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## Ethics or Bust

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# Ethics or Bust: Beyond Compliance and Good Marketing

**Winner ex-aequo of the Robin Cosgrove Prize**

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La plupart d'entre nous savent ce qu'est l'éthique et croient en l'importance d'une conduite éthique dans le fonctionnement coopératif de la société.

*The views and opinions expressed in this paper are those of the author and do not necessarily represent the views of, and should not be attributed to, Macquarie Bank.*

Australia's national dictionary defines ethics as 'a system of moral principles, by which human actions and proposals may be judged good or bad, or right or wrong'. Other definitions include concepts such as values relating to human conduct, principles of right conduct, rules or standards or a theory of moral values. Popular understandings of ethics are more likely to include such notions as trust, integrity, honesty, social responsibility and doing the right thing.

Whilst most of us have an understanding of what ethics is, and believe in the importance of ethical conduct in the cooperative functioning of society, difficulty is often met when determining agreed standards of ethical behaviour for the various complex situations in which individuals and organisations find themselves. It seems that society's ethical 'goal posts' are constantly shifting and this presents particular challenges to the business world and the finance industry.

Broadly, the finance industry refers to organisations that deal with the management of money. More

specifically, this includes banks, investment banks, insurance companies, credit card companies, stock brokerages, private equity and hedge funds.

## Laying the foundation for ethical work cultures

Measured by earnings, financial services are the largest industry category in the world. The industry represents 26.1% of the market capitalization of the Standard & Poors Global 1200. Worldwide profits in the publicly quoted banking sector were approximately \$100 billion in 2005. Such statistics highlight the significance of the finance industry to the world economy.

By its very nature - involving money - the finance industry and its economic performance is susceptible to quantifiable analysis and measurement. Historically, the success of the finance industry has been judged by profits. Increasingly however, society is seeking to judge the finance industry's performance and role in society according to broader criteria, such as its social and environmental impact and ethical conduct. Herein

Pourtant, on rencontre souvent des difficultés quand il s'agit de déterminer des modèles acceptables de comportements éthiques pour les diverses situations complexes où se trouvent les individus et les organisations.

Ce qui est clair, c'est que le secteur financier ne parvient pas aujourd'hui à satisfaire les attentes du public en matière de conduite éthique. Cela pose problème parce que l'industrie de la finance gère constamment des fonds publics et privés et a besoin de la confiance du public pour le faire efficacement et avec efficience.

lies the challenge for the finance industry. How does a complex and constantly evolving industry that relies on measurable outcomes to judge performance, satisfy society's ethical expectations of it? This is particularly the case when society - itself resistant to cohesive consensus and susceptible to changing social climates - is incapable of articulating what its ethical expectations are.

What is clear is that the finance industry is currently failing to meet the public's expectations of ethical conduct. This matters, because the finance industry constantly deals in public and private funds and needs the trust and confidence of the public to do so effectively and efficiently. As A. Persaud and J. Plender (2007) state: 'If the public is to be persuaded of the legitimacy of wealth creation, trust in business and finance has to be rebuilt and a more robust ethical climate established'.

### Ethical lapses

Whilst society might find it difficult to define exactly what constitutes ethical behaviour, it seems that ethical lapses are easier to identify. There has been a range of examples of ethical lapses as the catalyst for significant corporate collapses in the corporate sector since the new millennium, from Enron (US, 2001) to Adelphia (US, 2001), HIH (Australia, 2001), One.Tel (Australia, 2001) WorldCom (US, 2002), Tyco (US, 2002) and Parmalat (Italy, 2003). Among the ethical lapses experienced by the companies listed above are

excessive compensation, misstatements of revenues and operations, improper identification and management of risks, conflicts of interests and fiduciary failure by Board.

The raft of ethical lapses identified as contributing to these and other collapses has served to put corporate behaviour on the public's radar. However, despite such high profile cases as Enron, ethical failures continue to plague the corporate sphere and the finance industry is no exception.

In 2004 there was a \$360 million foreign currency trading scandal at National Australia Bank, followed by Marsh and McLennan paying \$850 million to settle an investigation into bid-rigging that cheated its policy holders, a \$100 million settlement by Merrill Lynch for tainted investment advice favouring large investment banks and Morgan Stanley was fined \$2.9 million by NASD for Trading Violations in 2006.

