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PERSPECTIVES

Ethical Decision Making: More Needed Than Good Intentions

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> There are truly sinister businesspeople with sinister intentions, but, for the most part, ethical and legal lapses are the stuff of average people who know better.
>
> John Dalla Costa
> *The Ethical Imperative* (1988)

As William Bernstein recently wrote in these pages, the comparatively lucrative compensation generally enjoyed in the financial industry both tempts professionals to act unethically and invites persons with such a bent to self-select into the industry (Bernstein 2006). Despite that fact, most financial analysts and other finance professionals have a basic desire to act ethically (Diermeier 2005; Dobson 2005). Nonetheless, many in the finance industry have fallen far short of even the most minimal ethical standard in recent years (Jennings 2005; Dobson 2003).

When looking at media images of Jack Grubman, Henry Blodget, Frank Quattrone, Andy Fastow, Bernie Ebbers, Ken Lay, and others doing the proverbial "perp walk," most people have a tendency to say reassuringly to themselves, "They have done bad things. They must be bad people. I am a good person. I would not do such things." This tendency to overemphasize character and underemphasize situational influences is particularly common in Western societies that value individualism.

However, few of the finance professionals involved in recent scandals involving fraudulent research recommendations, front running, late trading, market timing, insider trading, and the like, woke up one morning and said to themselves, "Today is the day that I start my life of crime. The rules don't apply to me any more." Most of these "perps" were just as their neighbors described them in interviews—good parents, good neighbors, often active in their churches and communities. In short, the unethical actions of the infamous wrongdoers who have recently populated the crime sections of the financial papers do not prove that they are evil people. Rather, they simply illustrate one of the most fundamental lessons of psychology research in the past century: The circumstances in which we find ourselves often (not always) have more to do with the decisions we make and actions we take than do our basic character traits (Ross and Nisbett 2001).

The tendency to conclude that other people make mistakes because they are bad people whereas *we* make mistakes because we are trapped in a difficult situation is something researchers call the "fundamental attribution error." Mr. A and Ms. B may have an equivalent commitment to moral absolutes and similar strength of character. But Mr. A may be exposed to extreme temptation, or have a boss who pressures him to stretch the rules, or he may join an organization with a culture that encourages cutting corners in legal compliance. If Ms. B is lucky enough to avoid those pressures, then as she sees Mr. A led away in handcuffs, she should probably say, "There but for the grace of God go I." The fundamental attribution error is for Ms. B to say, "Mr. A must be a bad man." The psychology evidence is overwhelming that the situational dominates the dispositional; in other words, under the right conditions, "Good people can be induced, seduced, and initiated into behaving in evil ways" (Zimbardo 2007, p. 211).

The aim of this article is to underline for finance professionals that, although good intentions are essential to ethical behavior, they are not sufficient. Even well-intentioned people can stumble into ethical minefields if they do not keep their ethical antennae up and guard against errors in judgment that are commonly made—errors that, indeed, people are often *predisposed* to make. The first part of the article describes many of the cognitive biases and decisional heuristics (mental shortcuts) that can create ethical traps. These concepts form the basis of

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behavioral finance and have been addressed in the pages of this journal in relation to their adverse impact on investment decisions (e.g., Dimson, Marsh, and Staunton 2004; Shiller 2002; Thaler 1999). But many people do not fully realize how the same cognitive limitations may also lead to decisions that are unethical. The second major part of the article suggests attitudes and actions that can assist those acting in good faith to minimize, even if not eliminate, those dangerous limitations.

Difficulties in Ethical Decision Making

Decisions that have an ethical aspect are subject to various biases in how people see the situation and how they tend to behave.

Obedience to Authority. Fastow of Enron Corporation, David Duncan of Arthur Andersen, and other leading figures in the Enron-era scandals explicitly raised the so-called Good Nazi defense that they were "just following orders." Although this defense did not play well in the media, most people realize at some level that *obedience to authority* is a natural human tendency.

Psychologist Stanley Milgram conducted a famous experiment to understand why so many seemingly normal people willingly took part in Hitler's Final Solution. In the experiment, participants were asked to obey the experimenter's instructions to administer increasingly injurious shocks to an innocent, protesting victim (in fact, the victims were not harmed and were actors pretending to be harmed). People to whom his experiment was described predicted that fewer than 1 percent of participants would obey, but he found that about 65 percent obeyed. People tend to be far more deferential to authority than they realize (Milgram 1963).

The subjects of the Milgram experiment were responding to directions from a fellow whose authority derived solely from the white lab coat he was wearing. How much stronger is the influence of a boss whom employees like and trust and who may hold their economic future in his or her hands? Pleasing authority usually leads to rewards; displeasing authority often gives rise to penalties, including loss of employment. Therefore, we should not be surprised by empirical studies indicating that people are much less likely to take part in unethical actions when acting on their own volition than when ordered, or even simply urged, to do so by a superior. Thus, in Blodget's infamous e-mails while he was at Merrill Lynch, he privately wished that he had the courage to describe stocks that he had praised publicly as being the pieces of "crap" and worse that he truly believed them to be. His employer's pressure to help the firm drum up investment banking business was too great for Blodget to overcome.

Two related points are important. First, for the authority problem to come into play, the boss need not explicitly order an employee to perform unethical activities. Employees are *intuitive politicians* who can infer the wishes of those to whom they are accountable and act accordingly (Tetlock 1991). Often, those inferences are easily drawn from incentive schemes, such as the bonuses that dot-com era securities analysts enjoyed when their stock cheerleading garnered investment banking business for their firms.

