Overview

- A critical role of the compliance function is to promote an ethical corporate culture
  - People often find it harder to violate social norms (i.e. culture) than they do laws, regulations, or policies, because it is harder to rationalize misconduct that violates those norms
- Most people believe that they are honest—even the “bad actors”
  - Misconduct often arises out of ethical blind spots, rationalization, and/or self-deception, rather than a calculated choice to engage in misconduct
  - As such, a sanctions-based compliance program will have limited effect
- Subtle methods of increasing ethical awareness and improving behavior tend to be more effective than sweeping mandates or bright-line prohibitions
  - It’s much easier to “nudge” people in the right direction than to shove them
U.S. Federal Sentencing Guidelines for Organizations

18 USC §8B2.1 - Effective Compliance and Ethics Program

- (a) To have an effective compliance and ethics program, for purposes of subsection (f) of §8C2.5 (Culpability Score) and subsection (b)(1) of §8D1.4 (Recommended Conditions of Probation — Organizations), an organization shall —
  » (1) exercise due diligence to prevent and detect criminal conduct; and
  » (2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

(Emphasis added.)

DOJ Guidance (June 2020)

- Also stresses the significance of an ethical corporate culture
  » The company should have "established policies and procedures that incorporate the culture of compliance into its day-to-day operations." (p. 4) (emphasis added)
  » "Beyond compliance structures, policies, and procedures, it is important for a company to create and foster a culture of ethics and compliance with the law at all levels of the company." (p. 10) (emphasis added)

But WHY?

- “Corporate Culture” is just another way of saying “Social Norms in the Workplace”
  » People are more inclined to do what they believe that others are doing
    - The actions they witness in their peers
    - The messages they receive from authority
  » As such, misconduct and a weak ethical culture go hand in hand, because it is easier for employees to rationalize bad behavior
The Fraud Triangle

- **Pressure**
  - Motivation or Incentive to Commit Fraud
  - **MITIGATION = BACKGROUND CHECKS & EMPLOYEE MONITORING**

- **Rationalization**
  - Justification of Dishonest Actions
  - **MITIGATION = ETHICAL CULTURE**

- **Opportunity**
  - The Knowledge and Ability To Carry Out Fraud
  - **MITIGATION = INTERNAL CONTROLS**

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Origins of Behavioral Ethics and Behavioral Economics

- **“Traditional” Economics**
  - Assumes that where markets are fair and information is freely available, the “Rational Economic Actor” will behave in such a way as to maximize utility, i.e. get the most out of every dollar spent and avoid unnecessary costs
    - Analogous to the “Reasonable and Prudent Person” in tort law
  - However, not all people behave rationally—at least not all the time

- **Behavioral Economics**
  - Recognizes that individuals do not always behave rationally, i.e. in their stated or perceived best interest
  - However, this irrationality is itself often predicable
    - Can be anticipated to better understand how people behave in the real world, and even anticipate and manipulate that behavior to encourage specific outcomes
  - Places a greater reliance on psychology and the study of human behavior
Most of us like to think of ourselves as honest people (and we’d like others to think of us that way as well)

However, most of us will also cheat just a little bit when given the chance

» We will cheat right up to the point where the cheating begins to make us question whether we actually are honest people, then we stop

Ariely refers to the delta between these two points (absolute honesty and our actual honesty) as the “fudge factor”

The fudge factor and rationalization are closely linked

» Cultural conditions may allow the fudge factor to increase as the employee is able to rationalize more and more misconduct
  – Not a cost-benefit analysis
  – It is a function of social norms

» For that reason, a corporate culture which stresses honesty and integrity (and reiterates that message at key moments!) will decrease the fudge factor, because the employee will have a harder time rationalizing misconduct

» Promoting such a corporate culture is a key function of Compliance
Rationalization and Culture

- **The “Matrix Experiments”**
  - Ariely and his fellow researchers conducted experiments in which subjects took math tests together in a room before a proctor and were paid for the number of correct answers
    - Control condition (no cheating possible): Average was 7/20 correct
    - Test condition (cheating possible): Average was 12/20 correct
    - Actor (in-group peer) flagrantly cheats: 15/20 correct
    - Actor (out-group peer) flagrantly cheats: 9/20 correct

