

Lessons Learned in Uncovering Perverse Incentives

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What are Incentives?

- U.S. companies spend an estimated \$38 billion on bonuses and incentives, but there's been debate in the business community about how effective they really are.
- When designed properly and intentionally, incentive programs can increase performance and drive organizational success.
- They can be used to shape people's behavior by highlighting what's important to an organization and providing positive reinforcement to those who display the desired behaviors.
- Unfortunately, when designed poorly, incentives can put a company's sustainability at risk by:
 - paying out too much
 - incentivizing the wrong behaviors
 - driving people to game the system to meet their targets
- Incentives that may appear completely rational to leaders can have the unintended consequence of rewarding bad behavior.

Source: Forbes magazine, My Say, 6/7/14 GUEST POST WRITTEN BY Chris Cancialosi, Managing Partner and Founder at [gothamCulture](http://gothamCulture.com)

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What are Incentives?

- Incentives are a loud, unspoken message as to "what management really wants."
- Landscape is littered with ethical failures resulting from the unintended consequences of incentives.
- Perverse incentives can drive good people to do things that they look back on with surprise and regret, when it's too late.
- When does an incentive to perform become an incentive to cheat?
 - Incentive is not properly balanced with communication on the "how".
 - Incentives are solely financial; none are aligned with core values and ethics objectives.
 - When goals linked to reasonable sales growth start to "stretch" and run ahead of market realities, then "cutting corners" can look like a reasonable way to meet the goals in a particular month or quarter.
- Informal incentives such as the promise of promotion, the threat of losing one's job, or the prospects of special recognition, are also potent drivers of behavior.
- Not all measures can be found in an employment contract.
- What is being communicated?

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Incentives in Ethics and Compliance

- The Federal Sentencing Guidelines state that the compliance and ethics program should be “promoted and enforced consistently throughout the organization through appropriate incentives to perform in accordance with the compliance and ethics program.”
- Management should design an incentive program to steer employees toward compliance and ethical behavior.

Incentivizing Ethical Behavior to Minimize Misconduct

- An incentive program must:
 - Be highly visible (where appropriate).
 - Be easily understood.
 - Be viewed as fair by all.
 - Complement any other incentive programs.
 - Provide timely and appropriate rewards.
 - Clearly indicate how and when the incentive is awarded and that not everyone receives it.
 - Include effective oversight and monitoring.
- “WHAT GETS MEASURED GETS DONE”

Incentives and Controls

- A robust compliance, ethics and control environment can ensure appropriate execution of incentives.
- Ethical Culture is a foundational internal control without which all other controls will ultimately fail.
- Controls that work well always come at a cost: poorer results now in exchange for longer-term gains.
 - Economic Crisis in 2008: Most profitable divisions of companies engaged in unethical behavior to achieve goals.
 - "Don't kill the Golden Goose".
- Conflict between short-term results and long-term goals can place management against compliance personnel.
- We have seen a number of cases of corporate misconduct where controls were ignored or overridden; just as dangerous as no controls at all.
- Controls that are ignored or distorted to fit short-term business objectives can lead to deceptive or unethical business practices.
- Supervisors are sometimes aware of the practices but are not incentivized to stop them.
- When controls are ignored to achieve a temporary improvement of financial results, it erodes the ethical culture creating long-term damage.
- Warren Buffet: "Only when the tide goes out do you discover who's been swimming naked."

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What is Ethical Culture?



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It's how things are “really done around here”



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Hallmarks of an Ethical Culture

- Open, transparent, and timely communication.
- Management that:
 - Is held to a higher standard of ethics.
 - Expects, models, prioritizes, and rewards ethical behavior and decision making.
- Policies founded in organizational core values.
- Employees who feel comfortable and able to raise concerns or communicate bad news.