Second, although employees may recognize the unethical nature of their behavior, as Blodget apparently did, a desire to please authority may lead them to focus on carrying out instructions or fulfilling a superior's desires without even realizing the ethical dimensions of their actions. For example, pursuing the *acceptability heuristic* (Tetlock 1985), employees often frame their task as finding the answer that will be acceptable to their superiors rather than the accurate answer or the ethical answer.

Conformity Bias. In every aspect of their lives, people take cues from those around them about the proper way to act. By observing others, newcomers to the workplace learn office protocol for everything from how deferential to be to the boss to how much to spend on Administrative Assistants' Day. By conforming their behavior to that of those around them, people can avoid any embarrassing social faux pas and, perhaps, a career-ending breach of office etiquette. As with obedience to authority, however, people not only tend to underestimate the strength of this *conformity bias* but also fail to realize how it can lead them to make unethical decisions.

The conformity bias strongly pushes people to conform their judgments to the judgments of their reference group. Conforming behavior delivers psychic payoffs when it is observed by peers. In a famous experiment, psychologist Solomon Asch found that when asked to tell which of three lines was the same length as a fourth line, subjects had no difficulty *unless* they were placed in an experimental condition in the presence of six of the experimenter's confederates who gave obviously wrong answers. Almost all subjects then found it very difficult to give the obviously correct answer in contradiction to total strangers' erroneous answers. More than 60 percent of the subjects gave an obviously incorrect answer at least once (Asch 1951). If

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people have such a strong need for social approval even in this artificial setting involving strangers, imagine how much stronger the pressure is when the observers are friends and coworkers.

Parents tend to reject their children's pleas of "everyone else is doing it," but this defense is inevitably raised by those accused of sleight of hand in the financial world (see Levitt and Dubner 2006). Overcoming peer pressure in order to criticize colleagues' strategic or tactical decisions is difficult. To criticize their decisions on ethical grounds is much more difficult because of the subjective nature of ethical judgments and the implicit criticism being made of the colleague's character. Brain scans indicate that going along with the group does not necessarily entail higher-order thinking but making independent judgments contrary to those of peers lights up areas of the brain associated with emotion, indicating that asserting independent judgment exacts a psychic cost (Berns, Chappelow, Zink, Pagnoni, Martin-Skurski, and Richards 2005). *Harry Potter's* Albus Dumbledore was correct, therefore, when he noted, "It takes a great deal of bravery to stand up to our enemies, but just as much to stand up to our friends" (Rowling 1997, p. 306). No wonder it is so difficult to be a whistleblower. People who muster the courage to blow the whistle—such as Sherron Watkins at Enron and Cynthia Cooper at WorldCom—are rightly regarded as heroes.

Dobson (2003) explained that corporate codes of conduct cannot effectively compete with actual corporate cultures that are inconsistent with the code's stated values. He noted how employees become *acculturated* to the day-to-day behavior they see around them because they assume such behavior is what is normal and acceptable in their field.

As a professor at the University of Texas, I know that this institution sent many freshly minted MBAs into the ethical meat grinder that was Enron. Any quick perusal of the "tell-all" books penned by Enron insiders quickly shows how readily many new employees were acculturated into Enron's fast-and-loose corporate style without fully recognizing the ethical implications of company practices. An employee in a risk management position at Enron admitted:

> If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings . . . . Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into "Well, everybody else is doing it, so maybe it isn't so bad." (Byrne 2002)

The famous Enron RICE (for Respect, Integrity, Communication, and Excellence) Code of Ethics did not stand a chance when new employees daily saw it being observed mainly in the breach.

Incrementalism. Acculturation can be particularly effective when accomplished incrementally. *Incrementalism*, also known as the "boiling frog" syndrome or the "slippery slope," means that much "unethical behavior occurs when people unconsciously 'lower the bar' over time through small changes in the ethicality of behavior" (Gino and Bazerman 2005, p. 4). Research indicates that German doctors who participated in euthanasia of "undesirables" in the Nazi era were generally introduced to the process slowly. They were not initially asked to perform the deed themselves. They were first brought to the place where the work was done. Then, they were asked to sign a relevant document. Then, they were to supervise a "mercy killing." Only later were they asked to do themselves what they probably would have refused to do had they been asked in the beginning (Lifton 1986).

Rather than making a significant, conscious decision to violate ethical precepts, people more often slide down a slippery slope in tandem with their peers in an organization. People who would not have signed off on bogus special-purpose entities or engaged in round-trip energy trades on the day they began working for Enron gradually adapted to a corporate culture that encouraged and rewarded aggressive actions that pushed the envelope into the unethical and the illegal (Bagley 2005). Officers trying to groom their company for an IPO may recognize sales that are not quite completed, then ship the goods to a warehouse while details are being worked out. Then, they stretch the practice from sales that are a few days from being completed to those that are a few weeks from being completed and lower the certainty bar. Soon, the sales representatives are forging customer names on contracts (because they are confident the deals will soon be signed) and officers begin forging confirmations in order to mislead auditors (Maremont 1996).

Groupthink. Pressures from superiors and peers can be reinforced by the tendency of members of a cohesive group to avoid introducing stress into their unanimity by suppressing dissent and characterizing potential critics as "just not getting it" (Sims 1992). Research psychologist Irving Janis coined the term *groupthink* for this tendency and defined it as the "deterioration of mental efficiency, reality testing, and moral judgment that results from in-group pressures" (Janis 1982, p. 9). When independent thinking is replaced by groupthink, poor decisions of all types can be made, including

those involving ethical issues. Groups under the sway of groupthink tend to assume that their goals are ethical and to avoid questioning the morality of their own behavior. Moral doubts are assuaged by group concurrence. Feelings of guilt are rationalized by thinking "we are a good and wise group." Groupthink has contributed to such apparently unethical decision making as Ford Motor Company's decision to market the explosive Pinto (Giola 1992) and the inappropriate passivity of Enron's board of directors (O'Connor 2003).

