10-107
September 10, 2010

Chris Peterson at DSS Consulting

Deborah Ancona and David Caldwell

Late Thursday afternoon, Chris Peterson was reflecting on the meeting she would have tomorrow with her boss, Meg Cooke. The purpose of the meeting was to give Meg an update on the status of the integrated budget and planning system her team had been working on over the last six months and plans for the team to begin marketing this system and other new DSS consulting services to clients.

Overall, Chris was quite pleased with the work her team had done. The team had been formed as part of a strategic change, including a somewhat controversial re-organization at DSS. The changes and new structure had created dissatisfaction and a fair amount of anxiety among many of DSS's consultants, but Chris felt her team had overcome their concerns to become a very effective group. They had worked together well, avoided the conflicts that often plague these kinds of teams, and generally maintained a high level of motivation and satisfaction. Most of all, Chris was proud of the work her team had done. They had created a budget and planning system that the team believed would be embraced by DSS's clients. The team had not gotten much support from other groups at DSS in developing the system, so team members had done much of the technical work on their own that would have normally been done by support people in the company. Despite this, Chris was very pleased with the system and looked forward to sharing her team's accomplishments with Meg.

DSS Consulting

DSS Consulting was formed in 1997 to provide administrative support to small school districts primarily in the mid-west and mountain west. The company was founded by three retired school district administrators to help small school districts that had limited staff deal with difficult and somewhat specialized administrative problems, such as negotiating labor agreements or setting up procurement systems.

This case was prepared by Professors Deborah Ancona, MIT Sloan School of Management and David Caldwell, Santa Clara University, Leavey School of Business.

During the late 1990s, DSS grew rapidly as small school districts faced more complex challenges and pressures to cut costs, particularly in administration. In response to this growth, DSS organized itself into four practice departments—Procurement and Systems, Information Technology, Contract Negotiation, and Facilities Planning—to deal with different types of engagements. Business came primarily through contacts the five founders had developed. Once DSS was engaged, the project would be referred to the head of the appropriate practice group who would assign consultants to the project.

By 2005, a number of changes had begun to affect DSS. First, the founders were cutting back their involvement in the company. As a result, management decisions were being passed on to new leaders, including people hired from other consulting companies. In addition, since much of DSS's business was generated through contacts established by the founders, their reduced involvement was creating a need for new marketing strategies. Second, the types of problems for which districts were looking for help were becoming more diverse and often didn't fit clearly into a specific practice area. The increasing complexities districts were facing were both reducing the need for the relatively straightforward projects DSS had been working on and creating demands for new types of services. Finally, state standards for school districts were diverging from one another, so that certain issues were more important in one region than in another. All of these changes led to stagnation in revenue growth for DSS.

Because of these changes, the founders decided that a shift in strategy would be necessary for DSS to continue to grow and be successful. As a first step, they promoted Meg Cooke to the position of Chief Operating Officer. Meg had joined DSS in the Contract Negotiation group about four years earlier after spending time with a larger east coast firm. Two years after joining DSS, she had been promoted to head the Contract Negotiation group. The founders and Meg had concluded that if DSS was to continue to be successful, it would need to expand beyond its traditional customer base of small districts and offer services to larger districts much more than it had in the past. They felt that accomplishing this would require developing new services and reorganizing into a more cross-functional, customer-focused organization. A major part of the strategic change involved reorganizing DSS from a purely practice-oriented functional structure to a hybrid structure. Most of the consultants would now be assigned to new cross-functional teams that would be responsible for marketing and delivering services to districts within a particular geographic region. The practice groups were maintained to provide specialized expertise to support the cross-functional teams in their work but with many fewer staff members than in the past.

The new cross-functional teams were given two responsibilities. Over the long run, the teams were to build relationships with the school districts in their regions and provide a full range of DSS consulting services to those districts. The teams were also to develop new consulting offerings in response to district needs. The expectations were that the cross-functional teams would eliminate the functional "silos" that constrained the services DSS could provide and help DSS develop services that could be sold to larger districts. Both these were seen as crucial steps in the plan to grow DSS.

Chris Peterson and the Southwest Region Team

Chris Peterson joined DSS in 2001. She started her career as a high school teacher in a small school district in Iowa. When the district began to deploy personal computers, she was asked to head up the implementation in her school. The process went so smoothly that she was asked to give up classroom teaching and work full-time for the district in rolling out technology across all the schools. After five years in that job she joined DSS as a consultant in the Information Technology group. She rose to the position of project manager in the group and had been very successful in leading consulting projects. When the decision was made to reorganize into cross-functional teams, Chris was seen as a "natural" to lead one of the teams and was assigned to head the Southwest Region team.

Chris looked on her new assignment with a mixture of excitement and apprehension. Much of the excitement came from the opportunity to lead a permanent team rather than coordinate individuals for short consulting projects. Her apprehension came in large part because of some uncertainties about how the new strategy would unfold. Chris was aware that many people were ambivalent about the new strategy and uncertain about the necessity of the change and whether or not it was likely to be successful. The result of this was that there was a great deal of anxiety among many consultants about the future of DSS and their roles in the new structure. Chris also suspected that the strategy was still evolving and might change as management got a sense of how well the new organization was working.

One of the decisions that Meg had made about the new teams was that the team leaders ought to have a great deal of flexibility in inviting people to join their teams. Chris welcomed this opportunity. In thinking about who she wanted for the team, she considered two factors. First, she wanted people who had good skills and were experienced in the DSS consulting process. Second, she felt she needed people who would be able to work together well. She believed this would be important because of both the nature of the work to be done and her fear that the anxiety created by the change would boil over into dissatisfaction if people had trouble working together.

Chris gave a great deal of thought about who to ask to join the Southwest Region team. She decided that one thing that would help the group work together smoothly would be to select people who already had some experience in working with one another. Overall, Chris was quite happy with the team she was able to put together. She ended up asking two consultants each from Contract Negotiations, Procurement and Systems, and Information Technology, and one consultant from the Facilities group to join the team, all of whom accepted. Even though the consultants had not worked on specific projects with each other in the past, they knew one another and had a great deal in common. Nearly all of them had worked on DSS's annual Habitat for Humanity project and all had started at DSS at about the same time. Many members of the group socialized with one another outside of work. At the first group meeting Chris realized that her strategy had worked well. Two of the consultants marveled about how nice it would be to work with people who were both very competent and friends as well. Another consultant mentioned that he didn't know many people at DSS other than the members of his new team and he was really looking forward to the project. Like most DSS consultants, members of Chris's new team had some questions about the new strategy and leadership; however all believed that their new team had tremendous potential.

Beginning the Work

As DSS was making the transition to the new structure, consultants continued to finish existing projects even as they began working with their new teams. Chris believed it was very important that her team members be located together as soon as possible even though the team would not be working together full-time right away. She believed that co-locating the team would allow the group to get a quick start on the major deliverable of developing new products for DSS and prevent the group from getting distracted by some of the uncertainties created by the new structure. Chris was able to identify some space and a plan that could bring the full team together. Since none of the other new team managers felt as strongly about the co-location of their teams as Chris did, Meg allowed Chris's team to move together before the other teams did.

Once the team got settled into its new location, they quickly got to work. Chris believed that the first issue for the team would be to share their experiences and use their collective knowledge to identify one or more potential new products, and that her initial job would be to help the group pull together their experiences. The group had a number of meetings over the next month discussing their perspectives. Chris was very pleased with what happened in the meetings. The team members seemed comfortable sharing information with one another. If a disagreement emerged, the team dealt with it without creating animosity or substantial delay. Chris was particularly pleased when two of the team members told her that this was one of the best groups they had ever been a part of.

