

# Compliance Take-Aways: What to Do About “Irrational Dishonesty”

By Lorna A. Schnase

**B**ehavioral economics is an interesting mash-up of economics and psychology. Research in the field has much to teach the securities industry and, in particular, those of us concerned with compliance.

This article discusses important points about dishonesty brought to light by research in behavioral economics and related fields. It then lists practical take-aways drawn from those points, along with concrete measures that firms might implement to build more robust and efficient compliance programs.

## Rational and Irrational Dishonesty

In the last issue of this journal, authors Nina Mazar and Dan Ariely discussed research conducted on dishonesty, looking at why people are dishonest, to what degree they are dishonest and how dishonesty might be curbed.<sup>1</sup> Dr. Ariely also discussed dishonesty during a presentation he made to the SEC’s Investor Advisory Committee in 2010.<sup>2</sup> Among the many interesting points illuminated by these discussions<sup>3</sup> are the following:

- Rational, ‘strategic’ dishonesty is based on an analysis of *external* cost-benefits considering how much can be gained, what is the probability of being caught and what is at stake if caught. This type of dishonesty is most likely committed by just a few ‘bad apples.’
- In contrast, most people engage in naïve “irrational dishonesty,” which allows them to cheat just a little bit and reap some of the benefits of being dishonest while still being able to maintain a positive image of themselves as basically moral and honest people.
- The total costs incurred due to irrational dishonesty may be much greater than those associated with rational dishonesty. This suggests that the effort applied to deterring dishonesty – especially standard rational dishonesty – might be misplaced.
- In the case of irrational dishonesty, *internal* factors bearing on self-image or self-concept influence whether and to what degree people



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are dishonest. Under this theory, even people who think highly of themselves in terms of honesty can engage in a certain amount of dishonesty – within an acceptable ‘band’ -- while retaining their positive views of themselves.

- The standard economic approach to deterring dishonesty is relatively ineffective in deterring irrational dishonesty.
- As part of socialization, people internalize the norms and values of the society around them, which serve as an internal benchmark against which people compare and judge their own behavior.
- When people are mindful of their own moral standards, any dishonesty is more likely to require them to change how they think of themselves, which in turn will cause them to adhere to a stricter definition of honest versus dishonest behavior.
- The more behaviors are susceptible to being re-interpreted in a self-serving manner (that is, the higher their degree of ‘categorization malleability’ in research-speak), the more people can rationalize their behavior and the more dishonest they can be without having to change their self-concept.
- When people see another person cheating in an egregious way, they cheat more, at least when the other person is viewed as part of their group.

These points could have far-reaching implications for the way financial services firms design, monitor and test their compliance programs, as well as the way they train, compensate and reward their personnel. Some of the practical take-aways and potential measures firms might consider are listed in the next section.<sup>4</sup> Of course, this information should be taken with appropriate caveats, including:

- The research in this area is far from definitive. Many open points remain to be addressed and tested,<sup>5</sup> although many of the points discussed have undeniable intuitive appeal.
- I am not an expert in behavioral economics, and I have interpreted the research discussed from my own lay perspective.
- The leap from scientific research to real-life application is always perilous.

Despite these caveats, firms would be wise to consider carefully the practical implications and potential applications of the points discussed, including those listed in the following section.

## Compliance Take-Aways

### 1) *Rational, ‘strategic’ dishonesty is most likely committed by just a few ‘bad apples.’*

There is strange comfort in knowing that strategic, calculated dishonesty may be the rare exception rather than the rule. However, no matter how rare the ‘bad apples’ may be, most financial services firms would not likely shift compliance resources away from preventing rational, strategic dishonesty -- like classic fraud – in today’s regulatory environment. Rather, firms are more likely to continue devoting considerable effort to avoiding the next Bernard Madoff,<sup>6</sup> Jerome Kerviel<sup>7</sup> or other ‘bad apple’ who goes to great lengths to plan, pull off and cover up their wrongdoing.

