LETTER *from the* PRESIDENT

July 2002

Dear Friends,

In all my years in this profession, it's never been easier to make the case that ethics matters.

Is that encouraging? Sure. Moral integrity is essential for global survival. It's good to see more receptivity to that message. But it's also disheartening, because the receptivity arises from the corporate scandals we've been hearing about. One reason the public wants more ethics is that we seem so close to a meltdown at the core of global finance.

If a meltdown came, it would be deep, threatening companies everyone thought were sound. It would be broad, affecting millions of people whose livelihoods are tied to market performance. It would be severe, involving numbers awesome to contemplate. It would be chronic, creating effects rippling out into the future. And it would be toxic, poisoning responsible companies with public distrust.

Is the meltdown already occurring? The market has descended into troughs not seen for five years. In a *USA Today*/CNN/Gallup Poll taken June 29–30, Americans characterize these scandals as a "major problem" for the nation (57 percent), and say they are now "less likely" to invest in stocks (58 percent). Lashing out at what he called "high-profile acts of deception," President Bush devoted a major speech on July 9 to his plans for promoting "a new ethic of responsibility" in business—with new laws to support it. "All investment is an act of faith, and faith is earned by integrity," he told a Wall Street audience. "In the long run, there is no capitalism without conscience; there is no wealth without character."

Why are we in this mess? In my last letter, I wrote about the link uniting terrorism, Enron, and global corruption. It's still accurate to say that the public response to 9/11 brought the American public to unprecedented levels of moral consciousness and metaphysical questioning. And it remains true that one reason Enron moved from the business section to the front pages was that it hit us while this post-9/11 ethical sensitivity was still set at Code Red.

Then came the implosion of Enron's auditor, the "Big Five" accounting firm Arthur Andersen. History, I suspect, will relegate Houston-based Enron to a footnote. It will be seen as yet another example of charlatanry and hubris, its roots stretching back to the itinerant snake-oil salesmen who trotted around that part of Texas a century ago. Andersen is an entirely different matter. Until its shredders started whirring, it appears that Andersen did nothing illegal. Point by point, step by step, it adhered to the accounting practices of its peers—pushing the black-and-white limits, maybe, and playing fast and loose among the grays, but never actually breaking the law.

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Yet Andersen's description of Enron's financial position didn't square with reality: The whole was different from the sum of the parts. That's deceptive. And deception, especially in the accounting business, is unethical. What brought down Andersen was not law. It was ethics—or, more exactly, a lack of public trust. When Andersen could no longer be trusted to resist unethical behavior among clients and staff, it effectively lost its most important resource: credibility. Without that, it could neither hang onto old business nor generate new. You can express it (as accountants like to do) almost arithmetically: Negative ethics equals negative business.

That's a hugely important point, for two reasons. First, it provides an example of a major company whose demise can only be explained from an ethical perspective. That fact will flummox some business schools. For decades, they've allowed their students to think that ethics isn't very important. Even among schools requiring ethics for everyone, graduates will tell you how rarely the topic gets seriously discussed *outside* the ethics class. "We're teaching you the hard stuff—finance, strategy, marketing—to help you survive," those other courses seem to be saying. "Soft stuff like ethics has little to do with the real world. So study it if you wish, but remember what *really* matters."

The fallacy of that approach is now jarringly clear. When something changes the corporate landscape overnight, it's not soft. When the "Big Five" becomes the "Big Four" because of something the schools never took seriously, something's amiss. Point One: The business-school curriculum needs to move into the 21st century—in a hurry.

Point Two: The fall of Andersen involved not a single entity but an entire auditing system. That system was used to bill Enron as the seventh largest firm on the Fortune 500. In fact, like the Wizard of Oz, it was nowhere near that big. When that truth became clear, the next question became obvious: What other firms in my portfolio are not what they claim to be? Who else has fiddled the numbers? Whom can I trust?

It's on this point that, in the last several months, the "one bad apple" theory of corporate turpitude has been tested. That theory holds that while most companies are well-managed and financially sound, a few rotten ones have given the rest a bad name. The public longs to believe that theory. Why else would they keep investing in stocks?

But look at the latest list of big bad apples. Adelphia. Dynegy. Global Crossings. ImClone. Qwest. Tyco. WorldCom. Xerox. How many more will there be? Is this really just a few bad apples? Or is there a virus in the motherboard of 21st-century capitalism, launched from the audit and finance areas and ultimately infecting all firms, good or bad? Is there so much corruption out there that it's dangerous to own stocks at all? And even if some firms are sound, who knows which ones?