Even though they were from different functional areas, the team members found that they had very similar experiences in dealing with districts. All of them had at least one story about how they had been delayed in a project because the people they were working with in the district were not able to get accurate data about budgets or long term plans. What emerged from the discussions was that small districts seemed to lack any integrated system for linking plans and budgets over time. The superintendent of the district seemed to be the only person who knew everything that was going on and if he or she was not available it was difficult to get timely information. The team concluded that what small districts needed was an integrated system for planning and budgeting. Although most large districts had the systems or the human resources to do this, the costs were prohibitive for a small district. The team determined, therefore, that a scaled down system could provide the level of planning small districts needed at a price they could afford. Further, this project both excited the team and was something they felt they could do well.

Planning the New Product

As members of the team began finishing the consulting projects they had been working on, they were able to devote more time to developing specifications for the new system. The majority of the team were now spending nearly all their time working with one another and saw less and less of the other consultants who were not on the team. Occasionally people would bring up what other consultants had said their teams were doing, but this seldom generated much interest and was sometimes seen as almost a distraction to the group. At this point in time, Chris had two primary goals for the team. First, she wanted to keep the group focused on the jobs of defining the new system and determining exactly how DSS consultants would use it. Second, she wanted to help the group avoid distractions and continue to build cohesion.

In addition to working with the team, Chris tried to deal with people outside the group. She had developed friendships with two superintendents in small districts and when she saw them, she took the opportunity to describe the system her team was developing. Generally, the feedback she received was positive and she relayed this to her team. Chris also met occasionally with Meg to update her on the project; however these meetings were generally short. Chris observed that some of the other team leaders spent more time meeting with Meg than she did, but she didn't see that there was much need for her to do so, given the progress her team was making.

Developing the Planning and Budgeting System

Once the specific design of the proposed budget and planning system was complete, Chris felt it was time to share the work of the team with others. She took a detailed description of the program out to a number of districts she had worked with in the past and asked for comments. She also emailed the program description to Meg and some of the DSS functional specialists who would have to provide some technical support in developing the consulting protocols and specifying parts of the code for managing the data base.

The conversations with people in the districts were informative and more-or-less positive. While generally expressing support for the new system, people in the districts raised some specific questions. Many of the comments or questions were about how the system would deal with issues that were unique to a district. A few questions emerged about the price of the product and how it would differ from other products already on the market. When Chris took these comments back to the group they tried to modify the initial design and specifications of the program to meet the concerns that were raised. This worked well in the short run, but as more comments came in, the group began to flounder as the team tried to adapt the design to meet many of the questions from outsiders.

The reactions from others inside DSS were different from those in the districts. Most of the functional specialists who received descriptions of the project simply acknowledged receiving them but did not offer any real comments. Meg responded by asking a couple of questions and saying that she and Chris would talk more about it later. Overall, the group was pleased with these responses; no one had raised any objections to the program design or identified any difficulties that would slow the project down.

As the group worked to change the project specifications in response to the comments coming in from the districts, Chris felt that the effective process the group had developed was beginning to break down. There were disagreements about how important various comments actually were and progress in finalizing the specifications seemed to slow. Team members began to voice more concerns than they had in the past about the direction DSS was going and question whether the team would be able to accomplish its task. Chris decided that something needed to be done to get the group back on track. She cancelled work on the next Friday and had the whole team meet at a nearby nature preserve. After a hike, the group returned to Chris's house for a barbeque lunch. Following lunch, the members spent the rest of the afternoon discussing how they were performing and what they needed to do to finish designing the project. Overall, this seemed to work quite well. When the team got back to work on Monday, they quickly finalized the specifications and identified the steps that would be necessary to actually develop the product and consulting protocols.

The team turned its attention to completing the project. The project had four components: a database program provided by a third-party vendor; a program for putting information into the database program written by an outside consulting firm; a set of forms districts would use to organize information about schedules and budgets; and a set of instructions for consultants to use in helping districts use the program and its results. The team split into sub-groups to work on pieces of the final project.

Putting together the forms and developing instructions for consultants were the most challenging parts of the project. Both of these tasks required detailed knowledge about the different types of projects districts might undertake. Although members of the team had the knowledge and experience to complete most of this work, they often found that they needed to draw on the specialized knowledge of the DSS specialists in the practice groups. When a specific question came up that the team could not answer, one member of the Southwest team would either email a question or have a face-to-face meeting with the specialist. This worked well for simple issues but not for more complex problems. When team members tried to get functional specialists to spend time working on these more complex problems, they were often not given much help and were occasionally rebuffed. Chris found that she often had to go directly to the manager of the practice area to try to get support. Even this didn't always work. One event typified the problem Chris was experiencing. She met with the head of Contract Negotiation to identify the specific information about a district's employees that would need to be entered into the program. He told Chris that he would ask one of his specialists to work on it with the team. When one member of Chris's team contacted the specialist, he was told that this project had not been built into her schedule and that she would not be able to help him until other things got done.

When Chris learned of this she scheduled a meeting with Meg to discuss the difficulty her team was having in getting support. From Chris's perspective, the meeting with Meg did not go particularly well. Meg seemed sympathetic to the difficulty Chris was having getting support and suggested that she could keep working with the practice group managers to get the final elements of the project completed. Chris had hoped that Meg would take more direct action. When Chris reported back to the team, the overall reaction by team members was negative. There were a number of comments about how decisions at DSS seemed to be more "political" under the new organization and how the "new Meg" seemed to be playing favorites.

Finishing the Project

Despite the difficulty in getting support from others in the organization, Chris knew that the project was close to completion and could still be a success in the market. Chris conveyed this to her team. She reminded them that even if they were not getting the type of support they would like, they had the experience necessary to finish the program on their own. Chris's optimism was contagious. The team increased their efforts and did independent research to fill in their own knowledge gaps. The project came together quickly and within 10 days the team had a full product ready for beta testing. A few weeks earlier, Chris had recruited a district that would be willing to serve as a test site and a date was scheduled for the team to go into the district to demonstrate the product.

The Meeting with Meg Cooke

As Chris came into work on Friday morning, she thought back over the last few months and was quite pleased. The group had done a terrific job of specifying and developing a new product that was ready for a beta test. Initially her team members had doubts about the new strategy and their new roles but they had overcome those, and some real obstacles, to finish the assignment. Chris was looking forward to sharing this with Meg.

From Chris's perspective, the Friday morning meeting with Meg started off very well. Chris outlined the progress her team had made on the integrated budget and planning system. She spoke about how she was managing the beta test for the program and of the positive comments she was getting from the district. She also talked about how effective her team was. They worked together very well, were cohesive, and made decisions easily and quickly. Chris also mentioned that a number of the team members had not supported the reorganization at first but despite that had invested a great deal of effort in making the team and project work and were now committed to the new direction for DSS. In particular, Chris complimented the team members on their initiative in finishing the project even when they didn't have a great deal of help from the specialists in the practice groups.

