Globethics Repository

Lab Dispatches [vol. 2]

This page was generated automatically upon download from the Globethics Repository. More information on Globethics see https://www.globethics.net. Data and content policy of Globethics Repository see https://repository.globethics.net/pages/policy.

Item Type	Book
Publisher	Edmond J. Safra Center for Ethics
Rights	Creative Commons Copyright (CC 2.5)
Download date	2026-10-28 18:17:21
Link to Item	http://hdl.handle.net/20.500.12424/194856

Lab Dispatches
Vol. 2

Spring 2013 Blog Posts
by the
Edmond J. Safra Research Lab for Ethics

www.ethics.harvard.edu/lab/blog

CC BY NC

HARVARD UNIVERSITY
Edmond J. Safra Foundation Center for Ethics

Table of Contents

Feb 11, 2013, Gregg Fields. Burning Down the House: Dependency Corruption Issues in Credit Rating Practices 4

Feb 18, 2013, Ted Gup. The Power of Disclosure: (What Power?) 8

Feb 20, 2013, Paul Thacker. The Slow Pace of Success in a "Do Something Congress" 11

Feb 21, 2013, Ken Silverstein and Brooke Williams. Membership Has Its Privileges: Donor Perks and the Atlantic Council 15

Feb 22, 2013, Donald W. Light. Synergies Between Moral Philosophy and Institutional Corruption 18

Mar 07, 2013, Kirsten Austad and Aaron Kesselheim. Physicians and the Pharmaceutical Industry: Where does this Story Begin? 20

Mar 8, 2013, Donald W. Light. Institutional Corruption and Countervailing Powers 24

Mar 09, 2013, Gregg Fields. John Reed: On the Value of Values 27

Mar 26, 2013, Sheila Kaplan. Lobbyist's Progress: An Interview With Jeff Connaughton 30

Mar 27, 2013, Daniel Weeks. The Fiscal Fallout: A View From Below 34

Mar 29, 2013, Gregg Fields. Whale-Sized Institutional Corruption: Regulatory Capture and the JP Morgan Derivatives Scandal 37

Apr 03, 2013, Sebastían Pérez Saaibi and Juan Pablo Marín Díaz. Understanding Conflict of Interest Networks 40

Apr 05, 2013, Gregg Fields. How the Fed Came to See the Light: The Growing Role of Transparency in Monetary Policy 45

Apr 12, 2013, Gregg Fields. Wheel of Fortune: As Regulators Spin Off Duties, Ex-Regulators Cash in as Consultants 48

Apr 20, 2013, Gregg Fields. Capital Opportunities: A Watchdog Journalist's Take on Washington's Legalized Corruption 52

Apr 22, 2013, Brooke Williams. Just Asking: An Appeal for Voluntary Disclosure 55

Apr 22, 2013, Sheila Kaplan. Exploding Influence: How Lax Oversight Won by Industry Lobbyists Lessens Safety 57

Apr 25, 2013, Garry C. Gray. Insider Accounts of Institutional Corruption 60

Apr 25, 2013, Gregg Fields. Institutional Corruption and the Big Bang Theory 62

Apr 29, 2013, Susann Fiedler. Bad Apples and Dirty Barrels: Outliers and Systematic Institutional Failures 65

May 2, 2013, Paul D. Thacker. Performing the Job of a Congressional Staffer: Informing the Public Without Endangering Your Boss 67

May 10, 2013, Gregg Fields. Banking on Tomorrow: Why Today is Never Good for Financial Reform 70

May 10, 2013, Gregg Fields. The Shadow Knows: Ben Bernanke Battles Non-Bank Banks 73

May 13, 2013, D. James Greiner. Diagnosing Institutional Corruption 76

May 14, 2013, Brooke Williams. Good, Clean Data 80

May 15, 2013, Donald W. Light. Institutional Corruption: Linking and Learning from Regulatory Capture 82

May 16, 2013, Heather White. Bangladesh - Savar Solutions and Fast Fashion may not be Compatible 85

May 23, 2013, Jonathan H. Marks. The Perils of Public-Private Partnerships 88

Jun 05, 2013, Brooke Williams. Further Disclosure 92

Jun 12, 2013, Adriane Gelpi. Dispatch from Chile: The Ethics of Health Priority Setting, or Searching for True North Without a Compass.....98

Jun 13, 2013, Justin O'Brien. Tackling Institutional Corruption in Financial Markets.....101

Jun 18, 2013, Carla Miller. The Emperor's New Clothes: A View into the Current State of Municipal Ethics 107

Jul 2, 2013, Gregg Fields. The Tower of Institutional Corruption: The Bank for International Settlements In The Nightmare Years 105

Jul 9, 2013, Ken Silverstein. The Bipartisan Lobbying Center: How a Washington Think Tank Advocates for Political Unity - and its Top Donors.....108

Jul 16, 2013, Donald W. Light. Corrupting Practices Harm Patients 111

Jul 17, 2013, Donald W. Light. Risky Drugs: Why The FDA Cannot Be Trusted.....112

Jul 24, 2013, Genevieve Pham-Kanter. A Few Predictions on the Sunshine Act.....115

Jul 26, 2013, Gregg Fields. Simply Fab: Institutional Corruption and the Trial of Fabrice Tourre 118

Jul 31, 2013, Donald W. Light. Systematic Evidence of Less-Than-Truthful Commercial Free Speech That Harms Citizens 121

Aug 1, 2013, Gregg Fields. On The Edge: The SAC Capital Indictment Draws a New Line on Institutional Corruption 123

Aug 7, 2013, Dieter Zinnbauer. If You Could Ask 100,000 People Around the World One Thing to Better Understand or Tackle Institutional Corruption, What Would it Be? 127

Aug 14, 2013. Malcolm S. Salter. The AIG Bailout Revisited: Calculated Corruption or Miscalculated Risk Management?.....132

Aug 20, 2013, Carla Miller. The Tail Wagging the Dog: Institutional Corruption and the Federal Sentencing Guidelines for Organizations (FSGO).....137

Aug 22, 2013, Malcolm S. Salter. Is Financial Reform Being Gamed? What Implementation of the Volcker Rule will Reveal about the Gaming of Financial Reform.....142

Aug 22, 2013, Gregg Fields. One Holy Mess: Pope Francis Fights Institutional Corruption at the Vatican Bank.....151

Burning Down the House: Dependency Corruption Issues in Credit Rating Practices

Gregg Fields

A new federal lawsuit against Standard & Poor's raises a vexing question: Where is the line between an opinion that is paid for, and one that is bought?

Who knew that tweaking the lyrics to a Talking Heads song could so accurately reflect what happened during the mortgage meltdown?

In March 2007, an analyst at Standard & Poor's noticed something about the subprime mortgage-backed securities that had received relentlessly rosy ratings from S&P: They were crashing.

So the analyst sent an email to his colleagues, providing his own version of the Talking Heads' classic "Burning Down The House."

"Subprime is boiling over/ Bringing down the house," one of his three stanzas read in part. It was a fitting tribute to a band also known for their concert movie, "Stop Making Sense." The analyst even videotaped himself singing his ditty, while his S&P coworkers laughed.

Heart of the matter

That picture—of S&P fiddling while its customers got burned—is one of several disturbing take-aways from a civil lawsuit filed last week against S&P and its corporate parent, McGraw-Hill Cos. The case was filed in U.S. District Court for the Central District in California by the Department of Justice.

The DOJ claimed S&P's actions on how it rated mortgage-backed securities—and a related type of investment known as collateralized debt obligations—cost federally insured financial institutions more than $5 billion. And it didn't have to happen, U.S. Attorney General Eric Holder said at a press conference.

"Put simply, this alleged conduct is egregious—and it goes to the very heart of the recent financial crisis," Holder said.