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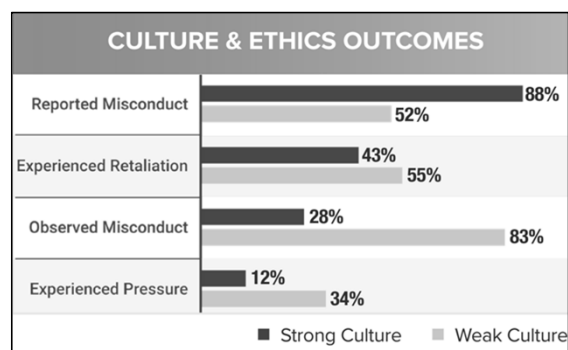
Warning Signs of an Unethical Culture

- Disrespectful attitudes or bullying
- Cliques, favoritism, or nepotism
- Low employee morale and lack of teamwork
- High absenteeism or turnover
- Large number of anonymous whistleblower complaints
- Lack of response to employee questions, concerns, or suggestions about process improvements

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Impact of Culture on Misconduct



Source: Ethics and Compliance Initiative's 2018 *Global Business Ethics Survey* (www.ethics.org/ecihome/research/gbes)

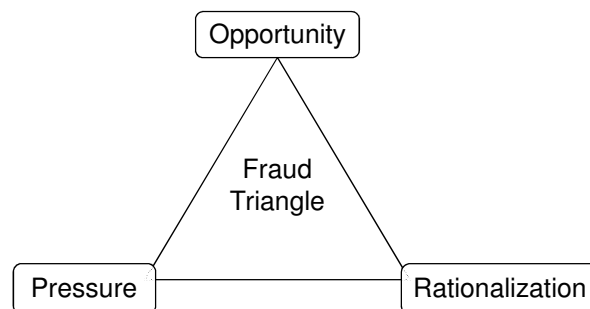
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Why Do People Comply?

- To comply, employees must:
 - Understand their responsibilities
 - Be able to comply
 - Be motivated to comply

Why Do People Commit Fraud?



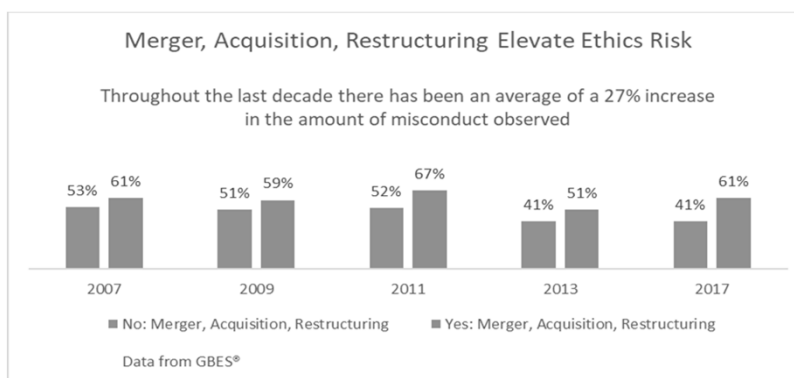
Fraud Triangle and Ethical Culture

- Opportunity
 - Greatest when an employee perceives bad behavior is an accepted way of doing business: culture
 - Fear of retaliation prevents reporting
- Rationalization
 - Sense of entitlement high in cultures with low morale
 - Perception of unfair treatment
 - Incentives/rewards favoring ethically challenged and promote the wrong behaviors
 - Doing the “wrong” thing for the “right” reasons
- Pressure
 - Unrealistic business objectives
 - Financial metrics divorced from core values and ethics
 - Not enough emphasis on the “HOW” we do things

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Organizational Stress Increases Misconduct



Source: www.ethics.org - ECI is comprised of the Ethics Research Center, the Ethics & Compliance Association and the Ethics & Compliance Certification Institute.

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Incentives: Challenges to Creating a Culture of Ethics and Compliance

- Rewards and incentives focused solely on financial performance.
- Incentives that reward people for doing the wrong things by ignoring the “how”.
- Incentives that penalize people for following the rules.
- Codes of Conduct that are unevenly enforced with different standards of discipline.
- Unrealistic performance measurements that create pressure.
- Mixed messages from the top on performance objectives...what is really important?