### Regulatory response

In response to these ethical lapses we have seen a proliferation of prescriptive legislation, governance codes and compliance measures.

In the United States the Sarbanes-Oxley Act 2002 (SOX) was implemented as well as comprehensive New York Stock Exchange Listing Rules. In the United Kingdom the *Tyson Report on Recruitment and Development of Non-Executive Directors* (2003) was commissioned and a *Combined Code on Corporate Gov-*

En réaction à ces lacunes éthiques, on a assisté à la prolifération de réglementations contraignantes, de codes de gouvernance et de dispositifs de compliance.

Aux Etats-Unis, la loi Sarbanes-Oxley 2002 (SOX) a été mise en œuvre parallèlement à de nombreuses règles de cotation relatives à la bourse de New York.

Beaucoup partagent le point de vue, dans le secteur de la finance, que le SOX est si normatif qu'il entrave et compromet le bon déroulement des affaires.

ernance 2003 established. Australia responded by implementing CLERP 9 Amendments (2004) and various Corporate Governance Codes. Singapore amended its Companies Act (2002) and revised its Corporate Governance Code in 2005.

There is now a commonly held view, within the finance industry, that the SOX is too prescriptive, to the point that it restricts and stifles the way the industry does business. Already organisations are circumventing these legislative restrictions by re-listing and having their equity capital raised in other locations where they can operate under less draconian regulatory regimes. Others believe that the regulatory reaction has actually served to exacerbate the problem by creating a risk management culture rather than an ethics based culture. Rather than view regulatory measures as a minimum baseline for governance, it is evident that compliance with corporate governance guidelines is actually the ultimate ethical goal for many organisations (CREDO, 2005).

Whilst regulation of the finance industry by formal regulatory mechanisms (self and government) is essential, it is not enough. Legislation cannot address every possibility and every eventuality of human behaviour, especially considering the complexity of modern business and finance. One thing is known, where there is opportunity, money will find a way to finance it. Financial products are increasingly difficult to understand, especially in new derivative

markets where financial institutions trade in instruments such as collateralised debt obligations, credit default swaps, exotic payoff functions and hybrid (multi asset class) securities. These new markets thus pose exceptionally difficult challenges for lawmakers, regulators and gatekeepers such as auditors and rating agencies, who find it hard to keep up with rapid financial innovation.

A comprehensive, constantly developing and responsive regulatory system needs to be one part of corporate governance, with the essential component being a strong ethical foundation. An ethical basis to the operation of finance is not a constraint or limitation on financial agents, but rather the condition that the financial system can exist at all.

The finance industry needs to recognise the shortcomings of legislation and regulation, and acknowledge the complex grey areas where individuals, in both their business and personal lives, have to make difficult decisions that have ethical dimensions.

## **Persistence of unethical work cultures**

Despite an increase in regulation, unethical work cultures persist in the finance industry. Whilst there has been an increase in references to ethical behaviour in company mission statements it is less clear that companies are actually weaving ethical considerations into the day-to-day conduct of their businesses.

Une loi ne peut pas prendre en compte chaque possibilité et chaque éventualité du comportement humain, particulièrement quand on considère la complexité des affaires et de la finance modernes. Une chose est sûre : là où il y a une opportunité, il y a de l'argent pour la financer.

L'industrie financière doit reconnaître les défauts de la loi et des règlements et tenir compte de cette zone grise complexe où les individus, dans le monde professionnel comme dans le domaine privé, doivent prendre des décisions difficiles qui ont des dimensions éthiques.

The \$360 million foreign currency trading losses at the National Australia Bank (NAB) provide a clear example of this lack of correlation between published statements and actual practice. John Stewart, NAB's current Managing Director and CEO admits that 'while the National had an agreed set of values, people were not held accountable and values were not reflected in the way people were assessed.

Culture change programs were voluntary and there was a lack of visible and consistent leadership in this area. This led to a focus on achieving short-term profits without regard to the way in which this was done'.

Aligning values and culture statements with actual practice is an ethical challenge facing the finance industry. As Australian philosopher Peter Singer (1979) states 'ethics is not an ideal system which is all very noble but no good in practice. The reverse of this is closer to the truth: an ethical judgment that is no good in practice must suffer from a theoretical defect as well, for the whole point of ethical judgement is to guide practice'.