In examining the voluminous case—it runs 119 pages long—a picture emerges of a system that appears to be built on a foundation of a perfectly legal form of dependency corruption. (This isn't a criminal case—the lawsuit is seeking damages suffered by federally insured financial institutions.) More broadly, considering how the mortgage meltdown shook the world, the case is a prime example of why institutional corruption issues should be a public policy priority.

First, it's helpful to define some terms. Dependency corruption is a system where institutions responsible for serving the public become dependent—typically, financially—on relationships that skew their ability to perform their duties.

The example most often used is the relationship between Congress and large campaign contributors. Congress is dependent on large contributors to finance the massive cost of campaigns. This dependency—in the 2012 cycle, the financial industries were the most generous donors—can skew the incentive Congress has to put the public first.

How it rates

At first blush, the S&P case might not seem to fit this model. Most notably, it isn't a government entity; it's part of a corporation that properly seeks to earn profits. And it doesn't take campaign contributions.

But S&P plays a quasi-regulatory, and vital, role in the financial markets. It is, in fact, designated a nationally recognized statistical rating organization, or NRSRO, by the Securities and Exchange Commission. There are only ten.

S&P rates creditworthiness. And the case filed last week concerns its involvement in assigning ratings to residential mortgage-backed securities, or RMBS, from 2004-07.

It was a heady time, with the housing market booming and investment houses buying up massive pools of home loans that became the collateral for securities then sold to investors.

That would all be fine, except for a couple of issues. One, many of the home loans were "subprime," or those made to impaired borrowers. As we now know, they were ticking time bombs that, when they exploded, produced collateral damage throughout the economy.

Two, and a more significant problem, according to the lawsuit: Investors bought the securities based on the presumably objective—and laudatory—ratings issued by S&P.

Co-dependent

And that's the difficulty, said Holder. S&P wasn't impartial. And in fact, the lawsuit contends that, in its efforts to protect profits, S&P kept high ratings on questionable securities long after even its own employees were feeling queasy over soaring default rates. (At one point, some executives looked at the high defaults and thought they were typos.)

S&P "falsely claimed that its ratings were independent, objective and not influenced by the company's relationship with the issuers who hired S&P to rate the securities in question," Holder said, adding that "in reality, the ratings were affected by significant conflicts of interest, and S&P was driven by its desire to increase its profits and market share to favor the interests of issuers over investors."

The issue is one of dependency. S&P was paid by the people who created and marketed the securities being graded. Give them a low rating, and there's always a chance they'll go elsewhere. Cut an existing rating, and you risk losing a lucrative business relationship.

As even one unnamed S&P client told an analyst at the company: "I mean, come on, we pay you to rate our deals, and the better the rating the more money we make?" the client wrote in an email reprinted in the complaint.

"How are you possibly supposed to be impartial?"

The lawsuit details how S&P—one of the more venerable names in American finance—internally developed stricter analytical standards as the problems became clear. But they weren't implemented, in part because the company believed it could send clients to its rival, Moody's.

Furthermore, if S&P produced a rating the issuers deemed too negative, the client could reject the analysis—greatly reducing the fee S&P would collect.

20/20 Hindsight

Nothing has yet been proven in court, so it's important to characterize the government's accusations as "alleged." And it's worth noting that S&P's alleged victims include titans like Citibank and Bank of America, institutions not often described as naive.

For its part, S&P responded that it did nothing wrong, saying "20/20 hindsight is no basis to take legal action against the good-faith opinions of professionals."

The company added: "Claims that we deliberately kept ratings high when we knew they should be lower are simply not true." The company said that, in the past five years, it has spent roughly $400 million "to reinforce the integrity, independence and performance of our ratings" and "introduced more stringent criteria" to obtain the coveted AAA rating.

But the reality is that reforms of credit rating practices have a sketchy record of success. In fact, many of the episodes detailed in the lawsuit occurred in 2007. That would be the year after the Credit Rating Agency Reform Act of 2006 was passed.

That law, critics say, had a fatal flaw. It required the SEC to oversee credit rating agencies, but it specifically precluded the agency from regulating the "procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings."

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act mandated that the SEC form an Office of Credit Ratings. It's still a bit early to see how effective it will be, although it did send a report to Congress late last year discussing, in general terms, ways to strengthen the ratings system.

The road ahead

By the summer of 2007—several months after the unnamed analyst did his David Byrne imitation—S&P (as well as other credit rating agencies) could no longer deny the obvious. Hundreds of securities got sweeping downgrades. Financial institutions had to record massive losses. The economy began to take on water.

In 2011, the permanent subcommittee on investigations of the U.S. Senate issued a massive report, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," that castigated the way ratings on mortgage-backed securities were propped up until it was too late.

"The most immediate cause of the financial crisis was the July 2007 mass ratings downgrades by Moody's and Standard & Poor's that exposed the risky nature of mortgage-related investments that, just months before, the same firms had deemed to be as safe as Treasury bills," reads the 639-page report.

The report added: "In the end, over 90 percent of the AAA ratings given to mortgage-backed securities in 2006 and 2007 were downgraded to junk status. When sound credit ratings conflicted with collecting profitable fees, credit rating agencies chose the fees."

It was a system that, according to the lawsuit, prolonged S&P's ride in the mortgage-backed market. But to use the title of another Talking Heads song, it also ultimately proved to be a road to nowhere.

http://www.ethics.harvard.edu/lab/blog/279-burning-down-the-house

The Power of Disclosure: (What Power?)

Ted Gup

As one who entered the ranks of investigative reporting in the immediate aftermath of Watergate, I took it as an article of faith that disclosure possessed a remarkable curative power. "Sunlight," as Louis Brandeis said, "is the best disinfectant."

Little more was needed to keep the ship of state - and those aboard it - – headed in the right direction. But now I am not so sure. I now have to make a distinction between "the ship of state" and the crew that mans it. In the first instant we are speaking of the institution of government; in the second the individuals upon whom it depends.

At the Edmond J. Safra Research Lab, I am just beginning to see the difference between institutional corruption (the ship of state) and individual corruption (the crew)—though I confess, I am still not a total convert to the Lessig-Thompson vision. But it is a helpful distinction and one which has changed my way of thinking about the potency of disclosure. Let me explain.

I am now of the belief that disclosure is not the panacea I once thought it was. Like certain antibiotics, it is good for some infections, not all. Disclosure is best suited when applied to instances of individual corruption, less suited for those of institutional corruption. Why? Because in most instances, what we define as individual corruption, outs an agent who, in pursuit of personal gain has gone beyond both the accepted bounds of his peers and public levels of tolerance.

Making the miscreant's actions public exposes him/her to public shaming and the condemnation of peers. The person is effectively shunned and stripped of his/her effectiveness for having betrayed the public trust. Such actions are almost invariably undertaken *clandestinely*, because the nature of the actions would not withstand public or peer scrutiny.

But institutional corruption is of a different character. The actions of an institution that has been corrupted need not—and indeed seldom are—undertaken in secret. Select actions may occur behind a veil, but there is no secret that in the aggregate such actions are taken. They have been routinized and have, in essence, become so systemized as to become the norm. And therein lies the weakness of disclosure. It only really works when it exposes that which is at variance with the norm.

Individual corruption renders an individual answerable for his or her actions. Institutional corruption is not about the identity or actions of individuals but about their actions in concert with one another. Individual corruption is often about particular actions taken outside the accepted realm. Disclosure often ferrets out the actions of a rogue player. It may or may not constitute a pattern of conduct. There is a "gotch ya" element to it.

