidity, and corruption.

Types of regulatory/legislative solutions warranted by the crisis were discussed as well. Mr. Glauber is in favor of regulations forcing greater transparency in markets. He would not like to see financial instruments of certain types outlawed, however.

"I don't think any regulation will improve the character of anybody," said Mr. Vasella. He believes the role of government should be to set minimal but clear rules.

Representative Oxley explained the dichotomy between rules-based and principles-based regulation. Changes to the SEC's recent accounting standards represented a move from a rules-based to a principles-based approach. The jury is still out about whether the system should adopt a principles-based approach and whether doing so will be effective.



Speaker Biographies

Rafael M. Di Tella (Moderator)

Joseph C. Wilson Professor of Business Administration

Rafael Di Tella is the Joseph C. Wilson Professor of Business Administration at HBS. He received his first degree in economics from the Universidad de Buenos Aires, Argentina, in 1990 and his D.Phil. in economics from Oxford University in 1996. After a short stay in Argentina, he came to HBS in July 1997, where he has taught Business History and Business, Government, and the International Economy in the first-year required curriculum as well as a course on Institutions, Macroeconomics, and the Global Economy in the second year.

Di Tella works on political economy, with a focus on institutional development. A large part of his research has been concerned with the causes of illegal behavior, with applications to corruption and common crime. Another strand of research studies measures of happiness and how they can inform government policies on issues ranging from the incidence of inequality to the inflation-unemployment tradeoff. His current research studies the role of beliefs in economic organization, including reversals of pro-market reform and, more generally, why capitalism doesn't flow to poor countries. His work has been published mainly in academic journals, including the *Journal of Political Economy*, the *American Economic Review*, and the *Review of Economic Studies*.

Robert R. Glauber, DBA 1965

Adjunct Lecturer, Harvard Kennedy School

Robert Glauber is an adjunct lecturer at Harvard's Kennedy School and will be a visiting professor at Harvard Law School in 2009. Previously, he served as chairman and CEO of NASD (now FINRA), the private-sector regulator of the U.S. securities markets, from September 2001 to September 2006, after becoming CEO in November 2000. Before NASD, he was a lecturer at the Kennedy School from 1992 to 2000, undersecretary of the treasury for finance from 1989 to 1992, and a professor of finance at HBS from 1964 to 1988. Glauber was executive director of the Brady Commission, appointed by President Reagan to report on the October 1987 stock-market crash. He has served on the boards of the Federal Reserve Bank of Boston, a number of Dreyfus mutual funds, and the Investment Company Institute, and as president of the Boston Economic Club. He is now a director of Moody's Corporation, Freddie Mac Corporation, and XL Capital Ltd. and a trustee of the International Accounting Standards Committee Foundation. He has been a senior advisor at Peter J. Solomon Company, an investment bank, since November 2006. Glauber graduated from Harvard College and received his doctorate from HBS.

Michael G. Oxley

Former Congressman and Chairman, House Financial Services Committee

Mike Oxley, former congressman and chairman of the House Financial Services Committee and now at the law firm of Baker Hostetler, serves clients in corporate governance, investigations, and government policy. After a 25-year career representing Ohio's 4th Congressional District, Oxley is best known for his coauthorship of the landmark Sarbanes-Oxley Act of 2002, which restored Americans' confidence in the capital markets and created a new accounting oversight board for publicly traded companies. Besides his position with Baker Hostetler, Oxley serves as vice chairman of the Nasdaq OMX Group Inc.

While in Congress, Oxley backed pro-business, low-tax, and pro-competition positions as the best policies to support strong economic growth. He is a well-known advocate for free-trade agreements and international business engagement and has consistently backed the nation's law enforcement, intelligence agencies, and military in the fights against drugs, crime, and terrorism.

From 2001 through 2006, Oxley served as chairman of the House Financial Services Committee, which in 2001 consolidated the jurisdiction of all financial services industries in one panel for the first time in the history of the House. The committee's scope included banking, insurance, securities and exchanges, housing, and monetary policy.

At Baker Hostetler, Oxley is part of the Government Policy Group, which represents multinational and corporate clients seeking to resolve or avert problems related to federal and/or state policy through legislative or administrative solutions.

Oxley also helps private and public companies with establishing governance policies and compliance programs and with confidential investigations related to noncompliance concerns. He supports the firm's premier white-collar defense and corporate investigations practice, which represents clients involved with complex white-collar crime, regulatory investigations, and litigation. The practice team has represented top-tier banking and investment firms by establishing monitorship programs in conjunction with government regulators in accordance with best-practice standards.

A member of the House Energy and Commerce Committee from 1983 to 2001, Oxley is well-known for his knowledge of federal telecommunications and energy policy. Before his election to Congress in 1981, he was a special agent of the FBI and a member of the Ohio General Assembly. Earlier, he practiced law with the firm Oxley, Malone, Fitzgerald & Hollister in Findlay, Ohio. He received his BA from Miami University and his JD from Ohio University's Moritz College of Law.

**Daniel L. Vasella, PMD 57 (1989)***Chairman and CEO, Novartis AG*

Daniel Vasella is chairman and CEO of Novartis AG. He was appointed chairman in April 1999, having served as CEO and executive member of the board of directors since the merger that created Novartis in 1996.

Before the merger, Vasella was CEO of Sandoz Pharma Ltd. and a member of the Sandoz Group executive committee. From 1988 to 1992, he was with Sandoz Pharmaceuticals Corporation in the U.S., and before then he held a number of medical positions in Switzerland. He graduated with an MD from the University of Bern and completed the Program for Management Development at HBS in 1989. He was also awarded an honorary doctorate by the University of Basel.

Vasella is a member of the boards of directors of PepsiCo Inc. and Alcon. He is also a member of the international board of governors of the Peres Center for Peace in Israel, the International Business Leaders Advisory Council for the Mayor of Shanghai, the Global Health Program Advisory Panel of the Bill & Melinda Gates Foundation, and a foreign honorary member of the American Academy of Arts and Sciences. He also serves as a member of several industry associations and educational institutions.