How might this be achieved? If the standard economic model is right, strategic dishonesty involves a rational analysis of three factors – how much can the perpetrators gain, what is the probability they will be caught and what will they lose if caught?<sup>8</sup> One approach, then, would be to adjust these three factors until the most cost effective deterrent is attained by, for example, decreasing the amount that can be gained, increasing the probability of being caught and/or increasing the penalties if caught.

Here are some concrete ideas of how this might be implemented in practice:

- Decrease the dollar threshold under which firm personnel can handle or access funds (write checks, transfer assets, etc.) without triggering additional safeguards, such as second signature requirements. This would decrease the amount that could be gained from any single act of dishonesty committed under the threshold.
- Decrease the dollar amount under which firm personnel are free from reporting requirements for gifts, entertainment or business courtesies. This too would decrease the amount that could be gained from any single dishonest or improper act under the dollar threshold.
- Increase the frequency and number of compliance tests conducted, including looking at cases where fewer safeguards are imposed, such as transactions in dollar amounts under the threshold where a second authorizing signature is triggered. This would increase the probability of any dishonest act being caught.
- Impose mandatory vacation or “out of the office” time on personnel. This would increase

the probability of dishonest acts being caught, to the extent they depend on the perpetrator continuously gaming, altering or rigging the system or taking advantage of its weaknesses.

- Cross train and rotate personnel to handle several different areas and avoid any single task becoming dependent on any single person. This would also increase the probability of dishonest acts coming to light as fresh personnel are rotated into new areas.
- Ensure a separation of duties between the personnel responsible for the day-to-day execution of tasks and the personnel responsible for testing, monitoring or supervising them. Not surprisingly, separation of duties is often cited by the SEC Staff as a vital part of every compliance program.<sup>9</sup> This too would increase the probability of dishonest acts being caught.
- Establish and consistently impose more severe consequences for acts of dishonesty. This would increase the penalties for being caught, as well as impress on personnel that the firm is serious about imposing those penalties in appropriate cases.

2) *Instead of engaging in rational, strategic dishonesty, most people engage in naïve "irrational dishonesty," which allows them to reap the benefits of a little cheating while still maintaining their positive feelings about themselves. In other words, a lot of people cheat just a little.<sup>10</sup> Moreover, the total costs incurred due to irrational dishonesty may be much greater than those associated with the rational dishonesty.*

Just being aware of these points can make a compliance system more robust by focusing attention on the prevalence of cheating and its impact. These points also suggest that compliance resources ought to be employed in a two-pronged approach, aimed at preventing *irrational* dishonesty as well as *rational* dishonesty.

Here are some concrete steps that might be taken in light of this:

- Increase the professional skepticism compliance personnel bring to their jobs to include the potential for dishonesty to be committed by anyone, even those you might suspect the least. This need not rise to the level of professional paranoia. However, if the research is right – a lot

of people cheat just a little – a broad skeptical mindset is warranted.

- Test areas that, relatively speaking, may seem like "small potatoes," which may be fertile ground for irrational dishonesty as well as rational, strategic dishonesty. This might involve looking at smaller trades, error accounts, catch-all suspense accounts, "plugged" accounting figures, periodic reconciliations, rounded figures, expense reimbursement requests, gifts/entertainment reports, fees/taxes/surcharges added to invoices, petty cash, routine forms requiring a client signature or initials, and so on.
- Periodically change the system used for monitoring and supervising various areas to minimize the chance that complacency, misplaced trust, tacit collusion, willful blindness or other factors may be causing dishonesty to go undetected. Examples include:
  - periodically re-assigning the personnel responsible for testing or supervising certain areas,
  - periodically changing the engagement partner and/or personnel responsible for auditing the firm's financial statements,
  - periodically bringing in outside consultants or auditors to test in various areas, or
  - periodically changing the dollar triggers or date ranges used for testing in various areas.