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Setting the Ethical Tone

**Tone at
the top**

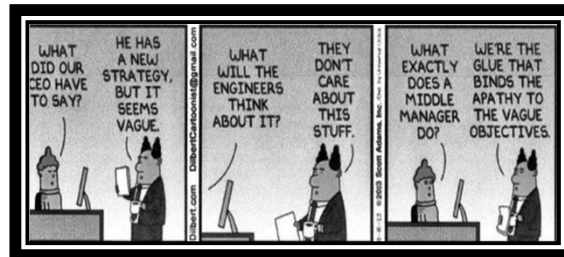
Mood in the middle

Buzz at the bottom

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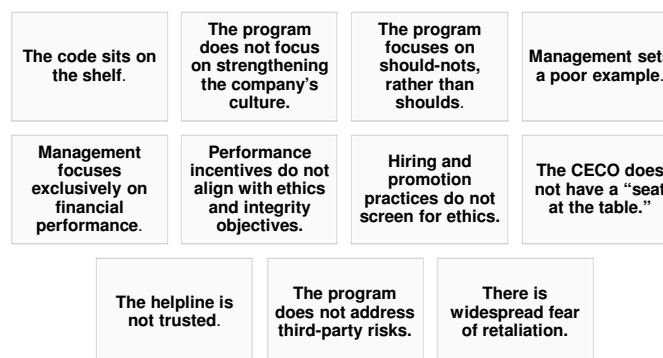
Senior Level Managers Should Be Setting The Tone



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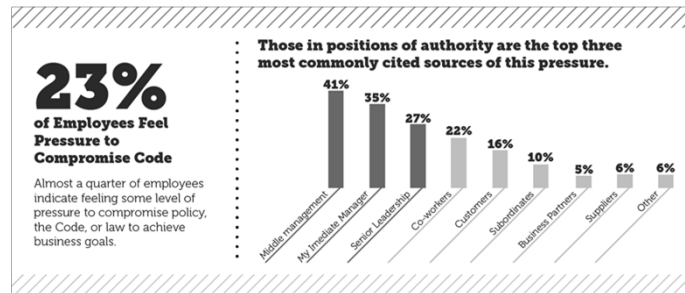
Why do Compliance and Ethics Programs Fail?from our Monitoring Case Files



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Pressure to Achieve Business Goals



Source: "Measuring Ethical Culture: What Out Data Tells Us" Infographic, Ethisphere, June 5, 2018

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How to Identify Proper Alignment of Incentives

- What drives the Performance management system?
 - Attention to ethics and integrity in performance appraisals
 - Criteria for promotion
 - Bonus determinations
 - Plum assignments
- Employee perceptions are critical
 - Perceptions about existing compensation structures – realistic?
 - What drives their performance?
 - Is there mixed messaging from the top?
 - Are core values and integrity objectives properly incentivized?
 - Are ethical objectives (the "how" we do things") balanced with the financial metrics?

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Incentivizing Ethical Behavior to Minimize Misconduct

- Incorporate significant fraud, compliance, and ethics risks into internal reporting metrics.
- Ensure organizational and individual performance goals are realistic and do not foster pressure for unethical conduct.
- Reward teams and managers who achieve full compliance.
- Reward employees who display ethical leadership and openly cultivate a culture of ethics.
- Reward employees for considering potential compliance issues or offering suggestions for increased compliance.
- Recognize employees for speaking up and reporting unethical behavior.

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Perverse Incentive: Target Awards

- One of the most common compensation structures in the corporate world is to have between 25 percent and 50 percent of target awards suddenly kick in when a threshold level of performance is achieved.
- At this point, the pay-for-performance curve is not just steep, it is vertical. To managers, that might mean millions of bonus dollars for hitting their number, or zero if they fall a dollar short.
- Unsurprisingly, about half of corporate scandals over the past two decades have happened with performance in a range right around an all-or-nothing threshold level.
- That is where you see “cutting corners” decisions such as deferred maintenance or temporary layoffs; unethical behavior such as channel stuffing or the manipulation of accounting reserves; or flat-out illegal behavior such as bribery and fraud.
- Enron, WorldCom, Rite-Aid, and Sunbeam all utilized all-or-nothing target awards that motivated bad employee behavior that led to scandal and/or bankruptcy.