### Conflicts of interest

Various real and perceived conflicts of interest continue to present a challenge for the finance industry. Managing these conflicts to the satisfaction of all stakeholders - employees, shareholders, regulators, customers and the public - is an ethical issue for the industry.

There are many situations and relationships within the finance industry where conflicts of interest have arisen and continue to arise. These include:

- Independence of non-executive directors (NEDs). NEDs are appointed to protect shareholders where their interests conflict with those of management. However there has been much reporting on the 'clubby' nature of Boards and corporate governance failures despite 'independent' NED positions.

- Shareholders interests versus the interests of clients. A company's obligations to look after their clients' interests can conflict with the short-term interest of shareholders.

- CEO and Board's personal interests versus shareholder interests. Recent proposals for management buyouts have met claims of conflicts of interest.

- Auditors can face conflict of interests through various business relationships, institutional structures and incentives that can be seen to impair their objectivity.

- Analysts face conflicts of interest when balancing financial promotion with their role of providing independent analysis.

- Private equity deals and leveraged buy-outs give rise to conflicts of interest where senior executives typically increase their stake in a company prior to a takeover.

- Many individuals working within the finance industry face personal conflicts of interest on a daily

De nombreux conflits d'intérêts, réels ou imaginaires, représentent toujours un défi pour l'industrie financière. Gérer ces conflits en essayant de satisfaire tous les participants - les employés, les actionnaires, les régulateurs, la clientèle et le public - est un problème éthique pour l'industrie.

Une énorme disparité s'est creusée entre la rémunération des cadres et le salaire des employés. Une étude récente a montré qu'il y a 20 ans, le PDG d'une société cotée en bourse gagnait en moyenne 42 fois plus que la moyenne des travailleurs affectés à la production. La même étude montre qu'en moyenne les PDG d'aujourd'hui gagnent plus de 400 fois plus que la moyenne du revenu des employés.

basis, where they find that their employer and/or the finance industry challenge their personal beliefs or moral values.

### Executive remuneration

The remuneration packages of finance industry executives, particularly Chief Executive Officers (CEO), have received increased criticism by the public. This potentially raises ethical questions and challenges for the finance industry. A huge disparity has developed between boardroom remuneration and employee salaries. A recent study shows that 20 years ago, the average CEO of a publicly traded company made 42 times more than the average production worker. The same study shows the average present day CEO makes over 400 times the average employee's income.

Whilst the statistics alone are alarming, there seems little justification for such remuneration packages when there is no compelling evidence that higher executive pay actually leads to better company performance. A study of 3000 companies found that the firms whose directors were the most well connected, and which paid their CEOs most lavishly in fact underperformed the market (Surowiecki, 2007).

Not only does the finance industry need to determine what is an equitable allocation between shareholders, executive directors and employees, it also needs to consider ethical issues around various incentive structures and the apparent discretion of com-

pensation committees. There is also the issue of whether the pay of individuals and results of privately held companies should be reported. Many hedge fund managers argue that their pay should be kept private. They see coverage as sensationalist voyeurism driven by envy and titillation.

Currently there appears to be little alignment between remuneration packages and the sustainability and ethics of a company's performance.

### Other ethical challenges

Private equity and hedge funds are private pools of largely unregulated capital. They are removed from the controls of investment banks and often operate according to the lower standard regulatory regimes of the Channel Islands, Spain, Bermuda and Austria.

There are now calls for more transparency and particularly calls for disclosure of positions due to concerns about the risks hedge funds pose, annoyance about their actions and political expediency and lack of information about them.

Globalisation poses difficult ethical challenges for the finance industry. Implementing single ethical codes, value statements or compliance systems across the world invariably encounters problems when various laws and cultural differences are taken into account. It raises the question of whether a common set of company values is really possible for corporations that have operations in multiple jurisdictions.

La mise en oeuvre de codes éthiques isolés, de déclarations d'intention ou de systèmes de compliance à travers le monde soulève invariablement des problèmes quand des lois et des cultures différentes sont en cause. Cela pose la question de savoir s'il peut exister un tronc commun de valeurs pour des entreprises qui opèrent sous des juridictions multiples.