Institutional corruption, by definition, is expressive of a pattern. And if we accept Professor Larry Lessig's definition of institutional corruption—that one of its hallmarks is a loss of

public faith in the institution—then it implicitly suggests that the offending behavior is already known to the public. (A loss of faith is predicated upon the idea that there is some requisite knowledge of institutional behavior that has undermined that faith.)

For all these reasons, the power of disclosure is, to a significant degree, diluted or negated in the context of institutional corruption. The offending behavior is already known (or at least presumed in some inchoate form), it is reflected in the broader conduct of one's peers, and it is within the bounds of what has become systematized. In short, the mechanisms of shunning and shame have been disabled.

It might be interesting to think of the power of disclosure in the context of the Watergate scandal, arguably the most celebrated and demonstrative example of the power of disclosure, having brought down a president and ushered in a decade of sweeping political reforms. Is Watergate to be seen as an instance of individual corruption, or an example of institutional corruption? One might argue either way. On the one hand, it was an instant of individual corruption, peopled by a cast of characters who rather than reflecting the system, sought to subvert it. They were rogue players acting literally under cover of darkness, and their actions were not of such an embedded nature that either the preceding administration, nor its successor, conducted itself in that way. It was sui generis.

On the other hand, the gains to be gotten were less of a personal nature, than a political nature—discrediting the opposition and thereby enhancing one's own chances for electoral victory. Curiously, one might even suggest that a test for whether it is individual or institutional corruption that we are looking at, is "*what would be the effect of disclosure*?" If the response to disclosure is moral outrage, public condemnation and ostracism by one's peers, then it's a good bet we're looking at individual corruption. If the response is a collective sigh of disgust, a rolling of the eyes by one's peers, and a shrug of the public's shoulder, well, it's probably institutional corruption.

Another interesting question is "*what would have happened had there been no Watergate story*?" Might the individual corruption have then become so rooted as to morph into institutional corruption? And isn't that precisely why the Watergate story stands apart from so many other scandals—that absent disclosure, it might well have metastasized into institutional corruption? That is why the stakes were so high and why its historical preeminence is assured.

None of this is to suggest that disclosure is without value in the context of institutional corruption. Far from it. Though it may not expose individuals to public and peer criticism, it does call attention to the problem (and remind the public that it is a *problem*) and it does illuminate institutional conditions (as opposed to mere individual conduct). And it is the conditions of government and the democratic process that require attention. In the case of individual corruption, a single expose is often enough to hold that person to account. With regard to institutional corruption, a single act of outing is seldom, if ever, sufficient to bring about change. And that too distinguishes individual corruption form institutional corruption. In the former, disclosure seeks to bring about censure and accountability. In the latter, the object is reform. Disclosure, dogged and persistent, remains a viable and essential instrument in the quest for better government.

Still, there is a risk that disclosure of institutional corruption will further alienate the public from government and civic responsibility, that it will fuel the sense of resignation. Because the focus is not on individuals but systems, it may engender a sense of despair that nothing can be done. Already the public suffers from moral fatigue. The bar on what triggers public

outrage has been continually raised to keep pace with the ever-expanding and insidious nature of money and politics, to the point where citizens are inured to virtually every disclosure.

Part of the challenge facing those who still believe that disclosure has a primary role to play —and I am one of these—is how to sensitize a public weary of such disclosures and not merely to add to the moral callouses that have formed in recent decades. In this context, I would argue that too much of disclosure is predicated upon the "what" and not enough upon the "why" and "to what effect." By that I mean that we must find fresh and creative ways to document the subversion of the deliberative process and to show its impact on the lives of ordinary citizens. Narrowly defined, disclosures which go no further than documenting system disintegration and the infusion of dollars have failed to move the public and, I suspect, are not likely to do so.

For institutional corruption, disclosure alone may be insufficient. It is unlikely, in my view, that government is capable of reforming itself or freeing itself from its addiction to campaign funding. If reform is to come, it will come from without, not from within—from the public, and that will require more than tables and spread sheets recording the demise of representative government. It's not as if the public is unaware that their government has been diverted, if not outright hijacked, by campaign dollars. Public disdain for Congress could hardly be higher, but disdain has yet to produce reform.

In other words, I am not convinced that institutional corruption can only exist so long as there is an information failure, or conversely, that information is the antidote to institutional corruption. Would that it were so easy. I do not pretend to know what it will take to turn things around. I suspect there will be a role to play for political scientists, journalists, activists, artists, teachers, parents—the list is as expansive as citizenship itself. Institutions can rid themselves of individual corruption, but institutional corruption can only be dealt with by individuals acting collectively. (Almost by definition, one cannot expect an institution that has been corrupted to clean up its own act.) Disclosure is one tool among many to help mobilize citizens, but facts alone will not penetrate complacency or resignation. Disclosure writ broadly, one that identifies patterns, fleshes out the deliberative process, and links those to narratives that demonstrate public injury in the context of story (putting a face on facts), I believe, remains a formidable tool.

http://www.ethics.harvard.edu/lab/blog/280-the-power-of-disclosure-what-power

The Slow Pace of Success in a "Do Something Congress"

Paul D. Thacker

Perhaps no American institution is more important yet more hated than Congress. A recent poll found that Congress has a 9% favorability rating, placing it lower than cockroaches, traffic jams, and the widely loathed Canadian rock band Nickelback.

In pointing this out to the congressional staffers I'm interviewing for my project at the Edmond J. Safra Research Lab, I always ask, "Is it fair that people hate Congress?" One staffer quipped in response, "If we polled the American public, even Hitler could get three percent."

This antipathy is based on the perception that Congress doesn't do anything. This message gets hammered home in the media with the "Do Nothing Congress" tagline and endless stories—some true, some not—about "bickering" and "failure to come together."

Staffers feel the same way as the public, and they're incredibly frustrated with the impossibility of getting anything done. The slow pace of the Hill was made perfectly clear to me a few Fridays back when I got an email from a reporter telling me that the government had published the final rule on the *Physician Payment Sunshine Act*. While working on the Senate Finance Committee for Sen. Chuck Grassley (R-Iowa), I worked with Senate lawyers to write the first draft of the bill, and then led the investigations of corruption in the medical industry that demonstrated the need to get the bill passed.

As I was reading that email, I wondered when we had really started working on the project. I couldn't remember. I Googled the bill, then called a reporter.

"I can't believe it," I said. "It was more than five years ago that I went to the Senate Legislative Counsel and sat down with them to draft the bill."

More than five years from Senate staffers having a productive idea to the time it started to affect policy. It was an incredible amount of work.

The beginning of a five-year odyssey

The *Physician Payment Sunshine Act* requires companies to report to the federal government any gifts or payments worth $10 or more that they provide to physicians. This information will be available on a public website so everyone can see if a particular doctor is getting goodies from drug companies. Instead of passing as a stand alone bill, it was incorporated into the *Affordable Care Act* (Obamacare) to rein in the rampant corruption in the drug industry, where scandal after scandal has exposed doctors with financial conflicts of interest.

It all began back in 2007, when *The New York Times* reported on Anya Bailey, a teenager who was suffering horrific side effects from the drugs she was prescribed to treat her bipolar disorder. As the *Times* reported, the only evidence that the drug Seroquel that Anya was taking actually worked came from a flimsy study sponsored by AstraZeneca. The lead author was an academic physician—Dr. Melissa DelBello.

A few sentences in the story caught my eye and got the ball rolling. I still remember walking into the office of the committee's Chief of Investigations and reading her this passage:

> Dr. DelBello, who earns $183,500 annually from the University of Cincinnati, would not discuss how much she is paid by AstraZeneca.
> "Trust me, I don't make much," she said.

It seemed clear to us both that Dr. DelBello was being less than honest. To figure out how right or wrong we were, we called the chairman of her department to demand the conflict of interest forms she had filed with the university. We could hear the panic in his voice when he came to the phone. Since the story had come out he had already taken multiple calls on this, he told us.