Meg thanked Chris for all the hard work on the project and mentioned that she had heard very positive things about Chris's leadership from members of the Southwest Region team. Meg then shifted the conversation and asked Chris for a report about the types of services districts in her region might be looking for DSS to provide in the future and whether some of the other projects the DSS regional teams were working on would be of interest to the districts. Chris responded that she had a general idea of what the other teams had been working on but did not feel she had sufficient information to present them to districts at this time. She went on to say that her team had focused on their project and that the plan was for them to go out and meet with all districts in the region after the project was in a beta test so that they would have something specific to discuss. She reassured Meg that although she did not have a clear answer to the question right now, she would in the near future. Meg then asked Chris how she saw the integrated budget and planning system being marketed to large school districts given that most of them already seemed to have either systems or personnel to do this. Chris responded that she understood the concern and that, at this point in time, large districts might not be interested in the system in its current form. She went to say that as the system was modified and expanded it would very likely be of interest to larger districts. After this, Chris and Meg exchanged a few pleasantries and the meeting ended.

The Monday Morning Meeting

When Chris arrived for work on Monday morning she found that she had a message from Meg asking if they could meet for coffee at 10:30. Chris was curious about the meeting, but quickly responded that she would be available, and the two agreed to meet at a nearby coffee shop. After getting coffee and talking a bit about the weekend, Meg told Chris that after reviewing her team's project and its potential, she had decided that DSS would not go forward with the scheduling and budgeting project. When Chris asked for the reasons for this decision, Meg replied that the number of new products DSS could support was limited and that teams in the other regions had not reported any interest on the part of the districts they had worked with for this type of product. Meg also said that she was concerned that the project would not be of interest to the large districts. Chris responded that she certainly understood the issue about large districts but did not agree with Meg's observation. She went on to say that she did not understand how other regional teams could say that there would not be a demand for the product when they did not even know what the planning and scheduling system could do. Meg said that she appreciated Chris's concerns but that the decision to cancel the project was final.

An awkward silence followed this last exchange. After a moment or two, Meg said that there was one more thing left to discuss. She said that the Southwest Region Team would focus exclusively on marketing DSS products and not be involved in product development work in the future and that there would be some change to the composition of the team. Meg ended by asking Chris if she was prepared to lead the group in a new direction or if she would be more comfortable and successful returning to the IT practice group as a functional specialist.

11-134
June 15, 2012

Corporate Personhood, Business Leadership, and the U.S. Presidential Election of 2012

Leigh Hafrey, Cate Reavis

Lead the people by laws and regulate them by penalties, and the people will try to keep out of jail, but will have no sense of shame. Lead the people by virtue and restrain them by the rules of decorum, and the people will have a sense of shame, and moreover will become good.

—Confucius, *The Analects* (II:3)[1]

The corporation's status as a legal person might seem an arcane matter, relative to the dire individual and organizational circumstances that set in following the subprime mortgage crisis of 2007. That crisis had evolved into the "Great Recession," which still weighed on many real, flesh-and-blood human beings in the U.S. and global economies in 2012. Yet by 2012, corporate personhood had become an issue in no less an event than the election of a U.S. president. Former Massachusetts Governor, Republican presidential candidate, and former Bain Capital CEO Mitt Romney commented to an interlocutor at the Iowa State Fair, in August 2011: "Corporations are people, my friend. . . . Everything corporations earn ultimately goes to people. Where do you think it goes?"[2] Incumbent President and Democratic candidate for re-election Barack Obama responded with equal certainty the following spring, telling an audience at a campaign stop in Ohio in May: "I don't care how many ways you explain it, corporations are not people. People are people."[3] If the debate over corporate personhood mattered to the American electorate as much as the candidates appeared to believe it should, how might businesspeople and the business community at large assess a core structural element of global business practice: the corporation?

[1] Simon Leys, *The Analects of Confucius* (New York: W.W. Norton & Company, Inc., 1997).

[2] Philip Rucker, "Mitt Romney Says 'Corporations Are People' at Iowa State Fair," *The Washington Post*, August 11, 2011.

[3] http://www.youtube.com/watch?v=mt1E6CMRzpM (accessed May 23, 2012).

This case was prepared by Cate Reavis, Associate Director, Curriculum Development, under the supervision of Senior Lecturer Leigh Hafrey.

The Great Recession and Corporate Free Speech

In early 2012, after five years of economic turmoil, glimmers of light indicated that the United States was emerging from the long dark tunnel that it had entered five years earlier.[4] The stock market was nearing 13,000, unemployment had inched its way down to 8.3%–after hitting a high of 10% in October 2009–[5]and the home foreclosure rate for the year (at 1.9 million homes, according to RealtyTrac) was the lowest since 2007. Banks were showing signs of renewed confidence. Commercial and industrial lending was up 10% in the third quarter of 2011, compared to a 1.7% decline the previous four years.[6] However, the country's debt-to-GDP ratio remained a matter of deep concern: it had started a steep upward climb right at the time the U.S. Government began bailing out financial institutions, with a ratio of 40% in 2008, and over 70% at the end of 2011.

As the economy appeared to improve, public attention focused on who should be held responsible for a crisis that had nearly brought down not only the U.S., but the entire global financial system. Heightened by a number of best selling books, including *The Big Short*, *Too Big To Fail*, and *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*; investigative pieces broadcast on the television news program *60 Minutes*; feature films including *Inside Job* and *Margin Call*; and the Occupy Wall Street protest movement, the public's interest turned to the role that financial corporations had played in the crisis. While many firms faced civil charges,[7] no firm had been criminally charged for its involvement, no executives prosecuted.[8] Beyond the possibility of criminal action lay the question of ethical responsibility: what curbs might corporations, or the boards and executives who ran them, have placed upon their operations during the run-up to the crisis? Could they themselves, as well as the society in which they operated, expect them to exercise such care, and if so, by what mechanism?

Under U.S. law, corporations had rights and responsibilities, like natural persons. In the *Santa Clara County vs. Southern Pacific Railroad Company* ruling in 1886, the chief justice of the U.S. Supreme Court, Morrison Waite, is reported to have begun oral arguments by stating, "The court does not wish to hear argument on the question whether the provision in the Fourteenth Amendment to the Constitution, which forbids a State to deny to any person within its jurisdiction the equal protection of

[4] "The Global Financial Crisis of 2008-2009: The Role of Fear, Greed and Oligarchs," provides a more detailed description of the financial crisis. The note can be accessed at https://mitsloan.mit.edu/MSTIR/world-economy/Crisis-2008-2009/Pages/default.aspx.

[5] U.S. Bureau of Labor Statistics, http://www.bls.gov/cps/tables.htm#empstat.

[6] Steve Matthews and Ilan Kolet, "Bank Credit Highest Since Before Lehman as U.S. Growth Continues," *Bloomberg*, December 11, 2011.

[7]A number of firms had paid fines for misleading investors without denying or admitting guilt. In 2011, Goldman Sachs settled a lawsuit with the Securities and Exchange Commission (SEC) agreeing to pay $550 million (4.1% of its 2010 net income) and JP Morgan agreed to pay the SEC $153.6 million (.9% of its 2010 net income). That same year, Citigroup agreed to pay $285 million (2.7% of its 2010 net income), to settle civil charges that it had defrauded customers during the housing bubble. As part of the settlement, the company made a pledge to the SEC that it would never again violate one of the main antifraud provisions of the nation's securities laws. The company had made the same pledge in July 2010, May 2006, March 2005, and April 2000. In September 2011 the Federal Housing Finance Agency, Fannie Mae and Freddie Mac's conservator since 2008, filed a lawsuit against 17 financial institutions—Ally Financial, Inc., Bank of America, Barclays Bank, Citigroup, Inc.; Countrywide Financial Corporation; Credit Suisse Holdings, Inc.; Deutsche Bank. AG; First Horizon National Corporation; Goldman Sachs & Co.; HSBC North America Holdings, Inc.; JPMorgan Chase & Co.; Merrill Lynch & Co./First Franklin Financial Corp.; Morgan Stanley; Nomura Holding America Inc.; The Royal Bank of Scotland PLC; Société Générale—alleging violations of securities laws and common law in the sale of mortgage-backed securities. Seeking damages of $200 billion the FHFA alleged that "the loans had different and more risky characteristics than the descriptions contained in the marketing and sales materials provided to the Enterprises for those securities."