Corruption remains an ethical challenge facing the finance industry. It continues to affect both developed and undeveloped economies. A pressing problem is the corruption of regulators in developing countries and the subsequent exploitation of weak legal systems. As anti-corruption rules have strengthened, forms of corruption, in developed economies in particular, are becoming increasingly subtle and sophisticated.

### The media as convenient scapegoat

The extent of the obligation of the finance industry to consider its social responsibilities and contribute to the societies in which they operate and impact is an ethical issue facing the finance industry. The *McKinsey Quarterly* survey of 2006 found that the global business community had embraced the idea that it should play a wider role in society. More than four out of five respondents agreed that generating higher returns for investors should be accompanied by broader contributions to the public good, for example by providing good jobs, making philanthropic donations and going beyond legal requirements to minimise pollution and other negative effects of business.

As the finance industry attempts to gain the confidence and trust of the public, the relationship between the industry and the media will present ethical challenges. With the much-publicised ethical lapses of the last ten years, public scrutiny, par-

ticularly by the media, has increased. Consequently the relationship between the finance industry and the media is now strained. More recently the finance industry has claimed that it is presented in a bad light by the media and suffers from overzealous reporting.

A report conducted by KPMG found that Australian Boards are concerned at their inability to reassure the news media, and through it the public, of their concern to promote and safeguard ethical business standards. The report concludes that the media is a convenient scapegoat, but not necessarily a convincing one.

The finance industry will continue to be affected by the influence of the media and this is only likely to increase with projects such as Wikileaks where an uncensorable Wikipedia is being developed for untraceable mass document leaking and analysis.

The persuasive business case for an increased emphasis on ethical considerations in and by the finance industry should be sufficient: ethical lapses can and often do lead to major profit losses and companies can cease to operate as a result. Damage to reputation and confidence loss is hard to measure and difficult to recover from. Scandals such as that of the National Australia Bank invariably taint the whole industry and the corporate sector. It is therefore in the interest of the whole corporate sector that the ethical issues facing the finance industry are addressed.

Un sondage du *McKinsey Quarterly* en 2006 a mis en évidence le fait que la communauté internationale des affaires a admis l'idée qu'elle devrait jouer un plus grand rôle dans la société. Plus de quatre personnes interrogées sur cinq sont d'accord pour dire qu'une augmentation du rendement pour les investisseurs devrait être accompagnée par une plus grande contribution au bien public, par exemple en créant des places de travail de qualité, en faisant des donations philanthropiques et en allant au-delà des exigences légales pour réduire la pollution et les retombées négatives de l'activité économique.

Whilst ethical codes, value statements, risk management programs and reputation indexes have become more prevalent, the ethical performance of the finance industry is hard to measure and therefore is likely to continue to trouble and struggle to gain traction in an industry that is accustomed to definite and quantitative rather than qualitative outcomes. There are however structural improvements and educational initiatives that the industry can implement in order to bring about real change to the ethical performance and culture of the finance industry.

### **Finance industry: beyond compliance and good marketing**

For ethics to catalyse and enliven the finance industry - essentially, for ethics to become a living concept - the industry must move beyond viewing ethics as a matter for compliance and good marketing. Ethical thinking and an ethical way of life need to be woven into corporate culture and thus the day-to-day business of the finance industry.

All initiatives must be endorsed by senior management, including the Board and the CEO, and attendance ought to be compulsory. Responsibility, ownership and communication of any initiatives should reside with Senior Management rather than Human Resources or Compliance.

The finance industry should further consider funding the establishment of an independent Ethics

Body to initially have the following responsibilities:

- provide ethics specialists to sit on and advise Boards;
- conduct situational and annual reviews of organisations ethical conduct and make recommendations;
- work with regulators to keep up with developments in the industry;
- facilitate focus groups and evaluation of the way financial institutions do business in new and developing markets; and
- facilitate the sharing of information and experiences between organisations so that organisations can learn from each other rather than managing issues away through clever public relations and payouts.

Ethical conduct should be a key performance indicator along with other standard indicators such as profit generation and business development. It must apply to Board members, CEOs, Senior Management and all staff. Ethical performance should then be linked to salary determination, bonus allocations and other performance incentives that are common to the finance industry.