The impact of groupthink is itself reinforced by *risky shift*, a well-established phenomenon whereby groups with some individuals who are relative risk takers will take bigger risks than the average risk preference of the group members (Coffee 1981). The main reason the deliberation process tends to lead to riskier choices than the average member would have made seems to be that group action dilutes individuals' feelings of accountability and responsibility (Schneyer 1991). Also, group members may shift opinions to preserve others' images of them and their images of themselves as risk takers. Risky shift has been observed in ethical judgments as well as strategic and other forms of decision making.

Overoptimism. Many people have a tendency toward optimism that is so strong it can lead to irrational beliefs and injurious decisions. For example, although most people know that approximately half of all marriages end in divorce, newlyweds typically believe that there is no chance that their particular marriage will end that way. In general, people are optimistic that the bad things that happen to other people will not happen to them (Smits and Hoorens 2005). This *overoptimism* may be evolutionarily beneficial (only the chronically depressed seem to be well calibrated regarding the difficulties they face in life), but irrational optimism can lead to systematic errors in decision making, and in some circumstances, it can induce unethical conduct.

Langevoort (1997) suggested that in many cases of corporate disclosure fraud, the offending officers and directors were not intentionally lying but, rather, were expressing honestly held but irrationally optimistic views of their firms' conditions and prospects. Therefore, we can conclude that, although some stock analysts during the dot-com boom were intentionally making false stock recommendations, a fair number were probably simply overly optimistic about the prospects of the companies they were following. They so much wished to believe that their analysis was true that, at some level, they did believe it.

Overconfidence. Decisional errors caused by overoptimism may be exacerbated by *overconfidence.* Studies have shown that high percentages of people believe they are better drivers, better teachers, better eyewitnesses, better auditors, and on and on, than their peers. Students, psychologists, CIA agents, engineers, stock analysts, financial analysts, investment bankers, investors, and many other categories of people have been studied and shown to tend toward irrational confidence in the accuracy of their decisions. Moreover, entrepreneurs, investors, stock analysts, and others who have had success in their chosen fields tend to develop a sense of invulnerability and ignore the role good fortune played in their success.

Importantly, people's overconfidence in their own decision making extends to their ethical judgments. People tend to believe not only that they are above average in driving and teaching but also that they are more honest and fair-minded than both their competitors and their peers. One study showed that, whereas 61 percent of physicians believed that their own judgment is unaffected by the free merchandise they receive from drug companies, only 16 percent believed those same free goods did not affect the judgments of their peers. As Jennings (2005) noted:

> Recent studies indicate that 74 percent of us believe our ethics are higher than those of our peers and 83 percent of us say that at least one-half of the people we know would list us as one of the most ethical people they know. An amazing 92 percent of us are satisfied with our ethics and character. (p. 52)

Overconfidence in their own moral compass often leads people to make decisions that have significant ethical implications without engaging in any serious reflection. They "know" that they are good people and are confident in their instinctive judgments. For example, studies indicate that auditors' overconfidence in their ability to execute an accurate audit apparently sometimes leads them to take short-cuts that might look unethical in retrospect (Kennedy and Peecher 1997). Enron employees' overweening confidence in the competence and strategies of their company, often called the "most innovative in America" at the time, caused them to express shock that anyone would question the morality, let alone legality, of the firm's actions—actions that now appear highly immoral to objective third persons. Outsiders who questioned Enron's tactics or numbers were told that they "just didn't get it," but it was the insiders' overconfidence in the morality of their actions that was the real problem.

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Self-Serving Bias. Probably the most intractable decisional bias I address in this article is the *self-serving bias*, which inclines decision makers to gather information, process information, and even remember information in such a manner as to advance their perceived self-interest and to support their preexisting views.

In terms of gathering information, the following frank admission by a British civil servant charged with helping his government build the case for invading Iraq will probably ring a familiar bell for many honest readers:

> The speeches I drafted for the [United Nations] Security Council and my telegrams back to London were composed of facts filtered from the stacks of reports and intelligence that daily hit my desk. As I read these reports, facts and judgments that contradicted the British version of events would almost literally fade into nothingness. Facts that reinforced our narrative would stand out to me almost as if highlighted, to be later deployed by me, my ambassador and my ministers like hand grenades in the diplomatic trench warfare. Details in otherwise complex reports would be extracted to be telegraphed back to London, where they would be inserted into ministerial briefings or press articles. A complicated picture was reduced to a selection of facts that became "factoids," such as the suggestion that Hussein imported huge quantities of whisky or built a dozen palaces, validated by constant repetition: true, but not the whole truth. (Ross 2005, p. W1)

All people have a tendency not only to gather information in a self-serving way but also to process it self-servingly. Fans of two teams watching a video of a football game between the two will tend to disagree completely about which team got the most breaks from the referees (Hastorf and Cantril 1954). Studies show that even people who are trained to be objective and skeptical, such as auditors and scientists, tend to find more persuasive the information that is consistent with their self-interest or their previously drawn conclusions. In general, people tend to see what they expect to see in the facts that they take in. Confirming evidence is accepted at face value, while disconfirming or contradictory evidence is rigorously scrutinized (Koehler 1993).