[8] Jean Eaglesham, "Financial Crimes Bedevil Prosecutors," *The Wall Street Journal*, December 6, 2011.

the laws, applies to these corporations. We are all of the opinion that it does."[9] Though the legal standing of Justice Waite's statement has been questioned,[10] the opinion has been widely taken to confirm corporate personhood in U.S. law. In 2010, the concept of the corporation as a fictitious person gained new complexity when the U.S. Supreme Court, in *Citizens United v. Federal Election Commission*, prohibited the government from banning corporate and union expenditures related to political campaigns; in the Court's opinion, the ban violated the First Amendment right to free speech. As Gov. Romney and President Obama's opposing views suggested, public opinion was sharply divided—often along political party lines—on whether corporations were indeed people, and if they were, what values they might choose to voice by exercising their right to free speech.

The Accountability Question

Ultimately, the question of personhood underlay the leadership role that both individuals at the top of the corporation and the corporations themselves had played or failed to play in the downturn. Those who believed that financial firms should be held accountable for their actions, including liability for harms committed by their agents,[11] argued that, like people, corporations were granted rights, but also held to responsibilities that extended beyond the law to moral or ethical commitments to certain values. People who fell into this group believed that financial institutions needed to be held legally accountable for their actions leading up to the financial crisis. Others, who also blamed the financial firms, were wary of holding entire firms responsible for their actions at a time when the economy was still recovering. They remembered what had happened to Arthur Andersen during the Enron scandal[12]: the thought of punishing, and ultimately destroying, an entire firm for the bad behavior of a minority didn't sit well.

At the same time, many observers and industry players saw the banks and other financial services providers as victims or innocent bystanders rather than culprits. Some felt that the public sector had precipitated the crisis when it deliberately eased banking regulations starting in the late 1990's, with the goal of making homeownership a reality for more Americans. In essence, they thought that government hadn't done its job, and it wasn't fair or right to blame financial institutions. Still others believed that responsibility for the crisis should be placed on the society as a whole. Financial firms, Congress, regulators, credit agencies, accounting firms, and consumers — all had played a role in the downturn; in other words, we were all to blame.

---

[9] Santa Clara County v. Southern Pacific R.Co. 118 U.S. 394 (1886), http://supreme.justia.com/cases/federal/us/118/394/case.html (accessed June 4, 2012).

[10] Jack Beatty, *Age of Betrayal* (New York: Alfred A. Knopf, 2007), p. 110.

[11] Susan Farbstein and Tyler Giannini, "Liability for Harms," *The New York Times*, February 28, 2012.

[12] In June 2002, a federal jury convicted the accounting firm Arthur Andersen of obstruction of justice for destroying documents pertaining to its accounting work with Enron. In addition to being fined $500,000 and sentenced to five years probation, the firm agreed to stop auditing public companies, which led to the demise of the business. In the United States alone, 28,000 people lost their jobs. In 2005, the United States Supreme Court overturned the conviction finding fatal flaws in the jury instructions on which the conviction was based. For more on this see Elizabeth K. Ainslie, "Indicting Corporations Revisited: Lessons of the Arthur Andersen Prosecution," *American Criminial Law Review*, Vol. 43:107, 2006.

1. Corporations

Among those who believed that financial firms should be held responsible for the financial crisis was William K. Black, a professor of economics and law at the University of Missouri and a senior regulator for the Federal Home Loan Board during the savings and loan banking crisis of the 1980's. "I think this crisis was driven by fraud and I believe it was systemic," he stated. Furthermore, he believed, the fraud had begun in CEOs' offices and boardrooms.[13]

According to Black, certain firms had participated in accounting-control fraud, a term Black himself had coined. A control fraud occurs when a person in a position of responsibility in a company or state subverts the organization and engages in extensive fraud for personal gain. The savings and loan crisis and Enron were examples of control frauds as was, in Black's opinion, the subprime mortgage crisis.

Black believed that compensation was a key factor in creating what he called the criminogenic environment at many Wall Street banks and even the government-sponsored entities Fannie Mae and Freddie Mac. The latter were responsible for purchasing and securitizing mortgages, thereby ensuring that funds were consistently available to the institutions that lent money to home buyers. In his view, compensation schemes in these firms created perverse incentives not only at the executive, but also at the lower levels of the company hierarchy. For example, loan officers at Washington Mutual and the brokers they hired were put on volume commissions. Black commented:

> Now that's insane. We know it will produce intense adverse selection. And we know that it will produce a negative expected value. Even the brokers were tempted with commissions of $20,000 for every loan that was approved, which perpetuated false reporting of income and assets on millions of loan applications. Now the broker doesn't believe they are doing anything wrong. They're helping the client get a loan and be able to become a homeowner. They know the lender is in on it and they're not cheating the lender, or at least the lender's management.

Black believed the control fraud, motivated by perverse compensation systems, extended to major investment firms like Goldman Sachs. "The investment banks all knew that the asset values of the CDOs were massively overstated, because the incredible problems in asset quality were deliberately being covered up," Black explained. As Black noted, the industry was warned several times that mortgage fraud was "epidemic" and would likely cause an economic crisis. The FBI issued its first warnings in September 2004, in open testimony to the House of Representatives, and the industry's anti-fraud experts released a warning in early 2006 that liar's loans[14] had a fraud incidence rate of 90%. The banks, however, continued to issue these loans. Credit Suisse reported that 49% of new

[13] Interview with Bill Moyers on *Bill Moyers Journal*, April 3, 2009, http://www.pbs.org/moyers/journal/04032009/transcript4.htm.

[14] A liar loan described a category of mortgages that required little if any documentation verifying the borrower's income and assets. These loans helped encourage unethical behavior by both borrowers and lenders. For more on this see William K. Black, "When 'Liar's Loans' Flourish," *The New York Times*, January 30, 2011.

originations in 2006 (more than 1 million) were liar's loans.[15]

Jeff Shames, former CEO and chairman of MFS Investment Management and a senior lecturer in finance at the MIT Sloan School of Management, believed the large Wall Street banks bore a good deal of responsibility. As he put it, "Nothing would have happened without the CDO vehicle in place that Wall Street firms and financial engineers created. CDOs allowed banks to make instant profits on risky securities by converting them into riskless securities."[16]

Unlike Black, however, Shames didn't accuse the banks of fraud. "No corporation sets out to lie. Everything starts out legitimate. And some risky type of business gets created that some people have qualms about but the quantitative models show that it's risky, but within the bounds. And if the firm diversifies enough, it will work. So nobody in these firms believes they are doing anything fraudulent or unethical. They think 'This is the industry norm right now. It's working fine.'"

Like Black, Shames placed blame on the industry's compensation system, which rewarded people for short-term gains, not long-term growth:

> Wall Street's broken in the sense that the compensation system doesn't work for what's good for society. Financial corporations should have a bigger obligation to society. You could drive the Internet off a cliff, and nothing happens to society. You can't drive the financial industry off a cliff. As a result, a financial company can't be treated like an Internet company or a manufacturing company. Financial firms have to be held to higher standards because of their effect on the financial system and on society. Do we want finance people to be the highest paid people in society? Definitely not. The compensation structure has got to be restructured in a dramatic way or else we need to make the business less profitable by forcing banks to keep a lot more of their capital.