Why, he wanted to know, did we want this information on a professor in his department? "You realize that if this type of information, if it becomes public, can destroy a person's career," he said. He added that it might cause a "misunderstanding" and that people might think that a doctor is corrupt if they are taking money from a drug company.

"We're worried about the same thing," I said. "People read this and get misled by reporters and sensational journalism. That's why we're calling you—to figure out how much money she's taking from the companies. That way we know all the facts and there's no misunderstanding."

After we got the financial information on Dr. DelBello from the university, I knew we had an issue with legs. The forms showed that Dr. DelBello was taking tens of thousands of dollars from drug companies. Before we went public I outlined what we wanted the bill to do and then met with Senate Legislative Counsel, to draft the actual language.

After I got a draft bill sent to me, I wrote a speech about what we had learned and Senator Grassley read it from the Senate Floor:

> Dr. DelBello's study, which helped put Seroquel on the map, was published in 2002. That next year, she got more money than she has ever received from the pharmaceutical companies—at least that is what the documents that I have say.
>
> In 2003, AstraZeneca alone paid her a little over $100,000 for lectures, consulting fees, travel expenses, and service on advisory boards. In 2004, AstraZeneca paid her over $80,000 for the same services.

The New York Times reported on Grassley's speech, noting that he planned to introduce legislation to require companies to report this money they were giving to doctors. Grassley told the *Times* that he was simply holding doctors to the same ethical standards as elected officials who are required to report campaign donations.

A few months later, we formally introduced the bill with Sen. Herb Kohl (D-Wisc.) as a co-sponsor.

Nothing gets passed in Congress, and we had no idea if we could get this bill through. Big Pharma is a very powerful industry, and all the major players were fundamentally opposed to what we were doing. How could we get this done?

> "You gotta be cynical to work on the Hill. Because it will crush you if you come in here hopeful, and thinking that change can happen. Because if change happens, it's extremely slow." (Senate Republican Staffer)

To lay the groundwork, we started talking with pharmaceutical companies, to see what they thought. In one early encounter, the vice president for a big company told us the bill would create huge expenses if it became law. As he explained it, companies provide all types of money to doctors, and these funds come out of different pots. A doctor may get taken out for dinner by a drug representative. The marketing department may pay the same doctor to give a talk. The research department may give him a grant for research. Each department is different and companies don't maintain a central database to track how much money they give to each doctor.

"Do you want to go public with the argument that you can't track all this money because you're shoveling so much of it out the door to doctors?" I asked. "I'm just not sure if your shareholders would be happy to hear this."

Still, this gave us a sense of the argument that pharma would use: the bill would create expensive regulations and drive up costs, hurting the public and potentially reducing access to lifesaving drugs.

To counter this line of attack, we launched a wide-ranging investigation into the scope of the problem. After talking to a variety of experts—people like Marcia Angell, the former editor in chief of the *New England Journal of Medicine*—and reporters who covered pharma, I put together a list of academic physicians seen as close to industry and who we thought were probably receiving industry money.

Sen. Grassley sent letters to these physicians' universities asking for financial information these doctors had filed. At the same time, he sent letters to the nation's largest pharmaceutical companies asking for a detailed list of payments they had given these same doctors.

But again, I didn't know if this would work. So I thought of a different tactic to backstop the investigations and give us some sort of win. I didn't want to spend months of time and have nothing to show for it. I had noticed that all these doctors were grantees of the National Institutes of Health (NIH), the federal agency that funds biomedical research. Even if we didn't pass a bill, I reasoned, we could force the NIH to change its regulations and force doctors getting government grants to be more transparent about their ties to industry.

The big push

Things changed dramatically in 2008 with President Obama's election. He made health care reform a top priority, and the Finance Committee was put in charge of writing the Senate version.

By the summer of 2008, I had gotten the information that we were looking for from universities and pharmaceutical companies. I wrote reports on doctors at Harvard, Emory, and Stanford who had failed to report millions of dollars in pharmaceutical money to their employers. Each report was given to the press to create maximum public pressure on the medical community to support the bill.

We also held meetings with the NIH director to pressure him for better policing of grant management. At first, agency officials tried to ignore the need for reform, arguing that they were a science agency and not an enforcement unit. We reminded them—in letter after letter

—that the $30 billion Congress appropriated to the NIH belonged to the taxpayers, and that public money came with strings attached.

Heading into 2009 we detected a change in industry's position. The media was publishing frequent stories about doctors on the take, and the old excuses weren't panning out any longer. Pharmaceutical companies were agreeing that change was needed, and that "transparency" was right approach. NIH officials changed their tune and agreed to reform the rules for their grants.

Our sunshine language was attached to the healthcare bill working its way through Congress, and was eventually passed with the rest of the *Affordable Care Act* in 2010.

It was now up to the agencies to write new regulations and start to enforce the law.

We also continued to apply pressure to Obama's NIH chief, Francis Collins, to change the NIH conflict of interest policies for their grantees. He later met with our office to discuss how to do this. After months of discussion, his team finalized its drafts and sent them to the White House for final approval. These proposed regulations would require NIH grantees to report monies they received from industry and require employing universities to post these reports online. At the last minute, the White House stripped out the reporting requirements. The watered-down version became the new standard.

The department of Health and Human Services (HHS) began promulgating different regulations for the Sunshine bill. The new law had rule-writing deadlines that the agency was failing to meet. By this time I had left Capitol Hill, but staffers for Sens. Grassley and Kohl kept working and sent several letters to the agency and the White House demanding that the regulations get done. Sen. Kohl's staff had invested hundreds of hours of time on the bill: giving speeches to medical societies, holding multiple hearings on the Senate Committee on Aging, and taking scores of meetings with stakeholders.

A few months before Obama's 2012 reelection, the HHS regulations were sent over to the White House for final approval. They were finally released a few weeks ago.

It took more than five years to get it done.

Now that it's all over, I can tell you it was worth it. This bill will bring some balance back to the relationship between doctors and industry. We need them to work together—industry needs the insight from expert physicians to create the next generation of drugs and devices, and doctors need these products to save lives. But we cannot tolerate companies buying off doctors who put profit before patients.

Years from now, I think people will look back on these reforms—the Grassley/Kohl Sunshine Act—and realize that they made academic medicine better. Few people will know about the staff behind the scenes making it possible. Even fewer will truly appreciate the long hours and great deal of stress we went through.

Even when Congress gets something done, it takes an incredibly long time and years of dedication.

http://www.ethics.harvard.edu/lab/blog/281-the-slow-pace-of-success-in-a-do-something-congress

Membership Has Its Privileges: Donor Perks and the Atlantic Council

Ken Silverstein and Brooke Williams

The Atlantic Council, a Washington think tank chaired by Chuck Hagel, President Obama's nominee for defense secretary, released a list of foreign donors in response to demands from Republican senators, who blocked his confirmation vote last week.

In a letter addressed to Hagel, the Council's president and CEO, Frederick Kempe, a former columnist at *The Wall Street Journal*, defended the think tank's intellectual independence and outlined its ethical policies, including clearly and consistently disclosing funding from foreign governments.

Kempe's letter listed roughly 100 corporations and 15 governments that donated to the Council in the past five years. But the list in the letter was hugely different from the one on the think tank's website. Indeed, the Council's online disclosure was missing key funders, including Bahrain, Jordan, Sweden, Saudi Arabia, Taiwan and Kazakhstan. If it weren't for Hagel's nomination and subsequent spotlight on the think tank's funding, their support might still be secret.

The Council didn't disclose in the letter or on its website exactly how much money countries and corporations had given. As a nonprofit organization, it doesn't have to divulge details about where it gets its cash. This is especially problematic given that the Council invites donors to pay for and participate in specific projects—even those in which they have a financial stake.