People even tend to *remember* information in a self-serving way. Research shows that a month after people have read a report on global warming, they usually remember the facts in the report that support their position better than the facts that undermine their position (see Taylor 1982).

Related phenomena are the *confirmation bias* (the tendency to seek to confirm original theories), *belief persistence* (the tendency to hold on to beliefs long after the basis for those beliefs has been substantially discredited), and *causal attribution theory* (the tendency of people to attribute to themselves more-than-average credit for their company's or team's successes and less-than-average responsibility for its failures).

All these biases can undermine decisions about tactics, strategy, fairness, ethics, and morality. For example, manufacturers of asbestos and tobacco who initially believed the products to be not harmful had great difficulty processing new information about the products' carcinogenic effects, thus creating an ethical minefield (Klayman 1996).

Most people wish to be fair and to be perceived by others as being fair. Unfortunately, their efforts to actually achieve those goals may be undermined by an unconscious self-serving bias. At contract negotiation time in baseball, for example, punch-and-judy batters (who get lots of hits but hit few home runs) think batting *average* is the most important metric whereas home-run sluggers think that *power* ratings should be the top measure. Analysts who are successful in picking stocks will tend to believe that such accuracy is the fairest measure of value; analysts who handle the most profitable clients may think client sales is the most important measure. Even when they are trying to be impartial, "[p]eople tend to confuse what is personally beneficial with what is fair or moral" (Bazerman 1988, p. 2).

Obviously, the greater the self-serving incentive, the stronger its influence on objective judgment. Large rewards may be sufficient to induce some people to consciously decide to lie, cheat, and steal. But the more insidious influence is unconscious. By strengthening people's inherent tendencies to see the world in a self-serving way, strong monetary incentives can warp the judgments of even well-intentioned people. Think of the Enron reward system and its dark side. Enron employees valued proposed deals that affected the numbers Enron could put on its books, which determined whether or not employees met their bonus targets, which in turn, determined whether millions of dollars would be paid to the very people who were deciding what the numbers should be. Even those officers who were acting in good faith must have been affected by the self-serving bias. In the case of Enron, moreover, employees were often not choosing between two legitimate options because the prices of both options were pulled out of the air (Prentice 2003).

The more complex and uncertain the factual setting is, the more impact the self-serving bias is likely to have. Overall, it is pervasive and unrelenting; Banaji, Bazerman, and Chugh (2003) noted:

> Research done with brokerage house analysts demonstrates how conflict of interest can unconsciously distort decision making. A survey of analysts conducted by the financial research service First Call showed that during a period in 2000 when the Nasdaq dropped 60 percent, fully 99 percent of brokerage analysts' client recommendations remained "strong buy," "buy," or "hold." What accounts for this discrepancy between what was happening and what was recommended? The answer may lie in a system that fosters conflicts of interest. A portion of analysts' pay is based on brokerage firm revenues. Some firms even tie analysts' compensation to the amount of business the analysts bring in from clients, giving analysts an obvious incentive to prolong and extend their relationships with clients. But to assume that during this Nasdaq free fall all brokerage house analysts were consciously corrupt, milking their clients to exploit this incentive system, defies common sense. Surely there were some bad apples, but how much more likely is it that most of these analysts believed their recommendations were sound and in their clients' best interests? What many didn't appreciate was that the built-in conflict of interest in their compensation incentives made it impossible for them to see the implicit bias in their own flawed recommendations. (p. 56)

In short, the self-serving bias unconsciously distorts evidence, allowing people to view themselves as "good and reasonable." Inevitably, self-interest clouds the ethical decision making of even the most well-intentioned people.

Framing. Psychologists have often demonstrated that a simple *reframing* of a question can produce a totally different answer from the same respondent. In particular, people's risk preferences change dramatically depending on whether an option is framed in terms of potential loss or potential gain (Tversky and Kahneman 1981). How financial planners, investment advisers, and investors frame the questions they face has a big impact on their decision making and is a key feature of behavioral finance theory (Shefrin 2000). Framing can affect even purchases of potato chips; people would rather buy potato chips labeled "95 percent fat free" than identical chips labeled "5 percent fat." Framing can also dramatically affect decision making in the ethical realm.

Decisions made by finance professionals often occur in a context where subjective factors predominate and framing is particularly likely to have an impact. When issues are framed so as to focus on one relevant factor and other factors are minimized, problems can result. The major actors in the Enron scandal were fixated on share price, which caused them to focus on earnings projections. Knowing that missing earnings targets would surely lead to Enron's stock price being hammered, they engaged in all manner of accounting manipulations to keep the stock price up. They seemingly framed their goals entirely in terms of stock price. Ethical considerations were utterly disregarded, despite Enron's code of ethics. Had Enron's officers managed to keep ethics in their decisional calculus, they might have acted differently.

Consider also Frank Walsh, Jr., the Tyco International director who proposed, advocated, and voted for a particular acquisition in which he expected to receive a *secret* $20 million "finder's fee." When other board members learned of the fee, which would have been starkly improper even had it been disclosed, they felt betrayed. But Walsh's frame of reference apparently did not include the ethical responsibilities of directors. He simply contrasted the amount he expected to receive with the much higher fees Tyco was paying to investment bankers in the deal. The self-serving bias caused him to frame the issue inappropriately by factoring out both legal and ethical factors.