Many believed that expecting financial firms to act with high moral standards was unrealistic. As Leo Strine, Chancellor of the Delaware Court of Chancery,[17] remarked:

> Instead of recognizing that for-profit corporations will seek profit for their stockholders using all legal means available, we imbue these corporations with a personality and assume they are moral beings capable of being 'better' in some way in the long-run than the lowest common denominator. We act as if entities in which only capital has a vote will, when a choice has to be

[15] William K. Black, "When 'Liar's Loans' Flourish," *The New York Times*, January 30, 2011.

[16] For a more detailed description of the CDO market see Michael Lewis, *The Big Short: Inside the Doomsday Machine* (W.W. Norton & Company, 2010).

[17] The Delaware Court of Chancery is a non-jury trial court that serves as Delaware's court of original and exclusive equity jurisdiction, and adjudicates a wide variety of cases involving trusts, real property, guardianships, civil rights, and commercial litigation.

> made between profit for those who control the board's re-election prospects and employees and communities who don't, somehow be able to deny the stockholders their desires.[18]

Robert Reich, former labor secretary under President Clinton, believed that endowing corporations with moral compasses was misguided:

> Corporate executives are not authorized by anyone—least of all by their investors—to balance profits against the public good. Nor do they have any expertise in making such moral calculations. Democracy is supposed to represent the public in drawing such lines. And the message that companies are moral beings with social responsibilities diverts public attention from the task of establishing such laws and rules in the first place.... By pretending that the economic success corporations enjoy saddles them with particular social duties only serves to distract the public from democracy's responsibility to set the rules of the game and thereby protect the common good.[19]

Milton Friedman, the Nobel Laureate in economics, had argued precisely Reich's points in an article he published in the *New York Times Magazine* on September 13, 1970: "The Social Responsibility of Business Is to Increase Its Profits." Enormously influential in the U.S. and abroad during the last decades of the 20th century, Friedman saw government as the umpire to the games businesses play. Hadn't the corporation changed during that time, though? What to make of the retort to Friedman implicit in management guru Charles Handy's 21st-century comment that "It used to be said that the business of business was business, but that was before those businesses became larger than countries"?[20] One might argue that the burden of responsibility on the business community had moved it beyond the freedom to play games with other people's money, let alone their lives: the analogy of controls on big finance, like the ones that the Federal Drug Administration applied to pharmaceutical companies, had begun to proliferate.

2. Government

The size and reach of 21st-century corporations notwithstanding, many believed that government was largely responsible for the financial crisis. David Schmittlein, John C Head Dean of the MIT Sloan School of Management, commented:

> I think a lot of people would like to make it about a few big banks that got together and did something naughty. And it isn't fair, and it's barely even true. The banks were not the root cause of the problem. They did not inflate housing prices. The housing bubble was first and foremost the result of an expansive monetary policy by the federal government, under multiple presidential

[18] Leo E. Strine, Jr., "Bailed Out Bankers, Oil Spills, Online Classifieds, Dairy Milk, and Potash: Our Continuing Struggle with the Idea that For-Profit Firms Seek Profit," *The University of Western Ontario, The Beattie Family Lecture in Business Law*, March 8, 2011.

[19] Robert Reich, "How Capitalism Is Killing Democracy," *Foreign Policy*, September/October, 2007.

[20] Charles Handy, "Tocqueville Revisited: the Meaning of American Prosperity," *Harvard Business Review* (Reprint # R0101C), January 1, 2001, p. 10.

> administrations, and secondly the result of federal government policies and institutions aimed at expanding home ownership.

Many argued that financial institutions, under extreme pressure to deliver short term results, were merely pushing boundaries that government had set too loose. As Leo Strine noted:

> It is well known that businesses aggressively seeking profit will tend to push right up against, and too often blow right through, the rules of the game as established by positive law. The more pressure business leaders are under to deliver high returns, the greater the danger that they will violate the law and shift costs to society generally, in the form of externalities. In that circumstance, if the rules of the game themselves are too loosely drawn to protect society adequately, businesses are free to engage in behavior that is socially costly without violating any legal obligations.[21]

Nouriel Roubini, an economist at New York University, was more assertive in blaming the government decision to loosen regulations. He believed the financial crisis represented a massive failure of public policy:

> There was an ideology for the last decade in Washington that was critical to this financial crisis. [It] was an ideology of laissez-faire, Wild West unregulated capitalists. The base of this ideology was the idea that banks and financial institutions will self-regulate. And as we know, self-regulation means no regulation. It was the ideology of relying on market discipline, and we know when there is irrational exuberance, there is zero market discipline….
>
> The job of the Fed is to take away the punchbowl when the party gets going but unfortunately not only did the Fed not take away the punchbowl, it added vodka, whiskey, gin and every toxic stuff to it. Greenspan was the biggest cheerleader of this kind of financial innovation: zero down payment, no verification of income, assets and jobs, interest-only mortgages, negative amortization, teaser rates, all this toxic stuff.[22]

Why didn't Alan Greenspan, then head of the Federal Reserve, "take away the punchbowl"? Simon Johnson, the former IMF chief economist and a professor at the MIT Sloan School of Management, believed that the government had fallen victim to regulatory capture. In essence, the government had allowed a few big financial institutions to use their size and power to reshape the political and regulatory landscape to their advantage. As a result, they had become too big to fail:

> The political influence of Wall Street helped create the laissez-faire environment in which the big banks became bigger and riskier until by 2008 the threat of their failure could hold the rest of the

[21] Leo E. Strine, Jr., "Why Excessive Risk-Taking Is Not Unexpected," *The New York Times*, October 5, 2009.
[22] "Blame Washington More Than Wall Street for the Financial Crisis," *Intelligence Squared US*, March 17, 2009.

> economy hostage. That political influence also meant that when the government did rescue the financial system, it did so on terms that were favorable to the banks. What 'we're all in this together' really meant was that the major banks were already entrenched at the heart of the political system, and the government had decided it needed the banks as much as the banks needed government. So long as the political establishment remained captive to the idea that America needs big, sophisticated, risk-seeking, highly profitable banks, they had the upper hand in any negotiation. Politicians may come and go, but Goldman Sachs remains.[23]

3. Society

Andrew Lo, a professor of finance at the MIT Sloan School of Management and the director of MIT's Laboratory of Financial Engineering, believed that responsibility for the crisis could not be placed on one group or even shared among financial corporations and the government:

> When you have society-wide disregard for certain practices, then effectively what's happening is that the rules are being rewritten. I think this is about a broader set of issues that interact between ethics and sociology and economic behavior.
>
> This is not just about one group that fell asleep at the wheel. It was systemic. And the reason it was systemic is pretty simple. When things go well—politicians are getting reelected, regulators are getting kudos for how stable the markets are, shareholders are making money, mortgage brokers are making money, homeowners are making money—nobody wants to leave the party early. It takes an enormous amount of courage to stand up to that. And people did and they were crushed. The whistle-blowers at Citi and Countrywide were fired.[24] We have to think much more expansively then simply saying corporations were irresponsible. There are plenty of people that were irresponsible in addition to corporations.