3) *The standard economic approach to deterring dishonesty is relatively ineffective to deter irrational dishonesty, where internal factors (self-concept) influence whether and to what degree people are dishonest. When people are mindful of their own moral standards, they adhere to a stricter definition of honest versus dishonest behavior.*

If the standard measures used to deter rational dishonesty – decreasing the amount that can be gained, increasing the probability of being caught and/or increasing the penalties if caught – are less effective in deterring irrational dishonesty, other measures ought to be found. These points suggest that measures should be oriented toward influencing people's self-concept and reminding them of their own moral standards so they will be inclined to act more honestly.

Here are a few concrete ideas:

- Periodically obtain a signed certificate from all personnel verifying that they have acted – and will continue to act – in compliance with the law and firm policies. This can be integrated into any other certifications routinely obtained from firm personnel, for example, under the firm's Code of Ethics. This idea is directly in line with research that shows signed certifications can actually work, making people less inclined to cheat, at least for a little while.<sup>11</sup>
  - Require that personnel sign a statement at the *top* of every form they submit to the firm (personal trading reports, account opening forms, D&O questionnaires, expense reimbursement requests and so on) acknowledging that they are required to fill out the form accurately and honestly and confirming that they know severe consequences are at stake for not doing so.
  - Conduct periodic training sessions reminding personnel of their obligations under the law and firm policies. Training not only presents the opportunity to teach, update and clarify requirements, but another opportunity to make people more mindful of their own moral standards.
  - Include 'morality' reminders in appropriate communications with firm personnel. For example, include a short 'compliance column' or 'message from compliance' in the monthly firm newsletter, reminding personnel of their obligations and their promises to remain in compliance.
  - Place compliance message signs in the coffee room, lunch room or anywhere else they might be appropriate and accessible to firm personnel. Change them periodically so they do not become ignored as simply part of the décor.
- 4) *The more behaviors are susceptible to being reinterpreted in a self-serving manner (what researchers call having a higher degree of 'categorization malleability'), the more dishonest people can be without having to change their self-concept.*

This implies that when people cheat in direct exchange for money, they cheat less. When they cheat for something one or more steps removed from money, they cheat more.<sup>12</sup>

Here are some concrete thoughts on how this information might be used to make a compliance program more robust:

- Increase compliance and supervisory vigilance in areas involving substitutes for money, such as:
  - The placement of brokerage when soft dollar "credits" are earned.
  - The purchase of research or other benefits using soft dollar credits in a soft dollar or client commission arrangement.
  - The design of internal compensation arrangements that reward personnel with trips, prizes, awards or other benefits for achieving certain goals.
  - The granting of stock options or phantom stock as compensation.
  - The utilization by firm personnel of other perks or benefits provided by the firm that do not involve direct exchanges of money, such as firm credit cards, firm transportation allowances (firm provided car, limo or taxi service), vacation/sick leave, parking or commuter passes, firm provided electronics/communications (cell phone, PDA or Internet access) and so on.
- Increase compliance and supervisory vigilance when advice, recommendations or selections made for clients or customers involve a conflict of interest providing an indirect economic benefit to the firm or its personnel, such as:
  - The selection or recommendation of mutual funds among alternatives that pay out different distribution or shareholder servicing fees, commissions or other amounts to the firm or its personnel.
  - The selection of affiliated funds (paying the firm or its affiliates asset-based fees) over non-affiliated fund alternatives to satisfy client or customer needs.
  - The allocation of investment opportunities or aggregated trades among accounts where the firm or its personnel have a proprietary stake in one or more accounts.
  - The use of affiliated brokers to execute client trades or affiliated advisers to manage customer portfolios, where the firm may not be compensated directly but the organization as a whole is benefited by the commissions or fees generated.
  - The selection of brokers to execute client or customer trades when the broker has referred or is in a position to refer clients to the firm.