Social Norms and Compliance

- **Social norms are critical in establishing baseline expectations around honesty**
  - A culture of integrity and honesty makes it much more difficult for employees to rationalize bad behavior → positive “peer pressure”
  - Social and cultural cues influence notions of what is and is not acceptable, and therefore affect the “fudge factor”

- Of paramount importance is the cultural **message** that employees receive about honesty and integrity
  - If employees see their peers behaving ethically and with integrity, they are far more likely to do so themselves
  - **Regular reminders** about honesty and the expectation of integrity substantially drive down dishonest behavior

- Training, codes, and policies that stress ethical conduct therefore need to be fully **integrated into the culture**, and not just exist as words on a page
**Digging Deeper - Three Modes of Thinking**

- **Traditional View of Misconduct – Calculated Wrongdoing**
  - Misconduct is the deliberative product of a rational cost-benefit analysis by a bad actor
    - If the value of the misconduct outweighs the risk of getting caught, I will engage in the misconduct
    - This assumption underlies the deterrence approach (i.e. punishment, sanction) behind much of the legal and regulatory environment

- **Behavioral View of Misconduct – Bounded Ethicality**
  - Behavioral ethics highlights the concept of bounded ethicality and other mechanisms by which people—even "good" people—fail to conduct a fully objective assessment of the situation and/or their own ethical behavior or other situations in which ethical deliberation is hindered (i.e. ethical “blind spots”)
  - While calculated wrongdoing is still possible, in most instances, misconduct originates from a less-than-fully-deliberative process of decision making
  - People will act unethically as long as they can do so while maintaining a moral self-image

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**Three Modes of Thinking (cont’d)**

- **Self-Justified Wrongdoing**
  - Actor recognizes the ethical dilemma, but her self-interest prevents her from conducting a fair and objective assessment of the situation
    - Example – justifying misconduct where the profits go to the corporation, and not to the individual

- **Self-Blinded Wrongdoing**
  - Actor’s self interest leads to self-serving biases that prevent him from recognizing a moral ethical dilemma exists
    - "Motivated reasoning" – adopting a biased perception of reality that prevents one from recognizing their own wrongdoing
    - Example - the "good faith" conflict of interest and contract award
    - Interpreting a vague reg or rule in the way most favorable to your desired outcome
Three Modes of Thinking (cont’d) – Moral Blind Spots

- Examples of Biases and Circumstances that Impact Ethical Awareness
  - Objectivity bias (believing one is more objective than one actually is)
  - Moral licensing (relying on previously-established image of moral self to justify minor deviations from ethical conduct)
  - Moral disengagement (finding ways to excuse one’s own misconduct while holding others to a high standard; similar to fundamental attribution error)
  - Altruism (justifying unethical conduct as beneficial to others, like the company or clients)
  - Distant/non-specific victims (ignoring the consequences of misconduct where the harms are diffuse and/or fall on victims not directly known to the wrongdoer)
  - Legitimate and illegitimate rationale (emphasizing the legitimate reasons for the decision when the conduct can be attributed to both ethical and unethical reasons)
  - Ambiguity in laws, rules, or norms (interpreting rules in a way that will justify wrongful actions)

Source - “Behavioral Ethics and Compliance,” Yuval Feldman and Yotam Kaplan, September 2019

Three Modes of Thinking (cont’d)

- Impact on Compliance
  - If wrongdoing is calculated and deliberate, then the traditional means of deterrence, such as tighter regulations, sanctions, etc., should be employed to impact a would-be bad actor’s deliberative processes
  - However, if wrongdoing arises because the actor fails to engage in full and objective deliberation (i.e. ethical blind spots), then an emphasis on traditional means like deterrence is likely to be ineffective
  - Instead, methods should be employed to increase awareness of ethical dilemmas and enhance ethical deliberation
Cobra vs. Nudge (or, “You Catch More Flies With Honey…”)

- Cobra Effect
  » Specific application of the “law of unintended consequences” in which the solution implemented actually makes the problem worse
  » Frequently a risk with broad-stroke or heavy-handed prescriptive or prescriptive solutions → they almost invite workarounds
    - Example – Insurance churning

- Nudge
  » Any intervention that can alter people’s behavior in a predictable way without forbidding options or significantly changing their level of effort or incentives

Suggestions for Your Compliance Program - Overview

- Social Norms Define Your Corporate Culture
  » Misconduct, Rationalization, and Culture go Hand in Hand (in Hand)