As reported in the *Wall Street Journal*, KPMG decided in 1998 to promote tax shelters without registering them with the U.S. IRS. The decision reflects a fairly undisguised determination to gain profit by flouting the rules—with an "ethics be damned" attitude. Some evidence indicates that KPMG executives weighed the benefits of noncompliance against the costs of being caught and penalized by the IRS, but the *Wall Street Journal* also quoted KPMG employees' descriptions of a business culture "focused on revenue growth" (Bryan-Low 2003). When revenue growth becomes the overwhelming focus of decision making inside a firm, ethical considerations may be shunted to the side and ignored.

During the dot-com boom, too many stock analysts focused only on the amount of investment banking revenue they could generate for their employers. The accuracy of their analyses was often sacrificed and, occasionally, it appears, scarcely considered.

Sunk Costs. Economists know that considering or honoring *sunk costs* is illogical. Psychologists know that people do it anyway. Studies show that

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people will attend a play they have decided they do not really want to see simply because they have already spent money on the tickets. Worse yet, sunk costs can lead to an *escalation of commitment*—that is, people throwing good money after bad—in a deteriorating situation. Many people believe that the U.S. Pentagon's behavior in the Vietnam War is a salient example.

Because people often honor sunk costs and then escalate a losing commitment, managers of companies that have poured huge amounts of resources into development of a new product have great difficulty abandoning that product when evidence of safety problems surfaces. Investment banks that have invested substantial resources in developing a relationship with an Enron or a WorldCom or a promising new start-up have difficulty cutting the cord even when they learn that the client is a fraudster. No one but Merrill Lynch's Daniel Bayly can know why he signed off on the infamous Nigerian barge deal with Enron that led to his criminal conviction (overturned on appeal and pending retrial at this writing), but sunk costs and escalation of commitment could easily have played a role (Thomas 2005).

Escalation of commitment has also been suggested as a cause of the "rogue trader" phenomenon (Krawiec 2000). Consider how Nick Leeson kept irrationally doubling up his bets as he sank Barings Bank. He intentionally continued on a course of trading that destroyed the institution, although he clearly did not intend any such result and was, in fact, trying desperately (if irrationally) to avoid injuring the bank (Leeson 1996).

The Tangible, the Close, and the Near Term. Vivid, tangible factors that affect those near to us have a greater impact on decision making than do factors that are subdued, abstract, or far removed in space. Most people are more emotionally distressed and more motivated to take action by minor injuries to their own family members (and even their pets) than by genocide being visited on strangers abroad. This disparity in impact can cause people to make decisions that are ethically unsound.

Designers and marketers of products with safety concerns have found it tremendously difficult to pull the plug on a defective product, lay off employees working on the product, and damage the company's profits in the short term when the injuries that might be caused by the product are hypothetical and the victims are merely future statistics.

A stock analyst who knows that a "sell" recommendation for a company's stock is warranted but also knows that to make that recommendation is likely to cost his firm potential business and current revenue from an important client faces a difficult dilemma. To issue the new recommendation will damage his firm (to whom he feels loyalty), his coworkers (whom he likes), and his personal economic situation. Those injuries will probably happen nearly immediately to known and tangible victims. To continue an unjustified "buy" recommendation, however, will visit a loss mostly on a mass of nameless, faceless investors that will occur, if at all, sometime off in the future. And, heck, their portfolios are probably diversified anyway, so that injury is easy to ignore or rationalize away. This disparity puts substantial pressure on the analyst to not only keep the buy recommendation but to actually come to believe that it has been right all along.

The temporal factors that affect decision making may be considered a *time-delay trap*: When an action has both short-term and long-term consequences, the short-term effects are much more vivid and, therefore, much easier for people to consider. People subject to this time-delay trap tend to prefer immediate to delayed gratification. Not surprisingly, studies indicate that prisons are populated largely by people who have an inability to defer gratification and a tendency to underestimate the pain of long-term consequences.

Utset (2005) has shown in the world of auditing that the long-term adverse consequences (in terms of legal liability and reputational damage) of allowing an audit client to push the envelope may be underappreciated by auditors who are focused on the immediate loss of revenue and damage to friendships that would occur if hard choices were made. Most stock analysts, investment bankers, stockbrokers, and other Wall Street professionals presumably wish to follow the rules—to act in such a way as to enhance their reputations and to avoid the costs that can follow the cutting of ethical corners. In the short run, however, they often face temptations that are difficult to resist:

> [People] want to be relatively patient in future periods, but they become increasingly impatient the closer that they get to incurring an immediate cost or receiving an immediate reward. From a long-term point of view, people tend to have the best intentions for their long-run selves: They make plans to start diets, stop smoking, finish writing papers, and so on. However, when the time to act arrives, the chocolate cake trumps the diet, the Camel prevails, and finishing the paper gives way to going to the movies. In the end, our best intentions are always up for reconsideration, particularly when they stand in the way of immediate gratification. (Utset 2005, p. 430)

The short-term gratification that Grubman and Blodget enjoyed as highly compensated celebrity analysts probably outweighed in their minds the long-term consequences of being caught in their own web of lies. Almost every day, we can read in the *Wall Street Journal* or *Financial Times* about Wall Street professionals or corporate executives who, it appears, succumbed to the time-delay trap.

Loss Aversion. Studies show that people enjoy gains only about half as much as they suffer from losses. This *loss aversion* is related to the *endowment effect*, the notion that people easily attach themselves to things and then value them much more than they valued them before they identified with them. Any item usually becomes more dear to people once they view it as part of their "endowment." Numerous studies show that people tend to demand some multiple of the price they paid (7× in some studies) to part with something they view as part of their endowment.