This last question is crucial. If the above analysis is correct, a "sound" firm is above all an ethical one. Suppose I believe in the idea of the market and want to keep investing. But I worry that the companies I buy may self-destruct over an ethical implosion. So how can I tell the good ones from the bad? I used to be able to rely on two things: independent audits and government regulation. But I now know auditors can't help me, because I trust neither their processes nor their independence. And government, for all the talk about accounting reform, is not going to impose rigid standards any time soon, given the lobbyists of laissez faire. So what can possibly bring me back into the market?

If, collectively, we can't answer that question, we may as well give up and watch the markets dwindle away, taking down the entire capitalist structure with them. At this point, only the ethics of trust can save the day. But how can that be convincingly inserted into the markets *now?*

Here let me make an admittedly provocative proposal, built on two things: a little-known example and a well-known fact. The example comes from Lloyd's of London. Like any insurer, Lloyd's has nothing to sell but promises on paper—in this case, promises to pay if bad things happen. Lloyd's is composed of syndicates, capitalized by individual member-underwriters. Here's how Lloyd's itself describes the relationship: "Individual members are liable to the full extent of their private wealth to meet their insurance commitments, while the corporate entities trade with limited liability."

The full extent of their private wealth. Think what that means. While Lloyd's and its syndicates are protected against some liabilities, there's no protection for members. If syndicates prosper, members benefit enormously. But if a syndicate fails, its members lose everything—bank accounts, investments, houses, cars, pensions, and everything else they've gained from a lifetime's work. That's why Lloyd's retains its credibility: Real people stand behind these promises, prepared to go the wall to keep their word.

And the well-known fact? That has to do with the extraordinary accumulation of power that has flowed to CEOs in recent decades, making them household names and giving them legendary wealth. They write books. They show up on television. They grace the covers of magazines. And they keep their companies' stock trending upward—sometimes by any means possible—because their own compensation depends on it.

The proposal? Ask the CEOs to do no more than Lloyd's asks of its members. Ask them to pledge "the full extent of their private wealth" behind their company's integrity. If they take the ethics pledge and the company prospers, so do they. If it tanks *over an ethical issue,* so do they—literally and totally.

How would this work? First, it would not penalize the CEO who fails after taking honest risks. If a transparent, well-managed, and ethical company goes belly up over issues involving strategy, marketing, or misplaced financial engagements, that's different. The CEO may have had poor business judgment, or market factors may simply have turned at the wrong moment. When that happens, the normal processes of rotation take effect and the CEO leaves with private wealth intact. Investors, as they have from time immemorial, take a cold bath. Nothing wrong with that. That's how markets work.

Second, this proposal would make clear that the CEO's principal duty—especially in this age of distrust—is to ensure the ethics of his or her company. That means more than simply signing off on the audit, as suggested in some proposals for reform. It means knowing enough about the audit process that you feel comfortable guaranteeing, with your full private wealth, the ethics of your firm. It means saying, "This is an ethically managed company, which is not suddenly going to restate its earnings because of some shenanigans. I've looked into everything before signing this ethics pledge. Trust me, because if I'm wrong I personally lose *my entire private wealth.*"

Third, regulations will be needed to ensure that the ethics pledge has teeth. Otherwise any CEO could say, "Sure, I'll guarantee," and then fail to pay up if the time comes. Can such regulations be workable? They certainly are at Lloyd's.

Fourth, even the fabled wealth of a CEO isn't enough to make whole all those who lost when, say, a WorldCom restated $3.85 billion in earnings. So the CEO may want to bring along a few others—the CFO, the board chair—into the ethics pledge. Even that won't make up a serious loss. But the symbolism will be enormous.

Fifth, nobody's demanding that every CEO sign up. Like membership in Lloyd's, it's voluntary. Some CEOs, sniffing the fiscal putrefaction of their companies, won't dare. Others, resenting any claim on their private wealth, will refuse.

But what if just a handful will? That may be all the market needs—some way to determine which companies can be trusted. It's not like sending in the ethics police. It's better: It's having an insider verifying not only the public numbers but the hidden infrastructure and integrity of the firm.

If the ethics pledge sounds like a stretch, ask yourself this:

- Was it a stretch for me to imagine the market would ever get this shaky?
- Am I still planning to invest in all these impressive-looking companies just as I used to, or is that a stretch, too?
- What else, besides a guarantee of ethics, can bring me back into the market?

Even here, you still have a choice. You can invest in a hundred current firms and cross your fingers that the Andersen influence won't hit their auditors and managers. Or you can invest in ten companies whose own CEOs are willing to bet the family farm on their corporate integrity. Personally, I'd go for the latter—betting that lots of others will join me, and that this segment of the market will shoot ahead of the rest.

If that happens, by the way, who benefits most? I hope it would be the CEO who had the moral courage to take the ethics pledge.

Sincerely,

Rushworth M. Kidder

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