Americans' cozy relationship with consumption and, therefore, debt, also bore a share of the blame. As David Beim, a finance professor at Columbia Business School, argued in early 2009:

> The ongoing recent global economic collapse is so monstrous, so broad and so deep that it requires a big-picture explanation. This isn't just about some stupid moves by mortgage brokers in California—how could that have such a vast impact on the global economy? It isn't just about Wall Street greed—hasn't Wall Street been greedy forever?
>
> For the past 25 years we have been over-consuming and over-borrowing…The problem is debt itself. All that borrowing by individuals had a powerful stimulatory effect on the economy. Business sales grew, and production increased to meet improved demand. But debt was growing

[23] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010), p. 6.

[24] For more on this see: "Prosecuting Wall Street," *60 Minutes*, December 4, 2011, http://www.cbsnews.com/8301-18560_162-57336042/prosecuting-wall-street/?tag=contentMain;cbsCarousel.

> faster than income, so the aggregate 'credit ratio' of household debt to median household income steadily deteriorated. People maxed out their credit cards and pulled the equity out of their houses. And most people stopped worrying about ever paying the debt back, since the abundant liquidity in our system made it seem that debt could always be rolled over and refinanced. More of our prosperity than we have been willing to admit has been driven by debt.[25]

A Business Solution?

If "we" were the cause, if all of us were to blame, what was the proper response to the crisis? Was it a matter of, in Beim's words, ending our addiction to overindulgence?[26] What clinic would or could coordinate such a collective detoxification? Andrew Lo believed that significant societal change might be in order:

> I think we have come to the conclusion that we cannot conduct business as usual any longer because our society has gotten so complex and it just doesn't work anymore. It's fine for the financial sector to do what it did when there were 1.5 billion people on this planet back in 1900. But we are now 7 billion people. And we may be at a point in our evolution where our technological advances have gotten a bit ahead of our ability to manage them responsibly. We may have to reinvent not just the corporation, but the way that we deal with regulatory issues, the way we handle social and political interactions.

But again, who were "we"? What role might corporations—and more specifically, financial institutions—play in the voluntary and many-faceted change that Lo envisioned? Could or should corporations step up to the complex role that their "personhood" implied, and that the sector leadership roles of AIG, J.P. Morgan Chase, Goldman Sachs and others brought with them?

The absence of swift and significant corporate punishment resulting from the financial crisis, together with the high-profile Supreme Court decision on Citizens United, suggested that corporate rights were being given precedence over responsibilities, and not just by the corporations. Yet Leo Strine argued that, whatever the implications of the Fourteenth Amendment for corporate freedoms, corporations likely could not claim First Amendment—free speech—rights:

> The standing, bipartisan statement of the federal judiciary had been that corporations are creatures of the state and have only such authority as is entrusted to them. The problem with Citizens United is that it ignores this. No one ever believed that the corporation was a human being for first amendment purposes. I don't think we should be treating corporations as if they're human beings. And I think it's incredibly important that we don't, precisely because the whole reason that you have for-profit corporations is to fuel economic growth. And there are great dangers in that, and that's why they have to be regulated.

[25] David. O. Beim, "It's All About Debt," *Forbes*, March 19, 2009.

[26] Karen Ingraham, "Anatomy of a Meltdown: Table Talk with David O. Beim, '58," *The Exeter Bulletin*, Spring 2009, p. 10.

It was hard to imagine where one might draw a line on the kind of adjustment Strine invoked, given the hostility towards corporations expressed by some citizens on the political spectrum, and the politicians who represented them. The repeal of corporate personhood was supported by a number of national and local lawmakers, [27] [28] [29] as well as Move to Amend, a social and economic justice coalition made up of hundreds of organizations.[30] One could conceivably reverse the legal precedents establishing corporate personhood, and eliminate the protections that firms had gradually acquired through them to enhance their operating freedom. Doing so might undo the structural benefits, such as lower transaction costs, that Ronald Coase had identified, in his influential 1937 essay "The Theory of the Firm," as a motivation for forming business entities: groups of people doing together what no individual or group of unaffiliated individuals could hope to achieve alone. It would likely entail a massive redefinition of the corporate entity and rethinking of the incorporation process, with a return to state chartering of corporations in a narrowly defined public interest; with that would come, at least in principle, much tighter state monitoring of corporate activity. As Robert Reich argued, "If the purpose of capitalism is to allow corporations to play the market as aggressively as possible, the challenge for citizens is to stop these economic entities from being the authors of the rules by which we live."[31]

The most obvious alternative had its own strong advocates and detractors. One might keep to the concept of "corporate personhood" and, recognizing that corporations had too often, sometimes inadvertently, sometimes for the best of motives, turned privilege into presumption, put in place a more structured system of responsibilities that were enforced as vigorously as corporate rights were protected. This approach underlay the renewed interest, as the 21st century began, in seeing business as a profession, with the commitment to service and expertise idealized in occupations like the law and medicine.[32] To translate individual into organizational responsibility, the business community would need to develop the commitment to a code, and a willingness among business people to monitor themselves through an organization of their own devising. This would allow corporations to maintain their current legal status, with the understanding that, as H.D. Thoreau had put it in *Civil Disobedience* over a century and-a-half before, "It is truly enough said that a corporation has no conscience; but a corporation of conscientious men is a corporation with a conscience."[33] With that shift in emphasis, corporate ethics would become a necessity, rather than the luxury for which it was too often mistaken, in both the corporation and society at large. The shift might also force a

---

[27] Supreme Court Justice Sonia Sotomayor hinted at her support for a repeal when she said, during a campaign-finance case, that the court should reconsider the 19th century rulings that first afforded corporations the same rights flesh-and-blood people have (Jess Bravin, "Sotomayor Issues Challenge to a Century of Corporate Law," *The Wall Street Journal*, September 17, 2009).

[28] Senator Bernie Sanders of Vermont and Representative Jim McGovern of Massachusetts had both introduced constitutional amendments in their respective legislative bodies calling for the repeal of corporate personhood (Steven Rosenfeld, "The Hard Truth About Citizens United," *Salon.com*, January 21, 2012).

[29] The cities of New York, Los Angeles, Albany, Boulder, and Oakland had all passed resolutions urging Congress to overturn corporate personhood ("New York City Council Passes Resolution Opposing Corporate Personhood," *The Huffington Post*, January 5, 2012).

[30] http://movetoamend.org/mta-coalition.

[31] Robert Reich, "How Capitalism Is Killing Democracy," *Foreign Policy*, September/October, 2007.

[32] Rakesh Khurana and Nitin Nohria, "It's Time to Make Management a True Profession," *Havard Business Review*, October 2008.

[33] Henry David Thoreau, "Civil Disobedience," Part 1, Paragraph 4. This essay was originally published in 1849 as "Resistance to Civil Government." (http://thoreau.eserver.org/civil1.html, accessed March 13, 2012).

redefinition of corporate leadership, one that aligned with the general social perception that leaders should demonstrate a higher-order self-discipline in their dealings, even as they took higher-order risks to insure the well-being of those they led.

Behind both choices, of course, lay the possibility of a systemic status quo: by 2012, the financial services community had become more powerful than it was before the downturn began,[34] with all of the attendant benefits and risks of its operations magnified. The election of 2012 would take place regardless of action on the part of the business community—some would say, *because* of that community's actions. Yet, as of mid-2012, the Great Recession continued not to yield the real gains in employment, overall economic growth, and social stability that constituents were seeking: other responsible parties to these events aside, who in the business community might step up to offer what an effective majority considered a sustainable path forward, and on what terms?

[34] David Lynch, "Banks Seen Dangerous Defying Obama's Too-Big-to-Fail Move," *Bloomberg*, April 16, 2012.