An implication of the powerful combination of the endowment effect and loss aversion is that people will make unethical decisions in order to protect their endowment that they would never have made to accumulate that endowment. In the 1969 case described in *U.S.* v. *Simon*,[1] two auditors discovered that a client's CEO had fooled them with a fraud, the embezzlement of large sums. No doubt, these auditors would have refused had the client asked them from the beginning to assist him with his fraud. But once the auditors learned of the fraud, the part played by their own negligence, and their potential liability, they knowingly decided to help cover up the fraud. This course of action led to a criminal conviction for felony securities fraud.

Indeed, it is at the cover-up stage that many actors who first acted carelessly, at most, cross over to conscious wrongdoing. Kessler (2003) suggested:

> My own opinion is that none of the managers of these once successful companies [WorldCom, Qwest Communications, Global Crossing] set out to commit fraud. But as pricing and demand dropped, they did anything and everything to keep their stock up, to buy time to raise more money, or hope demand would return. By doing this, they crossed the line of honesty into fraud. It's a short walk. (p. 199)

CEO Martin Grass of Rite Aid Corporation similarly explained his participation in a major accounting fraud:

> In early 1999, when things started to go wrong financially, I did some things to try to hide that fact. Those things were wrong. They were illegal. I did not do it to line my own pockets. (Maremont 2004)

Martha Stewart was not convicted of insider trading but of obstructing justice to prevent financial, reputational, and other losses that would come from an insider-trading accusation. Quattrone was convicted (initially) not of securities fraud but of inducing subordinates to destroy e-mails that could have created the losses that follow a conviction for securities fraud.[2] In trying to avert losses from one direction, both the widely admired entrepreneur Stewart and the influential banker Quattrone escalated their unethical behavior.

Loss aversion can interact with framing to create a volatile mix. One study found that *even in the absence of a direct economic incentive*, people are more willing to manage earnings when doing so will avoid reporting a loss, an earnings decrease, or a negative earnings surprise. Even people who thought that earnings management was highly unethical were likely to play that game in order to avoid a perceived loss (Pinello and Dusenbury 2005).

Improving the Odds of Doing the Right Thing

My main message so far has been somewhat disheartening: For even the best-intentioned person to stay on the straight and narrow is difficult in the competitive financial business. We can hope to avoid serious temptation, crooked bosses, and corner-cutting colleagues, yet the self-serving bias is still likely to lead to our framing problems and solutions in a manner that could appear unethical to objective third parties.

Worse still is that the same biases that may lead normal people to do unethical things also make it difficult for those same people to understand their vulnerability. In language that applies directly to readers of this article, Zimbardo wrote in 2007:

> I must warn you of a bias you likely possess that might shield you from drawing the right conclusions from all you are about to read. Most of us construct self-enhancing, self-serving, egocentric biases that make us feel special—never ordinary, and certainly "above average." Such cognitive biases serve a valuable function in boosting our self-esteem and protecting against life's hard knocks. . . . Yet these biases can be maladaptive as well by blinding us to our similarity to others and distancing us from the reality that people just like us behave badly in certain toxic situations. . . . That means when you read about [the psychological evidence] you might well conclude that *you* would not do what the majority has done, that you would, of course, be the exception to the rule. That statistically unreasonable belief (since most of us share it) makes you even more vulnerable to situational forces precisely because you underestimate their power as you overestimate yours. (p. 261)

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But remember, as Zimbardo notes, we are talking about psychology, not "excusiology." Judges, juries, and the general public are not going to give us a pass when we do unethical things simply because we are stuck in extremely difficult situations. Nor should they. Therefore, the burden rests on all of us to try to find ways to overcome the cognitive limitations we labor under and the situational pressures we face.

Jennings (2005) suggested that true reform consists of recognizing moral absolutes and vigilance in retaining the bright line between right and wrong. The shortcoming of focusing on moral absolutes is that Lay, Ebbers, Richard Scrushy (and most people sitting on death row for that matter) believe in moral absolutes. They simply had difficulty either perceiving that their own actions were violating those absolutes or in conforming their actions to the absolutes in their situations. All normal people have such difficulties.

What is to be done? Frankly, no easy answers are possible, but perhaps the biases can be "debiased."

Debiasing. Cognitive biases are vigorous phenomena, and they are not easy to neutralize or eliminate. Although the following suggestions can sometimes improve decision making, the general conclusion of researchers is that the outlook for debiasing is not encouraging (MacCoun 2000). The forces behind the self-serving and optimism biases, for example, not only warp the decision-making process in a particular direction; they also make it difficult for a person to debias his or her own decision making. Programs that have an impact tend to be context specific, somewhat invasive, and cognitively costly.

According to some experts, debiasing or correcting judgments impaired by cognitive bias requires four elements (Wilson and Brekke 1994):

1. Decision makers need to be informed of the cognitive biases they face. This article's main purpose is to do exactly that. Obviously, people will have difficulty correcting thinking that they do not realize is skewed.
2. The decision maker must be motivated to correct the bias. Most readers of this article are probably so motivated, to varying degrees.
3. The decision maker must be aware of the magnitude and direction of the bias. This article should be informative in that regard as well.
4. The decision maker must be able to adjust the response accordingly. One way to adjust for many of the biases discussed in this article, particularly the self-serving bias, is for decision makers to conclude their decision-making process by acting as devil's advocates—challenging their own decisions. This step is sometimes called the "consider the opposite" approach (Bibas 2004). Regarding the ethical aspects of a decision, this process should entail imagining the ethical objections that might be lodged against one's decision and attempting to evaluate how objective third parties would judge those objections. The decision maker must give serious and specific attention to the objections and to alternative courses of action (Babcock, Loewenstein, and Issacharoff 1997).