Kempe's letter described the Council's "Intellectual Independence" policy: "The Council maintains clear policies to ensure its ethical and legal operation as [an organization]…which values its credibility and integrity as a generator of creative ideas," Kempe wrote. "All agreements with donors stipulate that the Council retains intellectual independence and control over any content."

Following the release of Kempe's letter, James Joyner, the Council's managing editor, took to the think tank's website to publish a blog post entitled "The Atlantic Council, Foreign Funding, and Intellectual Independence." "Like all organizations of its kind, the Atlantic Council has to fund its work by cultivating donors," he wrote. "But we've always placed the integrity of our work above the preferences of our funders. Indeed, under the leadership of Hagel and Kempe, we've recognized the potential for these relationships to confer an appearance of conflict and therefore outlined detailed policies for review of foreign government funding and intellectual independence."

The Council's claims of intellectual independence are hard to square with its own promises to big donors which can be found on its website. "The Council works with our partners to develop their substantive narrative and determine the types of tools and products, including event opportunities and co-branded publications, required to meet their goals and needs," says one fundraising pitch. Another invites companies to contribute to research and reports

that "will help position them as thought leaders and influence top leaders in government, business, the military, and academia."

Kempe said during a phone interview that the Council does not advocate for donors and that "in the context of what you're talking about, rewording [of the pitch] perhaps would be useful." He said the donor list on the website must be outdated.

The pledge of intellectual independence is also hard to square with services the Council has rendered to at least one of its foreign donors, the government of Kazakhstan.

Kazakhstan is headed by crooked dictator Nursultan Nazerbayev, who has declared himself president-for-life. The country's rubber stamp parliament has granted him the permanent right "to address the people of Kazakhstan at any time" and to approve all "initiatives on the country's development."

The U.S. State Department's latest report on global human rights cites extensive problems in Kazakhstan. The most significant, among a very long list, were "severe limits on citizens' rights to change their government; restrictions on freedom of speech, press, assembly, and association; and lack of an independent judiciary and due process, especially in dealing with pervasive corruption and law enforcement and judicial abuse." Meanwhile, the oil-rich Kazakh government has in recent years spent millions of dollars on American lobbyists and PR firms to help improve and deepen its relationship with the United States.

Last year, the Atlantic Council hosted a conference on Kazakhstan. The conference was paid for by Chevron, which has vast oil interests in the country and is a top-level donor ($100,000-and-up) to the Council, and the Kazakh government, Kempe acknowledged. He declined to say how much they contributed, "not because I don't want to but because we're not authorized to give numbers."

Chevron and the Kazakh government are partners in a variety of initiatives in the country. While each certainly has its own, separate interests, this arrangement seems to violate at least the spirit of the Council's policy that it will try "to ensure that any one project is not dependent on one government funder."

Not surprisingly, the conference was essentially a love poem to Nazerbayev. During introductory remarks Hagel talked about "the partnership that evolved and grows and strengthens each day between our countries," according to the conference transcript, and said the Kazakhs "were responsible for pulling together a very, very impressive country that has made astounding progress."

Keynote speakers included Kenneth Derr, who was CEO of Chevron when it forged a partnership with Kazakhstan and is now the country's Honorary Consul in San Francisco. "Under President Nazarbayev's extraordinary leadership, Kazakhstan is now independent, secure and extremely prosperous," Derr said, according to a conference transcript. Yerzhan Kazykhanov, Nazerbayev's Minister of Foreign Affairs, was another keynoter. During his visit to Washington, the foreign minister presented several Americans, including Hagel, with state awards from the Nazerbayev regime.

"We chose all the speakers; we chose the subjects," Kempe said. "If you look through the whole day of speakers, they're hardly cheerleaders for Kazakhstan." He pointed to Lorne Cramer of the International Republican Institute as someone who offered a critical perspective. Yet according to the transcript, Cramer had this to say: "I will tell you, as

somebody that deals in human rights and democracy, that there's a lot to praise in Kazakhstan."

A Council speaker acknowledged that Chevron had sponsored the conference but the think tank said nothing about donations from Kazakhstan, based on transcripts of the affair. The closest it came was when Ross Wilson, director of the Council's Dinu Patriciu Eurasia Center, told the audience he wanted to recognize Kazakh Ambassador Erlan Idrissov, "a friend of many of us, who encouraged the council to put together this retrospective and prospective look at Kazakhstan that we'll have today."

In conjunction with the conference, the Council released three issue briefs, a perk offered to big donors, for a certain price. In a fundraising pitch on the Council's website, they're described as a "succinct document analyzing a specific, relevant topic with an emphasis on recommendations for policymakers." All three briefs offered positive analysis about the Nazarbayev regime though none mentioned the financial support from either Chevron or the Kazakh government.

Roberts, who chaired a panel on US-Kazakh relations, wrote one of the briefs. "In looking at twenty years of independence in the former Soviet region of Central Asia, Kazakhstan stands out in most respects as a stable oasis in a desert of uncertainty," he wrote. "It is little wonder, therefore, that the most stable and fruitful bilateral partnership for the United States in the region over the past twenty years has been with the Republic of Kazakhstan."

What good is the Council's pledge of independence if the think tank remains dependent on money that creates a conflict of interest? How could anyone trust the independence of a conference on Kazakhstan paid for by Kazakhstan? In order to trust the research of an institution, the public must be able to trust its independence.

What all of this says about Hagel's fitness to lead the Pentagon is not clear. What is clear, though, is that the Atlantic Council—like so many other Washington think tanks—has a definition of "intellectual independence" that differs from typical scholarly institutions. Hagel, via his unpaid position atop the board, surely didn't invent this system, but he also doesn't appear to have stopped it.

(Note: A version of this story originally ran in the New Republic.)

http://www.ethics.harvard.edu/lab/blog/282-membership-has-its-privileges

Synergies Between Moral Philosophy and Institutional Corruption

Donald W. Light

The felicitous occasion of Michael Sandel delivering the inaugural Kissel Lecture in Ethics on behalf of the Edmond J. Safra Center for Ethics provides a fit opportunity to advocate for the synergies that can occur by joining moral philosophy with institutional corruption theory in a sustained, mutually beneficial dialogue.

Sandel's lecture and recent work[1] center on how money and commercialization have and can crowd out or corrupt "moral virtues" such as civic duty and participation, democracy, honest-dealing and transparency, succor or duty to the sick or poor, compassion, loyalty, and trustworthiness. This focus nicely complements most of the work at the Center on the corrupting effects of money and commercialization of institutions that are supposed to support and advance one or more of these virtues.

Institutional corruption theory can give Sandel's work more power and scope into larger realms by considering organizational and institutional examples. There are also major, well-documented cases of how institutional corruption has destroyed a societal good that can give Sandel's arguments greater scope. For example, Blue Cross health insurance was set up in the 1930s to enable hospital care for seriously ill patients to be paid equitably through community-rated premiums on a non-profit, voluntary basis.[2] Commercial companies then began in the 1950s to undermine this societal provision of fairness by risk-rating and offering lower premiums to healthier groups. This increased the risks of the remaining pool in Blue Cross plans and forced them to raise their community-rate premiums, which then enabled the commercials to risk rate even more, by person, occupation, and specific illnesses. I spent several years in two campaigns to stop this form of institutional corruption, at least for a while.[3-5] The *Affordable Care Act* centers on restoring the fairness of the Blues but for everyone. The commercials, however, have kept in the law unfair discrimination against those at higher risk in provisions that no other affluent, capitalist country allows.