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Lesson Learned: Mylan EpiPen

- The seeds of Mylan's EpiPen scandal were planted when management became eligible for millions of dollars if they hit 90 percent of their cumulative earnings target.
- If they merely achieved 89.9 percent of their goal, they would lose out on all of it.
- If your team earned \$89 million toward a \$90 million threshold performance, what would you do for that last million?

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Lesson Learned: Wells Fargo

- When Wells Fargo imposed a target of eight accounts per customer on its branches, the bank created an aspirational goal. Cross-selling is a proven method of encouraging growth and maximizing upside, with little incremental expense.
- Bonuses made dependent on achieving sales goal, further inflamed by managers checking progress up to twice per day created a "Pressure Cooker".
- Some employees lost their jobs for falling short of those goals, and others observed the termination of their peers.
- Those who complained about pressure were sidelined or terminated.
- Bosses (management controls) failed to shut down the bad practices they knew were occurring.
- Outcome was hardly imaginable when the goals were designed, approved, and articulated. And it was certainly an outcome that no one wanted -- not management, employees, shareholders, or customers.

Source: [WELLS FARGO: HOW REASONABLE PAY PLANS MORPHED INTO PERVERSE INCENTIVES](#) BY Richard Bistrong and Marc Hodak | Thursday, January 26, 2017

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Lesson Learned: The Veteran's Administration

- Department of Veterans Affairs (VA) scandal in 2014 revealed long delays in veteran care at VA hospitals around the country.
- Employee bonuses linked to patient wait time at hospitals; staff falsified appointment records to meet a 14-day target.
- Some patients died while they were on the waiting list; reports differ about whether they died because of the delay.
- Defenders agreed that it was unacceptable to falsify data, but the 14-day target was unrealistic in understaffed facilities.
- Performance Pay system rewarded doctors for minimizing the number of patient follow-up visits.
- Decision made earlier to eliminate performance bonuses for VA leadership, removing incentive to pay attention.
- The VA did not begin reviewing the data supporting each requested incentive until after the organization paid \$400 million for bonuses in 2011.
- If VA leaders were financially incentivized to ensure that veterans seeking treatment were serviced quickly and efficiently it's plausible that some leaders found ways to manipulate the system to achieve their incentive goals without actually performing at the desired standard.

Source: Forbes magazine, My Say, 6/7/14 GUEST POST WRITTEN BY Chris Cancialosi, Managing Partner and Founder at [gothamCulture](#)

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Lesson Learned: United Airlines

- At O'Hare, gate staff asked for four volunteers to give up their seats to make room for a crew due at the destination.
- When none accepted the airline's offer of \$800, overnight accommodations, and a flight nearly 24 hours later, the staff selected four passengers by computer.
- Mr. Dao, a 69-year-old physician, refused to give up his seat. Instead, airport police forcibly removed Dao from his seat and dragged his bloodied body down the aisle.
- CEO Oscar Munoz chose to see the incident entirely from the workers' point of view.
 - The airline staff treated Dao "politely" and "apologetically"
 - Dao was "disruptive and belligerent."
 - Airline agents "were left with no choice but to call Chicago Aviation Security Officers"
- In a subsequent statement Munoz apologized: "I deeply apologize to the customer forcibly removed and to all the customers aboard, he said. "No one should ever be mistreated this way."
- He pledged to "work to make it right" via a "thorough review" of passenger bumping policies as well as United's relationship with local law enforcement agencies.

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Lesson Learned: United Airlines

- Munoz's reaction glossed over constraints on United employees' ability to manage glitches.
- At the United gate in Chicago, according to Smith, "the airline's staff reached a point, after perhaps offering whatever dollar amounts their procedures called for, where they simply didn't know what to do, and nobody was brave enough, or resourceful enough, to come up with something. Summoning the police simply became the easiest way to pass the buck."
- That's typical of the culture of big airlines, Smith adds. "Everything is scripted and rote and procedural. Workers are deterred from thinking creatively exactly when they need to."
- Solutions to the problem of getting a four-person crew to Louisville short of ejecting paying passengers are obvious:
 - Drive them to their destination, a trip of less than five hours;
 - Charter a plane for them; or
 - Offer more than \$800 to find passengers willing to give up their seats.
- Any of these options would require empowering the employees on the ground, and creating incentives for employees to think creatively and take action without fear of retaliation.