- The selection or recommendation of brokers as custodian for client or customer accounts when the brokers provide free or discounted back-office support or other benefits to the firm or its personnel.
- The selection of service providers (brokers, advisers, banks, administrators, record keepers or others) to handle outsourced business for the firm when the service provider has given the firm or its personnel freebies, perks or other benefits, such as paid trips, tickets, meals or entertainment, to mention a few.

**5) *People internalize the norms and values of the society around them, which serve as an internal benchmark against which people compare and judge their behavior. When people see another person cheating in an egregious way, they cheat more, at least when the other person is viewed as part of their group.***

Research confirms what we already knew, that people internalize the norms they are immersed in every day and will therefore cheat more if they see those around them cheating ("everybody does it"). This underscores the importance of the SEC's long-standing message to financial services firms urging them to set the "tone at the top" and establish a healthy "culture of compliance."<sup>13</sup>

Here are some concrete ideas about how these points might be implemented in practice:

- Treat personnel even-handedly in enforcing legal and firm obligations. Senior management should not be given special treatment or a "pass" on compliance. Rather, senior management should set the "tone at the top" using their own compliant behavior as an example, thereby reinforcing the firm's "culture of compliance."
- Make an example of violators in the firm who have been flagrant in their misconduct so that anyone who was aware of their wrongdoing is also aware that it was punished appropriately.
- Acknowledge and reward personnel who are consistently compliant, who actively strive for greater compliance and who step forward to report questionable conduct in accordance with firm procedures.
- Set up compliance hotlines or similar mechanisms making it simple and socially acceptable

for personnel to report cheating or other non-compliant behavior or to simply question conduct that they are not sure about.

- Discourage the attitude that "nobody likes a rat" and instead protect whistleblowers from retaliation.

## **Balancing Costs and Benefits**

Of course implementing compliance measures involves costs and, in the end, the efficient use of resources will depend on whether those costs are worth it. So, the decision to implement any of the compliance measures discussed should be approached just like the decision about any other compliance control, by weighing the expected benefits against the expected costs.

This is particularly true for more resource-intensive measures that involve testing many small individual transactions or amounts. While focusing on "small potatoes" may seem tedious or inefficient, the costs may well be worth it, to the extent these areas are fertile ground for irrational as well as rational dishonesty and if, as the research suggests, the total costs resulting from irrational dishonesty (a lot of people cheating just a little) may far outweigh the costs resulting from rational, strategic dishonesty (the rare 'bad apple').<sup>14</sup>

*Most people engage in naïve "irrational dishonesty," which allows them to cheat just a little bit and reap some of the benefits of being dishonest while still being able to maintain a positive image of themselves as basically moral and honest people.*

Moreover, real cases remind us that wrongdoers operating in the world of "small potatoes" can wreak havoc on a grand scale. Even the massive Health-South fraud was perpetrated by recording hundreds of fake accounting entries that company insiders knew were individually too small to attract the attention of outside auditors (under \$5,000), but which eventually totaled a whopping \$3 billion.<sup>15</sup> In another case, a South Carolina woman went to prison for overcharging the U.S. Government more

than \$20 million in shipping fees for supplies that rarely exceeded \$100 per item.<sup>16</sup>

Certainly, the costs of compliance are easier to measure than the benefits, which only rarely will be measurable with any precision. As a result, firms will have to continue doing the best they can to make valid estimates and track the results of their efforts. To the extent possible, measuring benefits should take into account not only direct harms avoided (such as misappropriation deterred), but also more intangible factors such as the firm's enhanced ability to:

- attract and retain business based on the firm's reputation for honesty and compliance,
- hire and retain quality personnel attracted to a fair and ethical work environment, and
- resolve regulatory matters more efficiently

when the firm is viewed as trying to "do the right thing."