- Choice Architecture
  » Improve Your Defaults

- Priming for Honesty
  » Thinking About Honesty Obligations at Key Moments
Appeal to Social Norms

- Nudge 1 - Appeal to Social Norms: Tell Them What Others are Doing
  - Increasing Awareness of a Norm Increases Compliance With the Norm
    - "90% of your fellow Minnesotans have already complied with the new tax law."
    - "Most Montana teens (70%) are tobacco free."
    - "Join your fellow guests in helping to save the environment – Please hang your towel if you would like to reuse it."
  - Reporting Mechanisms – Let Them Know That Others Use the Process
    - "125 of your colleagues raised concerns via the Hotline last year, and 546 more asked questions."
    - People are more likely to use it if they think others do, too
    - Reduces the risk that they won’t seem like a team player for reporting a concern

Appeal to Social Norms (cont’d)

- Nudge 1 – Social Norms (cont’d)
  - Witness Interviews - Phrasing Tips
    - No – "Compliance received a complaint through the Hotline."
    - Yes – "One of our colleagues was concerned about an issue, and felt so strongly that s/he contacted my office so see if we could look into it."
  - Other possibilities
    - "Several people have already spoken to me and provided helpful information."
    - "All of the team members to whom I have spoken have been very cooperative."
    - "Based on my conversations with other team members, others are concerned about this issue as well and went to help make sure we get it resolved."
  - CAVEAT – Don’t breach confidentiality; may need to strike a balance
Choice Architecture

- **Choice Architecture** is the practice of influencing choice by changing the manner in which options are presented to people.

- Of critical importance is the “default” option:
  - School cafeteria
  - Your company’s 401(k) plan
  - Your smartphone
  - “Contact the front desk if you wish to have your towels changed daily.”

Choice Architecture (cont’d)

- **Nudge 2 - Choice Architecture and Defaults: Make It Easy**
  - Most reporting processes place the burden on the employee to affirmatively raise and report issues (i.e., deciding there is an issue worth reporting, finding the hotline, submitting the concern, etc.).
  - This alone can be enough to stop an employee who feels stressed about process or is otherwise sitting on the fence from raising an issue.
  - Direct solicitation of the employee about misconduct might only happen annually (e.g., Code of Conduct Attestation, COI Questionnaire, etc.).

  - Alternatives:
    - Increase the frequency of direct solicitation – Quarterly? Monthly?
    - Embed a question in a more frequent process (e.g., boot-up of computer, weekly pop-up window, etc.)
Priming

- **Priming** describes how ideas prompt other ideas later on without an individual’s conscious awareness.

- Once people begin thinking about honesty, they tend to stop cheating.
  - Matrix experiment - When students were asked to sign a statement **before** the test acknowledging that the test fell under the school’s Honor Code, the number of correct results reported was the same as the control (non-cheating) condition (7/20).
  - Insurance industry experiment - Customers who signed an honesty attestation **before** completing annual mileage attestation declared driving 15% more miles than those who signed the attestation at the bottom of the form.

Priming (cont’d)

- **Nudge 3 - Priming: Prompting Honesty at Key Moments**
  - At the **start** of the interaction with the employee, inform him/her of honesty obligations, under the Code of Conduct, Investigation Policy, etc.
    - Witnesses Interviews – At the start of the interview, have them sign a witness form which sets out the honesty obligations
      - Or, let them know at the start of the interview that they will be expected to sign such a statement at the end
    - Annual Code of Conduct Attestation or Conflicts of Interest Disclosure form
      - Typically structured so that they sign at the end; move it to the start
      - If all else fails, belt and suspenders—sign in both places
  - Embed regular and repeated messaging about ethics into your company’s culture.
Summary

- A key role of Compliance is to limit the risk of rationalization
- Treating misconduct as deliberative and calculated will frequently miss the mark
  » Most people generally believe that they are honest, but their self-interest often blinds them to factors impairing their ethical judgment or preventing them from recognizing ethical dilemmas
- Broad proscriptive or prescriptive rules tend to backfire; use nudges when possible
  » “Corporate Culture” is another way of saying “Social Norms in the Workplace”
    – Appeal to social norms to encourage employees to do what they see others doing
  » Use Choice Architecture to your advantage
    – Adjust the default options to encourage people to behave more ethically and report misconduct
  » Prime your workforce for honesty at key moments
    – Remind them of their honesty obligations before they need to be honest

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