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Lessons Learned: More from our Monitoring Case Files

- Professional Services
 - If we don't get a win, lay off 400 people.
 - They got a big win...Procurement Integrity Act violation.
 - Perpetrator not motivated by self interest.
 - Wrong thing, right reason.
 - Suspension from govt work.
- Oil Services Company
 - Bonus based on getting inspections done.
 - End of life oil platforms.
 - Increase inspections by doing helicopter fly-overs, falsifying certifications.
 - Indicted by two US Attorney's Offices.

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Case Studies: Corporate Monitoring

- International Construction
 - Culture of full empowerment to office heads
 - Single performance metric: financial performance
 - Absence of controls and oversight
 - DPA for FCPA violations
- Government Security Contractor
 - Contract structured for payment when background checks submitted.
 - Quality Assurance process for clearances required.
 - Private equity pressure for EBITDA permeated entire organization.
 - Cases dumped without QA to meet quarterly earnings and EBITDA projections.
 - Suspension/ultimate contract termination.

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Case Studies: Corporate Monitoring cont'd

- Private Prisons Co.
 - Each facility: Mini P&L/Warden is the CEO
 - Bonus: Financial performance/profitability at prison level
 - Revenue: controlled by contract/# of prisoners
 - Expenses: Labor (Security), food, and health
 - What could possibly go wrong?

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What the DOJ Might Ask

- DoJ Fraud Section Issued Guidance on Evaluation of Corporate Compliance Programs:
 - What role has compliance played in the company's strategic and operational decisions?
 - How has the company incentivized compliance and ethical behavior?
 - Has the company considered the potential negative compliance implications of its incentives and rewards?
 - Have there been specific examples of actions taken (e.g., promotions or awards denied) as a result of compliance and ethics considerations?
- Some other questions:
 - In sum, are compensation plans aligned with ethics, integrity, and compliance objectives via a thoroughly articulated review plan?
 - How can we balance commercial objectives and incentives with compliance, and manage tensions, when they arise, as to mitigate behavioral, operational, and financial risk?

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Seven Ways to Avoid Incentivizing Bad Behavior

1. Design incentives to drive both individual and organizational success.
2. Focus on both short- and long-term incentives.
3. Provide a variety of incentives for all key behaviors.
4. Provide structured incentives rather than discretionary ones.
5. Make it transparent.
6. "Wargame" how things could go wrong.
7. Ensure that the incentive program reflects the organization's values.

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Best Practice: Include the Compliance Officer

- The SCCE April 2017 Survey
 - CCOs that review incentive plans to identify and mitigate risk prior to roll-out
 - Management Incentive Plans:
 - 23% of CCO's review management incentive plans
 - 52% don't review at all
 - Employee Incentive Plans:
 - 25% of CCO's review rank & file incentive plans roll-out.
 - 46% don't review at all

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Three Things the Compliance Officer Can Do

1. Check your company's incentive plans for:
 - Percent of total compensation at-risk
 - Metrics driving rewards (individual vs. group)
 - Team-based rewards can help incentive plan leverage, especially at threshold
 - Beware of cliffs (all-or-nothing rewards)
2. Don't settle for "what everyone else is doing"
 - Everyone else is also at risk.
3. Add Value through:
 - Awareness
 - Boundaries (controls)
 - Ethical messages
 - Collaboration

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Conclusions/Lessons Learned

- Perverse incentives are named that for a reason; they are destructive.
- There are creative ways to use positive incentives in your organization.
- There are fairly simple ways to better align your ethics, compliance, and integrity objectives with performance management systems.
- There is a business response to preventing, detecting, and eliminating perverse incentives that involves Ethics and Compliance.

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Questions?

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