12-135
Rev. October 1, 2012

Harry Markham's Loyalty Dilemma (A)

John Minahan, Cate Reavis

In early 2012, as he prepared to enter a meeting with the board of trustees of a state pension fund, Harry Markham,[1] CFA, couldn't help but feel professionally conflicted. Since earning his Master of Finance in 2004 at one of the top business schools in the United States, Markham had worked for Investment Consulting Associates (ICA), a firm that gave investment advice to pension funds. Since joining the firm, Markham had grown increasingly concerned over how public sector pension fund liabilities were being valued. If he valued the liabilities using the valuation and financial analysis principles he learned in his Master of Finance and CFA programs, he would get numbers almost twice as high as those reported by the funds. This wouldn't be such a problem if he were allowed to make adjustments to the official numbers, but neither his clients nor his firm were interested in questioning them. The board didn't want to hear that the fund's liabilities were much larger than the number being captured by the Government Accounting Standards Board (GASB) rules and his firm wanted to keep the board of trustees happy. How, Markham wondered, was he supposed to give sound investment advice to state treasurers and boards of trustees working from financials that he knew were grossly misleading?

Markham's dilemma came down to conflicting loyalties: loyalty to his firm, loyalty to the boards of trustees and others who made investment decisions for public pensions and who, by turn, hired his firm to provide investment expertise, and loyalty to the pensioners themselves, as Markham believed was called for by the CFA Code of Ethics and Standards of Professional Conduct.

---

[1] This case is based on actual events; however, the protagonist, the firm, and some of the narative is fictional.

This case was prepared by Cate Reavis, Associate Director, Curriculum Development, under the supervision of Senior Lecturer John Minahan.

Public Pensions

Like their private sector counterparts, public sector pensions provided retirement income and benefits for public sector employees. While the goal was the same, the way in which the two sectors reached that goal was often quite different. The private sector increasingly relied on defined contribution plans (e.g., 401Ks) whereby the employee decided where and how much money to invest in a retirement account. In a defined contribution plan, the employee bore all responsibility. (See **Figure 1**.)

In contrast, nearly 80% of state and local government workers had defined benefit pension plans.[2] In a defined benefit plan, an employer commits to paying its employee a specific benefit for life upon their retirement. The amount of the predetermined benefit was usually based on factors such as age, earnings, and years of service. Actuaries determined the contributions by using statistical analysis to calculate the costs of future risks.[3] Under a defined benefit plan, employers bore the financial risk. When payouts fell short, say, for example, if funds' return on investments failed to meet expectations as they did during the financial crisis of 2008, governments would be forced to dip into other areas of the budget and/or raise taxes to fill the gap.

Figure 1 Traditional Defined Benefit Plan and Traditional Defined Contribution Plan

Strategic Considerations	Defined Benefit Plan	Defined Contribution Plan
Employee retention	Attracts longer tenured/older employees	Attracts shorter tenured/younger employees
Financial liabilities	Placed on the corporate sponsor	Placed on the participant
Responsibility placed on employee	Very little	Significant--voluntary contributions, necessary investment decisions
Responsibility placed on employer	Significant--investment decisions, financial liability	Less significant
Employer fiduciary responsibility	Significant	Significant
Investment results	Average returns are higher/narrower distribution of returns	Average returns are lower/broader distribution of returns

[2] http://www.bls.gov/ncs/ebs/benefits/2010/ownership/govt/table03a.htm

[3] "What is a defined benefit pension plan?" *New York Life*, November 16, 2010.

Economic savings	Significantly increases savings rate and the available pool of national savings	Less significantly increases savings rate and the available pool of national savings
Personal retirement savings	Maximizes savings for retirement	Allows withdrawals and loans before retirement, depleting retirement savings
Fees	Lower overall fees	Higher overall fees
Administrative complexity	Generally high	Generally high
Portability	Not typical	Yes

Source: Stephen P. McCourt, "Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis," Benefits & Compensation Digest, February 2006.

Diverging Views on Liabilities

In their 2009 article, "The Liabilities and Risks of State-Sponsored Pension Plans," Joshua Rauh of Northwestern's Kellogg School of Management and Robert Novy-Marx of the University of Chicago, had some sobering words for the future of public pensions. While it was well known that public pension funds were facing a funding crisis, Rauh and Novy-Marx believed the problem was much worse than what was being reported in government financial statements. It was their view that state pension funds were underfunded not by $1.04 trillion, the official figure, but rather $3.23 trillion (**Exhibit 1**).[4]

What accounted for the discrepancy? In valuing the liabilities of pensions, actuaries followed the rules set forth by the Government Accounting Standards Board (GASB), which called for discounting the cash flow of pension liabilities at the expected return on assets that had been set aside to fund the liabilities. With support from GASB, actuaries argued that, due to the long-term horizon of public pension funds, a discount rate of about 8% was appropriate, and that this rate was supported by investment return history.[5] However, economists argued that it was inappropriate to discount liabilities at the expected return on assets — 8% was too high a discount rate not only because it reflected possibly over-optimistic expectations about future returns, but more importantly, because it was inappropriate to discount liabilities at the expected return on assets in the first place.[6] The use of an 8% discount rate resulted in "nonsense valuations," economists argued, valuations that were nonetheless taken seriously by actuaries and plan sponsors.

---

[4] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives*, Fall 2009, p. 191-210.

[5] Mark Miller, "How Big Is the Public Pension Funding Gap?" *Reuters Money*, March 16, 2011.

[6] Lawrence N. Bader and Jeremy Gold, "Reinventing Pension Actuarial Science," *The Pension Forum*, Society of Actuaries, 2003.

In contrast, economists and financial analysts, like Rauh, Novy-Marx, and Harry Markham, did not take accounting at face value. According to Markham, "Some actuaries and plan sponsors act and speak as if accounting measures are unambiguous, unbiased measures of reality, or perhaps are reality itself. Economists and financial analysts have a term for this: accounting illusion." Like Rauh and Novy Marx, Markham believed the discount rate should reflect the fact that public pensions were secure promises. In his view, a 3% to 4% rate was more appropriate. He explained:

> If you knew for sure you were going to earn 8%, then it would be appropriate to discount the liabilities at 8%. But the highest rate you can earn with any degree of certainty is about 3% in the current environment, so this is the appropriate discount rate for a promise, which is intended to be low-risk. The plan sponsor may decide to invest in assets more risky than the liabilities in the hope of earning 8%, but so long as the pensions remain secure, employing a risky investment strategy to juice expected returns doesn't change the value of the pensions, or the appropriateness of a low-risk discount rate.

But Markham was well aware that this wasn't the mindset of a majority of those responsible for managing state pension funds or, for that matter, Investment Consulting Associates.

Markham's Dilemma

In his role as investment advisor, the differing views on how to value pension liabilities challenged Markham on both a practical and an ethical level. "My role is not to decide the value of liabilities," he explained.

> That's the actuary's job. My role is to give investment advice. But as an investment adviser, the first thing you want to understand is the client's circumstances. That's a basic ethical precept. The CFA professional standards say you should never give advice without knowing what your client's circumstances are. And so what happens is that we have these funds that are grossly short of money, but the accounting doesn't show them as being grossly short of money. I make the case within my firm that we need to know where we're starting before we give advice. And perhaps our advice would be different if the client knew they were starting from a multi-billion dollar hole that they're seemingly not aware of.