## Conclusion

Research in behavioral economics has illuminated important points about dishonesty, addressing why people are dishonest, to what degree they are dishonest and how dishonesty might be curbed. This article lists practical take-aways drawn from those points, along with concrete measures that financial services firms might implement to make their compliance programs more robust and efficient. Of course not all the measures suggested will suit firms of every type and size, but they can serve as examples for firms to consider when building their own programs.

## ENDNOTES

<sup>1</sup> See Nina Mazar and Dan Ariely, "Irrational Dishonesty: A Little Compliance, A Little Violation," *Practical Compliance and Risk Management for the Securities Industry* (November-December 2010) at pp.39-50 (Irrational Dishonesty).

<sup>2</sup> Dishonesty (cheating) was among a number of topics discussed by Dr. Ariely in his presentation at the May 17, 2010 meeting of the SEC's Investor Advisory Committee (IAC Presentation). The minutes and webcast archive of the entire meeting can be accessed on the SEC's website at <http://www.sec.gov/spotlight/investoradvisorycommittee.shtml>.

<sup>3</sup> All of these points are discussed in *Irrational Dishonesty*, *supra* note 1, and/or Dr. Ariely's IAC Presentation, *supra* note 2.

<sup>4</sup> Some of the measures suggested are take-offs on the approaches suggested in *Irrational Dishonesty*, *supra* note 1, at pp.46-47.

<sup>5</sup> See *Irrational Dishonesty*, *supra* note 1, at p.47.

<sup>6</sup> In 2009, Bernard Madoff pled guilty to charges relating to his \$65 billion Ponzi scheme that harmed many money managers, banks and

other financial firms as well as their clients. See David Glovin, David Voreacos and Erik Larson, "Madoff to Plead Guilty in Largest U.S. Ponzi Scheme (Update 5)," Bloomberg, March 10, 2009, at [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajXKv\\_FgFU5g](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ajXKv_FgFU5g).

<sup>7</sup> Trader Jerome Kerviel was sentenced to prison for his role in one of the world's largest-ever trading scandals in which his former employer, Societe Generale, acknowledged that it did not have the right control systems in place to correctly supervise him. See David Gauthier-Villars, "Rogue French Trader Sentenced to 3 Years," *The Wall Street Journal Online*, October 6, 2010, at <http://online.wsj.com/article/SB10001424052748703726404575533392217262322.html>.

<sup>8</sup> *Irrational Dishonesty*, *supra* note 1, at p.40.

<sup>9</sup> See 2009 CCO Outreach Regional Seminars, The Evolving Compliance Environment: Examination Focus Areas (April 2009), at <http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf>.

<sup>10</sup> Dr. Ariely discusses this point in his IAC Presentation, *supra* note 2.

<sup>11</sup> See, for example, the "honor code" research

discussed in *Irrational Dishonesty*, *supra* note 1, at pp.44-45.

<sup>12</sup> This is how Dr. Ariely summarizes the point in his IAC Presentation, *supra* note 2.

<sup>13</sup> See "The Culture of Compliance," Remarks of Lori A. Richards, then Director of the SEC's Office of Compliance Inspections and Examinations, at the Spring Compliance Conference: National Regulatory Services in Tucson, Arizona (April 23, 2003), at: <http://www.sec.gov/news/speech/spch042303lar.htm>.

<sup>14</sup> See *Irrational Dishonesty*, *supra* note 1, at pp.47-48.

<sup>15</sup> See Jonathan Weil, "Missing Numbers -- Behind Wave of Corporate Fraud: A Change in How Auditors Work -- 'Risk Based' Model Narrowed Focus of Their Procedures, Leaving Room for Trouble -- A \$239 Million Sticky Note," *The Wall Street Journal*, March 25, 2004, col. A1.

<sup>16</sup> See "South Carolina Woman Sentenced for Defrauding the Department of Defense of Over \$20 Million," on the IRS website at <http://www.irs.gov/compliance/enforcement/article/0,,id=187268,00.html>.

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