This proposal will require a complete reorganisation of current incentive structures such as deferred compensation. If unethical behaviour is detected after an individual has left an organisation or division, future payments due to them should not be made without consideration of the individual's role in any unethical or fraudulent business that

La cause d'une meilleure prise en compte de considérations éthiques par et dans le secteur financier plaide pour elle-même : les manquements éthiques peuvent, et c'est souvent le cas, mener à des pertes importantes en terme de bénéfices, contraignant une société à cesser ses activités.

Pour que l'éthique puisse susciter et animer la réflexion dans le secteur financier - en particulier pour que l'éthique puisse devenir un concept vivant - elle doit être perçue comme quelque chose de plus qu'un simple problème de compliance et de bon marketing. Une vision et un mode de vie éthiques doivent être insérés dans la culture d'entreprise et faire partie de la gestion quotidienne des affaires.

has been uncovered. Additionally, money already paid to an individual should be retractable following the discovery of unethical or fraudulent business practices. Extending the accountability of executives beyond their narrowly defined term of employment would serve to curb the practice in the finance industry whereby individuals make vast amounts of money, without regard for the way in which such profits are achieved, and then leave an organisation before unethical or fraudulent practices are discovered or regulatory action is taken.

### **Rewarding good ethical behaviour**

Whilst this proposal will require much legal re-drafting, possible legislative changes to employment laws and financial analysis, it would undoubtedly serve to increase executive's ethical accountability and thus the ethical conduct of the finance industry.

Society is comfortable with imposing financial sanctions, such as fines and operating restrictions upon organisations and individuals for unethical and fraudulent behaviour. Whilst financial punishments for unethical behaviour should be maintained, this system needs to be complemented by a system of rewards. As well as punishing people for poor ethical performance by withholding bonuses or performance pay, organisations should move to a system of financially rewarding good ethical behaviour.

Of course, some will debate the ethics of providing financial incentives for people to behave ethically. Others will consider the difficulty in actually determining and quantifying ethical behaviour as insurmountable.

Ideally, acceptable ethical behaviour would be a natural part of business life and society would not require either a punishment or a reward system. However, the reality is that unethical behaviour has plagued and continues to plague the finance industry, thus proving that relying on the goodwill of individuals alone to recognise and promote 'right conduct' or a system of punishment is not enough. What should drive development in this area is the likely eventuality of increased ethical consideration in business as the finance industry and its participants are unarguably motivated by financial incentives.

### **Appointment of ethics role models**

Organisations should identify and appoint staff to hold the position of Ethics Role Model in addition to their existing business function. Ethics role models should come from all areas of an organisation, particularly profit centres, as well as support areas.

Criteria for selecting ethics role models should be based on their reputation for sound ethical judgement, integrity and trust. These individuals should be encouraged and rewarded by senior management and empow-

Si un comportement contraire à l'éthique est détecté après qu'un individu ait quitté une organisation ou un secteur, les paiements ultérieurs qui lui sont dus ne devraient pas être effectués sans prendre en considération un éventuel rôle joué dans une affaire découverte par la suite.

Les entreprises devraient désigner et nommer certains membres du personnel pour tenir le rôle de modèles éthiques, en plus de la fonction qu'ils occupent déjà. Les modèles éthiques devraient venir de tous les secteurs, particulièrement des centres de profit et de la logistique.

ered to play a more active role in the development of an ethical work culture within the organisation.

Ethics role models should be promoted as champions of ethics in the organisation and be available to staff as a point of contact to discuss the ethical dimension of business life. They should also be encouraged to take a proactive, educative role and encourage ethical networks within and outside an organisation. These positions should be considered prestigious and this will only come from Senior Management endorsement and encouragement.

### **Accountability at the point of innovation and deal making**

The finance industry is complex to the point that regulators, compliance and lawyers do not necessarily understand all, or many, aspects of the transactions and deals that they are subsequently required to sign-off, monitor and regulate.

In order to address this issue the finance industry needs to rethink the structure and responsibilities of their business, compliance and legal teams. Responsibility for the ethical aspect of a deal or innovation must be left to the individuals who understand the deal or innovation.