For any debiasing to have a chance to work, well-intentioned economic actors must follow Jennings' (2005) second admonition: eternal vigilance.

Keeping Ethics in the Frame of Reference. The finance professional who truly wishes to act ethically must be vigilant, must think about ethics in every situation. Many more people accidentally back into ethical problems than make a truly conscious decision to turn to a life of wrongdoing. If people get up every morning thinking only about how to raise their company's stock price, how to please their superiors, and how to make that bonus target and do not consciously keep ethical constraints in their decisional calculus, unethical conduct may ensue. Simple as it sounds, there remains no better technique than to think—every day: What would my mom say about the decisions I am making today if she were to read about them in the newspapers tomorrow?

In this connection, it is particularly important for finance professionals to remember that their ethics may well be judged by different standards from those that appear to dominate their industry. Such popular classics as *Liar's Poker* (Lewis 1989) and *Blood on the Street* (Gasparino 2005) depict securities industry professionals who either pay no attention to ethical standards at all or have ethical standards inconsistent with those commonly held in general society. As long ago as 1934, President Franklin D. Roosevelt cautioned Adolph Berle, a Columbia University law professor and member of FDR's "brain trust" who was scheduled to meet with the heads of Wall Street, that

> the fundamental trouble with this whole stock exchange crowd is their complete lack of elementary education. I do not mean lack of college diplomas, etc., but just inability to understand the country or public or their obligations to their fellow men. Perhaps you can help them acquire a kindergarten knowledge of these subjects. More power to you. (Schwarz 1987, p. 108)

Statman (2004) recently encouraged finance professionals to remember that their own perceptions of fairness are not shared by everybody. He gave numerous examples of situations where securities professionals thought they were being clever but most Americans would have thought they were being unethical. Finance professionals naturally value intelligence and aggressiveness, but any time corporate managers or Wall Street employees think they are being "oh so clever," they may be treading on thin ice. Thus, when the Enron energy traders created "Death Star," "Fat Boy," "Get Shorty," and other manipulative devices to exploit flaws in California's electricity deregulation scheme and when in their e-mails to one another they openly boasted about ripping off grandmothers, they certainly cannot have been thinking about how others would judge the morality of their actions (Eichenwald 2005).

Monitoring Rationalizations. As Jeff Goldblum's character pointed out in *The Big Chill*, "I don't know anyone who could get through the day without two or three juicy rationalizations." Most white-collar criminals do not view themselves as corrupt, as bad people, or as criminals. Rather, they rationalize their actions as normal in the business world and compartmentalize them from, for example, their family life.

The nearly universal human ability to rationalize allows people to do dishonest things without damaging their self-concept as honest (Mazar, Amir, and Ariely 2007). This process is also known as *self-justification*. Studies show that people who resist temptation tend to come to believe that the act they avoided was more immoral than they had originally thought, while those who give in to the temptation tend to rationalize or self-justify their actions, leading to a slippery slope:

> We make an early, apparently inconsequential decision, and then we justify it to reduce the ambiguity of the choice. This starts the process of entrapment—action, justification, further action—that increases our intensity and commitment, and may end up taking us far away from our original intentions or principles. (Tavris and Aronson 2007, p. 34)

A recent survey indicated that many business school faculty worry that students are being taught these rationalizations in business school (Gentile 2005).

Anand, Ashforth, and Joshi (2005) composed the summary of rationalization strategies shown in **Exhibit 1**. Similar rationalizations commonly heard in the finance industry are as follows:

- "Sure, I exaggerate, but customers are smart. You can't really fool them."
- "If clients are dumb enough to believe some of this stuff, they deserve to lose money."
- "If it's legal, it must be moral."
- "Everybody does it."

Indeed, some finance professionals are famous for their rationalizations:

- Grubman: "Objective? The other word for it is uninformed" (Reingold 2006, p. 219).
- Mary Meeker: "Where is the personal responsibility [on the part of investors]?" (Gasparino 2005, p. 309).

Exhibit 1. Rationalizations Summarized

Strategy	Description	Examples
Denial of responsibility	The actors engaged in corrupt behavior perceive that they have no other choice than to participate in such activities.	"What can I do? My arm is being twisted." "It is none of my business what the corporation does in overseas bribery."
Denial of injury	The actors are convinced that no one is harmed by their actions; hence, the actions are not really corrupt.	"No one was really harmed." "It could have been worse."
Denial of victim	The actors counter any blame for their actions by arguing that the violated party deserved whatever happened.	"They deserved it." "They chose to participate."
Social weighting	The actors assume two practices that moderate the salience of corrupt behaviors: (1) condemning the condemner and (2) selective social comparison.	"You have no right to criticize us." "Others are worse than we are."
Appeal to higher loyalties	The actors argue that their violation results from their attempt to realize a higher-order value.	"We answered to a more important cause." "I would not report it because of my loyalty to my boss."
Metaphor of the ledger	The actors rationalize that they are entitled to indulge in deviant behavior because of their accrued credits (time and effort) in their jobs.	"We've earned the right." "It's all right for me to use the internet for personal reasons at work. After all, I do work overtime."

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- Blodget: "... our exuberance helps build industries, however boneheaded it may later seem" (Blodget 2005).
- Morgan Stanley bankers: "IBG, YBG" ["I'll Be Gone, You'll Be Gone" (before the consequences of our actions occur)] (Knee 2006, p. xvii).

Well-intentioned people should monitor their rationalizations, and if they hear themselves invoking them, they should immediately realize that it is time to rethink a decision just made.