Professor Sandel pointed out that context and culture must be taken into account in assessing many moral dilemmas, conflicts, or actions. Several projects at this Center on institutional corruption involve in-depth detail on the context, culture, and countervailing powers at play in a given domain. Sociological and anthropological studies of how forms of structural corruption actually take place can contribute to deliberations in moral philosophy. These may include relationships of togetherness, friendship, and solidarity.[6]

In complementary ways, institutional corruption theory could benefit from drawing upon selected parts of moral philosophy. As Dan Wikler has pointed out, the claim that something is "corrupt" or "corrupted," or that one party is corrupting another must be anchored in moral principles outside of that claim.[7] In the case of big money corrupting democratic elections, this need is less obvious because big money in elections corrupts the democratic process by definition. As soon as big money becomes a factor, corruption begins. Thus even if the major donors were ideal philosopher-kings, and even if their priorities and values were

exemplary, the very institutional arrangements by which big money skews elections corrupts them.

In other realms, however, such as the professions, think tanks, banking, or the pharmaceutical industry, big money is not inherently corrupting. Defining which practices or institutional arrangements are requires an external moral purchase. Self-corruption may take place.[8] Consider the case of public housing. If we start with a moral commitment to provide housing for the poor (an argument that needs fuller development), how should it be arranged and funded? How shall builders be paid to construct it? In what ways do legal and institutional arrangements become "corrupt," as distinct from inefficient or wasteful?

Finally, moral philosophy can help in the search for solutions to given cases of institutional corruption. It can provide depth and persuasive power. We can draw on a wealth of talent and experience, and a focus on Sandel here should not detract from the relevance of work by a number of distinguished moral and political philosophers at or near the Center.

References:

1. Sandel M. What Money Can't Buy: The Moral Limits of Markets. New York Farrar, Straus and Giroux; 2012.

2. Starr P. The Social Transformation of American Medicine. New York: Basic; 1982.

3. Light DW. Keeping competition fair for health insurance: how the Irish beat back risk-rated policies. American Journal of Public Health 1998;88:745-48.

4. Light DW. Contributing to scholarship and theory through public sociology. Social Forces 2005;83:1647-53.

5. Light DW. The practice and ethics of risk-rated insurance. Journal of the American Medical Association 1992;267:2503-8.

6. Lessig L. Republic, Lost: How Money Corrupts Congress - and a Plan to Stop It. New York: Twelve/Hachette; 2011.

7. Wikler D. What is the moral content of the label "institutional corruption"? In. Boston, MA: Harvard School of Public Health; 2012:1-3.

8. Salter M. Lawful but corrupt: gaming and the problem of institutional corruption in the private sector. Boston: Harvard Business School 2009.

http://www.ethics.harvard.edu/lab/blog/283-the-synergies-of-joining-moral-philosophy-with-institutional-corruption-theory

Physicians and the Pharmaceutical Industry: Where does this Story Begin?

Kirsten Austad and Aaron Kesselheim

This blog post discusses the article "Changing Interactions Between Physician Trainees and the Pharmaceutical Industry" published in the February 27, 2013 electronic edition of the *Journal of General Internal Medicine*. The study was conducted by former Fellow in the Lab on Institutional Corruption Kirsten Austad, Lab affiliates Aaron Kesselheim M.D. J.D. and Eric Campbell Ph.D., and Jerry Avorn M.D. and other members of the Division of Pharmacoepidemiology and Pharmacoeconomics in the Department of Medicine at Brigham and Women's Hospital and Harvard Medical School.

Within a week of its online-first publication the article received worldwide coverage, including *The Boston Globe*, *Stuttgarter Zeitung*, *Popular Science*, Pharmalot, HealthDay (in English and Spanish), and a host of medical and legal themed news portals and blogs.

It is well known that physicians have frequent interactions with the pharmaceutical and device industries. While some interactions are in the context of research collaborations, others are more promotional in nature, and may involve sponsored educational dinners or free product samples (Wazana, JAMA, 2000). While recent surveys suggest that the public is skeptical of physician-industry relationships (Consumer Reports survey, Aug 2010), many doctors find these promotional relationships to be useful and deny that they influence medical judgment. Physicians' acceptance of industry promotion as a routine part of medical practice may have its roots in the fact that marketing interactions begin early in medical training.

Like all professions, medical school socializes students in to the role of doctor, and each stage of training presents unique opportunities for interactions with industry marketing representatives. First-year students are "pre-clinical," spending their time learning the fundamentals of their profession in a classroom setting where they may receive lectures from professors who also serve on speakers' bureaus. During third- and fourth-year they transition to immersion in the hospital environment where they begin to learn the practical aspects of patient care and may observe the daily interactions between their supervising physicians and industry representatives, including free meals at sponsored lunch talks. After graduation, trainees enter residency where they carry out the patient care responsibilities and may utilize industry representatives present in the clinical environment as resources to inform their prescribing.

In the past decade, many academic medical centers have implemented policies to shield trainees from promotional interactions with industry. These policies include banning free meals or other gifts, mandatory disclosure of teaching faculty members' conflicts of interest, and formal curriculum time devoted to learning about professional ethics. However, there is little empirical evidence to guide development of these policies and perhaps as a result, policies vary widely between institutions and there is no consensus on where efforts would best be focused.

Our study aimed to systemically examine how pharmaceutical and device industry promotional representatives interact with trainees over the course of their medical education, and how trainees view the role of industry marketing in medical education. We surveyed a large, random sample of first-year (pre-clinical) medical students, fourth-year (clinical) medical students, and third-year residents, representing all 121 U.S. allopathic (M.D.) schools. Demographics of our respondents compared favorably to the survey of graduating medical students conducted by the Association of American Medical Colleges (AAMC), which boasted an 83% response rate in 2010 (AAMC website), confirming that our sample was indeed representative.

Our results were surprising: despite the significant changes over the past decade, 33% of first-year students, 57% fourth-year students, and 54% residents reported accepting a gift within the past six months. Though this level of exposure is reduced compared with a more limited study of third-year medical students published in 2005 (Sierles et al, JAMA), this demonstrates that gift-giving is still prevalent. Receipt of gifts was common despite the fact that a minority of trainees felt it was appropriate for medical students and residents to accept gifts of less than fifty dollars in value (by year of training: 26% vs. 23% vs. 35%). Observing mentors' interactions with industry was also common, with 33% first-years, 59% fourth-years, and 53% of third-year residents reporting this occurrence. The frequency of trainees using industry for educational purposes also increased with training level across a variety of sources, including sponsored lectures, sales representatives, and promotional materials.

It is well-documented that most physicians believe they are less susceptible to influence from gifting than their colleagues (Wazana, JAMA, 2000). In our survey, all levels of training were more likely to report that their peers are influenced by accepting gifts from industry than they are swayed (52% vs. 33% for first-years, 46% vs. 36% for fourth-years, and 42% vs. 34% for third-year residents). Though this was not a longitudinal survey, we noticed a potential trend based on year of training for certain attitudes. For example, while 68% of first-year students reported that physician-industry interactions threaten the public's trust in doctors, only 55% of four-year students and 46% of third-year residents agreed with this contention. There are two potential mechanisms for such changes in attitude. One possibility is that as trainees learn clinical medicine through observation and emulation of mentors, they also absorb the views of the role models around them. Alternatively, if students accept gifts that are prevalent in the environment, they may subconsciously adopt attitudes that resolve the cognitive dissonance. Other research (Sah and Loewenstein, 2010) has suggested that perceived self-sacrifice is a powerful justification for residents in accepting gifts. Thus, since residents' work hours and financial strain due to loan payment are relatively worse than medical students', this could also mediate the attitudinal changes we observed.