Rather than, or at least in addition to, deal-makers and innovators seeking 'sign-off' from legal or compliance, legal and compliance teams should require acknowledgement from the innovators and deal-makers

that they have considered the ethical dimension of the way they are doing business, including the current impact and the future impact of a deal or product. Additionally, board papers should include a section on ethical implications as well as financial and risk analysis.

The best time for organisations to first impress upon staff that the ethical aspect of business is important to them is at the point of induction.

CEOs and senior management should play an active role in induction programs by personally attending and detailing how they expect staff to do business, as well as providing examples of what can and has happened when people have behaved inappropriately. It should be clear to inductees what is expected of them and what is acceptable business practice. The induction process is of particular importance in developing countries and markets.

### **Tool for engagement and collection**

For an organisation to make positive progress in the area of ethics, it must understand its current ethical climate and culture. It is imperative for an organisation to know what its staff thinks about ethics, how they define it and what they perceive as the ethical challenges facing them and the organisation. Collecting such information and analysing the responses will assist an organisation in designing and implementing effective programs and strategies.

Factors that individual organisations will need to consider when developing an engagement and collection tool are:

- **Time:** Executives have many competing interests with their main focus being their business role. Training is often viewed as taking them away from their real work. Considering this mindset any collection tool should be designed to be completed in 1 hour or less and executives given a realistic, yet tight, timeframe for completion.

- **Delivery:** Organisations should determine what delivery method best suits them. For a large global organisation an electronic collection tool may be the most effective. Other organisations could consider using simple hardcopy surveys, conducting focus groups or phone surveys. Factors such as organisation size, location and budget will affect the choices in this area.

- **Culture:** any material will need to take into account cultural factors such as language, office location and religious beliefs. The more tailored the program is, the more engaged the participants will be.

- **Communication:** Ideally a collection and engagement tool would use a variety of mediums including film, voice-overs, text and animation. Most organisations now have staff from at least three generations, all of whom have different methods of processing information. By using a variety of media an organisation has a better chance of reaching more staff.

- **Compulsory:** Completion of the engagement and collection tool should be compulsory for all staff, including senior management, with failure to participate attracting financial consequences.

After an organisation has determined its ethical starting position, the next step is to conduct meaningful workshops based on the content collected from the engagement and collection tool.

### A forum to discuss ethical dilemmas

Workshops should provide a forum to discuss real ethical dilemmas. Attendees should be given the opportunity to anonymously submit topics or issues for discussion prior to attending. This gives individuals another avenue for raising issues that may be of concern to them and removes the pressure and hesitation of raising such issues in front of peers or superiors. The process of engagement and collection followed by workshops can be repeated constantly in order to monitor progress and developments and to reach staff throughout their careers and time with an organisation.

As for the CEO and representatives of Senior Management, they should host ethical discussion lunches. Eight to twelve employees should be chosen randomly from across the organisation and invited to attend. This is an opportunity for Senior Management to open themselves to honest discussion and questions on

Pour qu'une institution puisse faire des progrès substantiels dans le domaine de l'éthique, elle doit pouvoir se baser sur l'éthique et la culture d'entreprise existantes. Il est impératif pour la direction de savoir ce que pense son personnel à propos de l'éthique, la manière dont il la définit et ce que sont pour lui les défis éthiques auxquels l'entreprise doit faire face.

De nombreux manquements éthiques et situations de conflit commencent par une simple erreur. Au lieu de reconnaître et d'affronter l'erreur, celle-ci est cachée, et la situation débouche en conséquence sur d'autres mensonges et manœuvres de dissimulation, pour aboutir finalement à une situation complexe qui aurait pu être évitée.

ethical issues. On a broader level, organisations should seek and internally publish feedback on their business performance including ethical and social performance from clients and industry peers.

### Acknowledging and addressing mistakes

While the ideas and strategies already covered are tailored specifically to the finance industry taking into account the nature of the industry and its participants, asking people to focus on their biggest mistake may create discussion among much

wider group. Many ethical lapses and litigious situations started with a simple mistake. Instead of acknowledging and addressing the mistake it was concealed leading to further lies and cover-ups, and ultimately to a complex but avoidable situation.

Hence, the necessity to re-train people to feel comfortable in admitting a mistake rather than attempting to conceal it. By looking at examples of mistakes people have made, we can start the cathartic process of acknowledging that as humans we make mistakes and use the information collected as an educative tool. •

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