In addition to the fact that Markham was constrained by not having what he believed were accurate accounting figures to work with, he was also well aware that his clients didn't like bad news. He feared that if he was to raise the liability issue, he and his firm could very well be fired:

> Most plan sponsors want to minimize near-term contributions to their pension fund, and this makes them predisposed to points of view that justify higher discount rates. Furthermore, investment committees and staffs consider their mandate to be to earn, at least, the discount rate assumed by actuaries. The social pressure to embrace overly optimistic return expectations can be

> enormous. As one plan sponsor told me, 'It wouldn't be in plan members' interest to lower the discount rate because the increase in liabilities would so shock the taxpayers and the state legislature that it would undermine political support for the plan.' Given this context, plan sponsors don't want to hear the news that they are less well funded than the numbers show and may blame the messenger. And if it's an elected official you're dealing with, they don't want a crisis on their watch.
>
> But an investment advisor has a professional responsibility to help plan sponsors make good investment decisions, and understanding one's financial condition is a necessary precursor to making sound investment decisions. This may require telling plan sponsors things they don't want to hear. If investment advisors don't do this, they become enablers of their clients' denial and of the poor decisions that result from that denial.

As a CFA charterholder, Markham annually attested to his compliance with the Code of Ethics and Standards of Professional Conduct (**Exhibit 2**). Specifically, CFAs must not knowingly make any misrepresentations in investment analysis recommendations. "So if you have an investment recommendation that's based on bad numbers," Markham began, "numbers that are legal and comply with the rules, but you know they're bad, are you violating this ethical rule?"

Risks and Loyalties

As Markham was summoned into the conference room to begin his presentation to the board of the state pension fund, he was wrestling with whether or not to raise the liability issue. He knew there were risks either way. There was the risk that his client would choose to take their business elsewhere if he told them what he believed to be the fund's financial reality. Furthermore, such a move would not only result in lost business, but would likely be interpreted as disloyalty towards his firm.

But then he thought about what didn't happen during the 2008 financial crisis, and this reality gnawed at him:

> When the subprime crisis played out everybody was asking why, even though there were all these people that had a role in making it happen, no one spoke up? And so does somebody who is playing a bit part in creating a reprise of the last crisis have a responsibility to speak up on behalf of the pensioners themselves even though this is contrary to the wishes of their employer and the board of trustees who has hired their employer to provide investment advice?

Exhibit 1 State Pension Underfunding (as of 2008)

State Name (# of plans)	Pension Assets (in $ billions)	Liabilities As stated (in $ billions)	Liabilities Economist Estimates (in $ billions)
Ohio (5)	115.6	190.9	332.5
Colorado (1)	29.3	55.6	105.4
Rhode Island (1)	6.0	12.4	27.1
Illinois (4)	65.7	151.1	284.8
Alabama (3)	22.3	41.0	78.8
Wisconsin (1)	62.2	82.9	153.3
South Dakota (1)	6.0	7.1	13.6
Missouri (3)	27.0	51.3	88.6
Mississippi (3)	15.1	29.3	51.8
Oregon (1)	46.1	56.6	90.4
New Mexico (2)	16.2	26.7	45.0
South Carolina (2)	21.8	39.7	68.4
Kentucky (3)	21.6	43.6	74.5
Oklahoma (4)	12.0	32.3	54.7
New Jersey (4)	60.5	123.4	204.8
Arizona (3)	25.0	40.6	85.1
Connecticut (3)	20.4	42.8	80.7
Texas (4)	125.3	179.0	313.5
Georgia (2)	53.7	75.2	137.3
New Hampshire (1)	4.4	7.8	14.2
Maine (1)	8.3	13.7	24.0
Nevada (1)	17.8	24.0	44.0
Minnesota (4)	36.2	57.9	109.9
California (3)	330.0	484.2	805.7
Montana (2)	5.9	8.6	15.4
Arkansas (3)	8.1	20.8	38.3
Louisiana (2)	17.7	35.7	61.4
Maryland (1)	27.8	50.2	88.2
Hawaii (1)	8.3	16.6	28.1
Pennsylvania (2)	70.9	104.1	190.5
Iowa (1)	18.1	24.5	42.3
Kansas (1)	10.3	20.1	36.0
Wyoming (4)	4.8	7.0	12.3
Alaska (2)	11.7	14.5	24.3
Idaho (1)	8.1	11.9	21.0
Utah (3)	18.6	20.4	38.5

Indiana (2)	15.5	36.4	62.4
Florida (1)	97.2	124.1	213.7
Washington (7)	44.3	58.9	101.1
Virginia (1)	41.3	61.6	100.1
Michigan (4)	43.4	69.9	118.4
Massachusetts (2)	37.8	55.4	96.7
Tennessee (1)	25.8	34.7	58.1
West Virginia (2)	6.6	12.3	19.1
New York (3)	189.8	227.0	356.2
North Carolina (2)	59.1	68.7	117.0
Nebraska (2)	5.4	7.9	14.1
North Dakota (2)	2.9	3.6	6.7
Delaware (1)	6.2	6.9	12.0
Vermont (3)	2.4	3.8	6.7
Total (116)	**1936.7**	**2975.1**	**5167.1**

Source: Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," Journal of Economic Perspectives*, Fall 2009, p. 191-210.*

Exhibit 2 CFA Code of Ethics and Standards of Professional Conduct

PREAMBLE

The CFA Institute Code of Ethics and Standards of Professional Conduct are fundamental to the values of CFA Institute and essential to achieving its mission to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. High ethical standards are critical to maintaining the public's trust in financial markets and in the investment profession. Since their creation in the 1960s, the Code and Standards have promoted the integrity of CFA Institute members and served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. All CFA Institute members (including holders of the Chartered Financial Analyst® [CFA®] designation) and CFA candidates must abide by the Code and Standards and are encouraged to notify their employer of this responsibility. Violations may result in disciplinary sanctions by CFA Institute. Sanctions can include revocation of membership, revocation of candidacy in the CFA Program, and revocation of the right to use the CFA designation.

THE CODE OF ETHICS

Members of CFA Institute (including CFA charterholders) and candidates for the CFA designation ("Members and Candidates) must:

- Act with integrity, competence, diligence, respect, and in an ethical manner with the public, clients, prospective clients, employers, employees, colleagues in the investment profession and other participants in the global capital markets.
- Place the integrity of the investment profession and the interests of clients above their own personal interests.
- Use reasonable care and exercise independent professional judgment when conducting investment analysis, making investment recommendations, taking investment actions, and engaging in other professional activities.
- Practice and encourage others to practice in a professional and ethical manner that will reflect credit on themselves and the profession.
- Promote the integrity of and uphold the rules governing capital markets.
- Maintain and improve their professional competence and strive to maintain and improve the competence of other investment professionals.

STANDARDS OF PROFESSIONAL CONDUCT

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must:

- **a.** Make a reasonable inquiry into a client's or prospective client's investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly.
- **b.** Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action.
- **c.** Judge the suitability of investments in the context of the client's total portfolio.

2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must make only investment recommendations or take only investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members and Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless:

- **1.** The information concerns illegal activities on the part of the client or prospective client,
- **2.** Disclosure is required by law, or
- **3.** The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that competes with or might reasonably be expected to create a conflict of interest with their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTIONS

A. Diligence and Reasonable Basis. Members and Candidates must:

1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions.

2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients.

Members and Candidates must:

1. Disclose to clients and prospective clients the basic format and general principles of the investment processes they use to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes.

2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients.

3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analyses, recommendations, actions, and other investment related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from or paid to others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Members and Candidates in the CFA Program.

Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA Designation, and the CFA Program.

When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA program.

Source: http://www.cfainstitute.org/ethics/codes/ethics.