Overall, students support policies regulating interactions between the profession and the pharmaceutical industry. Between 87 and 94% of trainees agreed with mandatory disclosure of professors' conflicts, though fewer (43-57%) felt that it was inappropriate for professors to have conflicts on a topic relevant to what they teach students. While most students felt that schools should ban the pharmaceutical industry from access to students in the pre-clinical learning environment (66-69.3%), slightly fewer felt that the same policy should apply to the clinical training sites (53-60.3%).

To explore how the learning environment influences trainees, we looked at whether responses were related to research intensity and strength of conflict of interest policy of the respondents' medical schools. Amount of NIH funding to schools served as a surrogate for

research intensity, and we found that trainees from medical schools with high research intensity were half as likely to have accepted a gift from the pharmaceutical industry in the preceding six months. This result may reflect the reality that many conflict of interest policies were crafted in response to concerns about safety of human subjects of clinical research, and thus research-focused academic medical centers were under more pressure to craft policies. Additionally, drug manufacturers may be more likely to cultivate relationships (facilitated by gifting) with trainees at less research-intensive schools who are more likely to become community practitioners.

To evaluate the impact of conflict of interest policy strength, we used each school's AMSA PharmFree Scorecard grades from 2008 and 2010, which rates academic medical centers from A to F based on eleven areas (including gifts, disclosure, and sales representative access to clinical areas). Interestingly, we found no association between respondents' medical school Scorecard grade and frequency of accepting gifts. Why might this be? Because the grade is a composite measure, it is possible that not all of the domains that contribute to the grade modulate students' exposure to industry, or their perceptions of interactions. Notably, a recent study (King et al, BMJ, 2013) that found that graduates of medical schools with strong policies prohibiting industry gifts were less likely to prescribe heavily promoted psychotropic medications (vs. clinically appropriate, inexpensive generic alternatives), as compared to those who trained in environments without such rigorous gift restrictions.

Another possible explanation for the lack of association that we found between survey responses and medical schools' PharmFree Scorecard score is that existence of a conflict of interest policy—even a strong one—is not enough. First, our data showed that a surprisingly low number of respondents (ranging from 10% of first-years to 24% of residents) reported understanding their schools' conflict of interest policies, suggesting that more trainees need formal orientations to their institutions' policies. Second, it is possible that school policies may be undermined by other aspects of the environment. According to Hafferty (Academic Medicine, 1994), the "hidden curriculum" denotes the norms and values learned through informal mechanisms such as off-handed comments made by attending physicians or observed behaviors of peers and mentors, and is thought to be an important contributor to development of professionalism. For example, a medical student may know that his school forbids accepting lunches from industry representatives but rationalize this behavior as appropriate and accept it himself after being told by a supervising resident "if you want to survive in the hospital environment, you take free food when you can get it." Trainees in an environment where a policy prohibiting gifts exists but is not adhered to by all faculty or affiliated institutions could paradoxically become more likely to accept gifts. Our survey indicates that there are lapses in compliance: only 29% of first-year students, 59% of fourth-year students, and 52% of third-year residents felt that their faculty complied with the policy "very well." This disparity between the formal policy and the implicit lessons taught via the hidden curriculum may mediate behaviors and attitudes.

The potential impact of the hidden curriculum is one of many questions arising from our data that merit further investigation. In one forthcoming project, we will consider how trainees learn about medications and explore their ability to correctly differentiate evidence-based treatments for common clinical scenarios. In the future, we also hope to conduct a follow-up study in which our survey respondents are re-contacted later in their professional development and results linked to their prescribing patterns. This longitudinal data will help us further examine how various aspects of the medical school learning environment affect physicians' attitudes and behaviors relating to pharmaceutical and medical device industry promotion.

http://www.ethics.harvard.edu/lab/featured/285-physicians-and-the-pharmaceutical-industry-where-does-this-story-begin

Institutional Corruption and Countervailing Powers

Donald W. Light

By its very nature, institutional corruption (IC) occurs in a force-field of countervailing powers. Corruption at the organizational or institutional levels inherently involves a larger constellation of stakeholders who participate in or are affected by the corruption being studied. Beyond them are other parties with other priorities who shape or are affected by different forms of corruption. These include public opinion and trust if its deterioration leads to organized responses. Doing research on how countervailing powers interact with the corruptors and shape either the forms of corruption or reforms for integrity to end it would strengthen IC studies.

Montesquieu[1] first developed the idea of countervailing powers in his 1748 treatise about the abuses of absolute power by the state and the need for counterbalancing centers of power. In 1767, Sir James Steuart[2] contributed ironic observations on how the monarch's promotion of commerce to enhance its domain and wealth produced the countervailing power of the mercantile class that tempered the absolute power of the monarchy and produced a set of interdependent relationships. The *Federalist Papers* in 1787-1788 addressed the need to balance countervailing powers.

In modern times, "countervailing powers" was first conceptualized by John Kenneth Galbraith, who wrote "Power on one side of a market creates both the need for, and the prospect of reward to, the exercise of countervailing power from the other side."[3] This statement has four implications: that dominance by one party plays an important role; that dominance leads to imbalances, exploitations, or distortions; that a countervailing power may be latent in a given domain but organize into manifest forms in response; and that countervailing power is a dyadic relationship.

In contemporary economics, Galbraith's concept has become rather narrowly construed to refer to the ability of large buyers to extract discounts from suppliers. In sociology, however, it has been substantially expanded to posit three or more latent or mobilized countervailing powers in a contested field or domain, whose boundaries and relations they shape over time.[4] Each stakeholder also has its own rationale and basis of legitimacy.

This conceptual framework allows one to trace and diagram the historical changes among key stakeholders, take measure of their power, describe their alliances and contests for power, and document the effects on costs, products or services, scope, and culture. For example, in the early 20th century, American medical organizations came to dominate all other stakeholders through legal and economic rule-making which its members then exploited.[5,6] This very dominance increasingly prompted stakeholders like employers, insurers, and taxpayers to develop increasingly powerful countervailing strategies to limit the legal and economic dominance of the profession. Now something similar is happening to the pharmaceutical industry.

The state as a countervailing power deserves special comment. The countervailing powers framework does not depend on any one view of the state. For example, after World War II, the East German state eliminated all professional associations as countervailing powers that corrupted its Communist mission. In West Germany, the democratic state allowed the organized medical profession to exploit universal health care to maximize its income and control until the 1980s, when the state and insurers as countervailing powers allied to harness professional practice to the needs of an affordable, universal health care system. In pharmaceuticals too, dominance has prompted countervailing responses.

A central tenet of countervailing power theory is that dominance by one party in ways that corrupt the mission of a social institution and societal function of other parties will over time prompt them to organize and alter the balance of power. This appears to be happening to the pharmaceutical industry, which has (1) abused patents by developing "innovative" drugs that are usually little better than existing ones, (2) compromised medical science and knowledge through conducting randomized clinical trials in biased ways and hiding negative results, (3) compromised the integrity of medical journals by ghost-managing "scientific" articles slanted in favor of the sponsor's drug, (4) tainted medical education through commercial influences, (5) corrupted the fiduciary commitment of physicians to their patients with commercial inducements, and (6) threatened the ability of countries to afford universal health care by charging exorbitant prices.[7]

Over the past 15 years, stakeholders have organized to curtail forms of institutional corruption. For example, (1) India is beginning to lead the developing world in limiting product patents and excluding variations like the "breakthrough drug," Gleevec, whose patent protection was denied. 2) Researchers have organized their voice against biased science and suppressed or distorted findings, leading to an ever more complete set of stipulations for transparency and registries. 3) Medical journal editors have taken several countervailing measures to protect the institutional integrity of their journals against institutionally corrupting practices. 4) Organized medical students have been pressing rule changes to de-commercialize medical education. Actual prescribing practices are changing,[8] yet commercial influences and an informal culture persist.[9] 5) Medical and specialty associations have taken several measures to try to restore professionalism and public trust. 6) Most affluent nations and India increasingly assess the comparative effectiveness of new drugs and pay accordingly, thus countering the undermining effects of unaffordable prices on affordable, universal health care as a social institution. Through these countervailing responses, dominant financial, legal, and organizational practices that distort the goal of better health through universal access to beneficial services are being addressed with increasing force in ways that also contribute to defining what institutional integrity would mean.

