

CONFIDENTIAL



SCCE Regional Compliance and Ethics Conference 2020: Behavioral Ethics and Compliance

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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

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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.

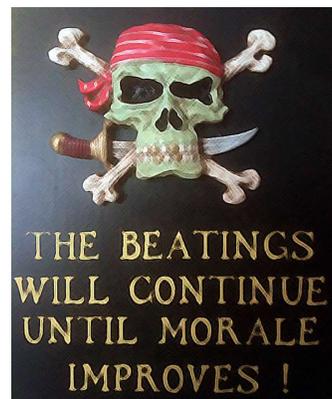
(Emphasis added.)

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)

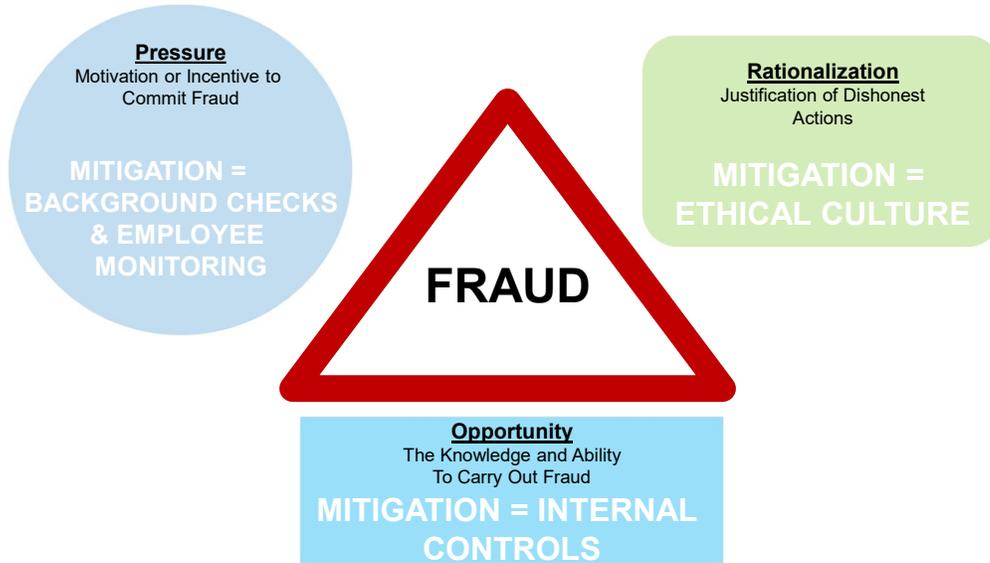
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- “Corporate Culture” is just another way of saying “**Social Norms** in the Workplace”
 - » People are more inclined to do what they believe that others are doing
 - The actions they witness in their peers
 - The messages they receive from authority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



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The Fraud Triangle



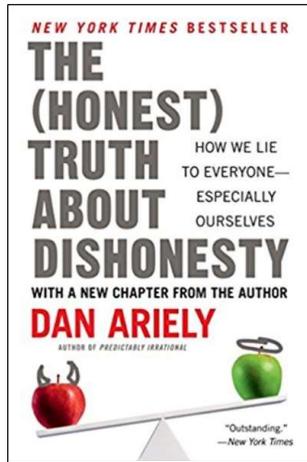
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Origins of Behavioral Ethics and Behavioral Economics

- “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 predictable
 - 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



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- 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



■ 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 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

- 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

- 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



- **Examples of Biases and Circumstances that Impact Ethical Awareness**
 - » Objectivity bias (believing one is more objective than s/he 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

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- **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



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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 proscriptive 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

- 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

- 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** 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.”



- **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** 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



- **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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