Before the 2003 global settlement between 10 brokerage firms, the SEC, National Association of Securities Dealers (NASD), NYSE, the New York Attorney General, and other state regulators on independence of research, Wall Street investment banks often compensated securities analysts, not by the accuracy of their recommendations, but by whether the recommendations helped the firms obtain or retain underwriting revenue. Defenders of the system alleged that all sophisticated investors knew the practice went on and, therefore, discounted the recommendations accordingly.

In contradiction, note two interesting results of laboratory studies of disclosures of conflicts of interests. First, people to whom conflicts of interests are disclosed tend to discount the recommendations of the conflicted source but not sufficiently. In other words, although they are informed of the conflict of interest, they act pretty much as though it did not exist when they evaluate the information from the conflicted source. (Studies of actual securities trading similarly indicate that investors who know of the conflicts of securities analysts tend to react to their recommendations as if the conflicts did not exist.) Second, and worse, people tend to feel less duty bound to be impartial when they know that their conflict of interest is being disclosed. Because they incorrectly believe that those receiving the information will view their information with a sufficiently skeptical eye, information providers tend to rationalize that to actually act impartially is not very important (Cain, Loewenstein, and Moore 2005). They believe that they can enjoy a bit of a "moral license" to stretch the truth (Bazerman and Malhotra 2005).

These empirical results make many common Wall Street rationalizations seem particularly lame and underline the advice that those who wish to act ethically monitor their own rationalizations and consider how they will be viewed by objective observers.

Acting Courageously. A person who navigates his or her professional career surrounded only by saints with no sinners in the mix is extremely lucky. Everyone else will have to contend with superiors and peers who sometimes suggest or even order unethical action. In such settings, well-intentioned finance professionals should remind themselves that they were hired for their brains, their training, their experience, and their judgment. If they stand by and allow their firms to go down the wrong strategic or operational path for fear of the consequences of standing up to bosses and peers, they will not be earning their paychecks. Just as investment banks, for example, need employees who can make wise financial, strategic, and managerial judgments, they need employees with the ability to make sound ethical judgments and the gumption to advocate for pursuing the moral course. All companies do.[3]

If they do so, they may quickly find that they are not alone. In his memoir, a member of President Kennedy's cabinet recalled the debate over whether to go forward with the Bay of Pigs invasion of Cuba. He believed that the idea was terrible but thought that everyone else in the room believed it was a good idea. Not wishing to appear to lack the courage to make this militarily aggressive decision, the cabinet member held his tongue. Only later did he learn that many other people in the room felt as he did and kept quiet for the same reason (Schlesinger 1965). Had only one person in the room had the courage to object aloud, he would likely have soon had substantial company and this debacle of U.S. foreign policy might not have happened.

Remember Asch's experiments with the lines? When only one confederate of the experimenter gave the right answer, errors by the subject were reduced by 75 percent. And in one variation of Milgram's experiments, he had two confederates refuse to administer shocks when the dial was turned into the dangerous range. When that happened, 92.5 percent of the subjects defied the experimenter's orders. In other words, it often takes only one or two people with a little courage to save organizations from terrible ethical mistakes.

As indicated earlier, many people accidentally blunder into ethical mistakes. They do not consider the ethical dimensions of a decision before acting and only later realize that had their ethical antennae been activated, they probably would have considered different factors in making their decisions and would have come to different conclusions. In contrast, some research on people who have acted heroically—for example, European civilians who helped shelter Jews during World War II and bystanders who rushed into fires to save children—indicates that these people had *pre-scripted* themselves to act in such a way. In other words, they

explained that they had thought in advance about how they would act in such a circumstance and when the situation arose, merely acted in accordance with the course of action they had scripted for themselves.

A psychiatrist at the business school at Emory University has studied brain scans and learned that when managers known to be good at making strategic decisions are asked to do so, their brains expend little energy. The brains of people with little experience making such decisions expended more energy, and these people found the process more difficult. The psychiatrist believes that giving students practice making ethical decisions in the classroom can carry over to the real world (Bradshaw 2004). Therefore, people who wish to act ethically during their professional careers would do well to spend time envisioning ethical problems that they may confront in their careers and anticipating how they wish to act when actually facing such dilemmas. Simply thinking about such ethical pitfalls in advance and considering a proper course of action should dramatically improve the odds that people will "do the right thing."

Conclusion

After a professional lifetime of studying why people do "evil" things, Philip Zimbardo, creator of the infamous Stanford Prison Experiment in which normal college students given the roles of guard and inmate within six days acted in ways that not only mandated the early termination of the experiment but eerily foreshadowed events at Abu Ghraib, concluded that the situational so dominates the dispositional that in the right circumstances, pretty much any person could become an abusive prison guard, a torturer, or a killer—not to mention a businessperson who does something unethical.

The good news is that just as normal people commit most of the evil acts in the world, they also commit most of the heroic acts. Most people who behave heroically do not resemble the characters in action movies. Whether charging a machine gun nest on Iwo Jima or blowing the whistle on Enron, heroic acts are generally performed by ordinary people who exercise vigilance, determination, self-reflection, and a little courage.

This article qualifies for 0.5 PD credit.

Notes

1. 425 F.2d 796 (2d Cir. 1969).
2. This conviction was later overturned on a technicality.
3. The last portion of this article draws substantially from materials created by Mary Gentile (Aspen Institute), Steven Tomlinson (formerly of the University of Texas), and Minette Drumwright (University of Texas) for an MBA minicourse on business ethics that the author helped present at McCombs School of Business, University of Texas, Austin, in October 2003.

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