One new countervailing power in institutional corruption is the organization of researchers and resources against it as an academic subject. Through the generous support of Mrs. Safra, the Edmond J. Safra Center for Ethics is developing a widening network of researchers across disciplines, a set of data tools, research methods, and substantive studies that together are inspiring other universities to follow its example of making institutional corruption an important subject of policy research.

References:

1. Montesquieu SCL. De l'Esprit des Loix. Geneva: Barillot & Sons; 1748.

2. Steuart J. Inquiry into the Principles of Political Economy Vol 1. London: Miller & Cadwell; 1767.

3. Galbraith J. American Capitalism: The Concept of Countervailing Power. Boston: Houghton Mifflin; 1956.

4. Light DW. The rhetorics and realities of community health care: limits of countervailing powers to meet the health care needs for the twenty-first century. Journal of Health Politics, Policy and Law 1997;22:105-45.

5. Light DW. Ironies of Success: A New History of the Current Health Care 'System'. Journal of Health and Social Behavior 2004;45 (Extra Issue):1-24.

6. Salter M. Lawful but corrupt: gaming and the problem of instituional corruption in the private sector. Boston: Harvard Business School 2009.

7. Healy D. Pharmageddon. Berkeley: University of California Press; 2012.

8. Epstein A, Busch S, Busch A, Asch D, Barry C. Does exposure to conflict of interest policies in psychiatry residency affect antidpressant prescribing? Medical Care 2013;51:199-203.

9. Austad K, Avorn J, Franklin J, Kowal M, Campbell E, Kesselheim A. Changing interactions between physician traniees and the pharmaceutical industry: a national survey. Journal of General Internal Medicine 2013 (Feb).

http://www.ethics.harvard.edu/lab/blog/286-institutional-corruption-and-countervailing-powers-

John Reed: On the Value of Values

Gregg Fields

For those who study institutional corruption, one of the most confounding difficulties can be establishing its boundaries—particularly the tipping point at which it veers into the criminal variety.

The challenge is particularly vexing for those examining the aftermath of the 2008 financial crisis. Wall Street recklessness pretty clearly crashed the world economy. A host of civil complaints—and settlements—have outlined egregious behavior at banks, credit rating agencies and other financial players. Which begs the question: How is it possible that no crime was committed?

In an insightful lecture Thursday evening, sponsored by the Edmond J. Safra Center for Ethics, one of the most noted financial figures of his generation shared his insights on the subject. John Reed, the former Citigroup leader, who became chairman of the MIT Corp. in 2010, made clear his distaste for the ways Wall Street evolved through the years, nurturing activities that would lead to the financial collapse.

But, he added, that doesn't automatically translate to a criminal activity. "Did the industry become corrupt?" Reed said, speaking to a receptive crowd in Austin Hall. "Yes, in my mind."

Crime vs. Corruption

Yet, he elaborated by noting that the corruption concerned the institutions' business models and corporate cultures. Ultimately, it resulted in the institutions becoming dependent on relationships that didn't serve the public interest. "I don't think it was largely a criminal thing," he said. "I think it was largely a corrupt thing."

What's the difference? Crime, obviously, relates to laws. Corruption of the kind Reed outlined relates more to values—though not the financial kind. (His lecture was titled, "Shareholder value vs. values.")

For instance, when he joined Citibank in 1965 the highly regulated industry "was almost a utility," he said. "It was a world, at the time, where the customer was first." Citibank didn't even have a formal budget, he said, and earnings were something of a corporate afterthought.

As he rose through the ranks, Reed himself became known as one of the industry's top innovators. Most notably, he revolutionized consumer banking by leading a relentless push in the 1970s to install ATMs at Citibank branches, with the rest of the industry racing to catch up. He retired from Citigroup in 2000.

In his lecture, Reed spoke of several factors that, over time, converged to create the shift in American corporate values that led to the financial crisis. One, the comparatively genteel world of finance became more cutthroat, he said. An example was, in the 1980s, the widespread practice of "greenmail," where outside investors would buy stakes in companies, then demand a premium to go away.

That led to a growing fixation on "shareholder value." High stock prices could help thwart greenmailers. And companies began adopting compensation based on stock options—the theory being that management is rewarded if shareholders are. Compensation soared. In one case at his bank, he said, executives who were in line for a total of $40 million in bonuses instead got options which ultimately were worth more than $200 million.

An engineered crisis

For banks, an additional factor was the rise of so-called financial engineering. Traditional lending is a low-margin business, with a limited upside potential. So increasingly they turned to new products like mortgage-backed securities, which offered greater returns. Over time, a proliferation of other financial products came on line.

Profits rose, and banker pay soared. But in the process, the historic banking culture—the values Reed encountered as a trainee in the 1960s—were altered. Bankers were now traders rather than lenders. "Instead of being customer-centered, you become salesmen who sell products to investors," Reed said. "All the inducements were running in the wrong direction."

In the years preceding the financial crisis, the prevailing values led Wall Street to market questionable products like derivatives and subprime mortgages. "The industry started inventing things that weren't so good," Reed said. "We created a garbage industry."

In a question and answer session following his lecture, Reed acknowledged being at the center of an event that some critics say contributed to the financial crisis. In 1998, Citicorp merged with Travelers Group, run by financier Sandy Weill. Travelers Group was a financial conglomerate whose properties included a namesake insurance company and an investment house called Salomon Bros. It was billed in *The New York Times* as the largest corporate combination ever.

The merger of all these financial businesses led to the repeal of the Glass-Steagall Act, which historically barred traditional banks from engaging in the riskier activities of Wall Street investment banks. Glass-Steagall's demise, some critics contend, unleashed banks and helped inflate the massive credit bubble that would later burst and usher in the Great Recession.

"I wouldn't do the merger" today, Reed said. "It was a mistake. Not on business grounds, but a mistake on social grounds." Of commercial versus investment banking, he added: "I do believe now there is no upside to putting these two businesses together, and a tremendous cultural downside."

The same players

He is a proponent of the proposed Volcker Rule. Part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule would re-build some of the old firewalls between investment and commercial banking. But the rule is yet to be implemented, bogged down by fierce industry opposition. "Anyone who says you can't do it is just lying," he said.

After retiring from Citigroup, Reed was named interim chairman of the New York Stock Exchange in 2003 after its previous chairman, Richard Grasso, resigned in a controversy involving his compensation. Reed agreed to do the job for $1.

Despite the passage of Dodd-Frank in 2010, Reed acknowledged not a lot has changed. For one thing, the people who led Wall Street before largely lead it now. "I was quite surprised the CEOs and boards continued as they were before," Reed said.

Industry reforms have languished. Reed suggested one problem is Dodd-Frank itself. It is so big, and so vague, that the ability of regulatory institutions to implement it is effectively blunted. Credit "the power of the lobbyists," Reed said, adding: "It's very much in their interest to have legislation that runs 10,000 pages."

http://www.ethics.harvard.edu/lab/blog/287-john-reed-on-the-value-of-values

Lobbyist's Progress: An Interview With Jeff Connaughton

Sheila Kaplan

Time was, Washington lobbyists followed a certain protocol at political fundraisers. They'd drink the bourbon, eat a few crab cakes, surrender their checks and move on. Anyone familiar with the form knew better than to ask a lawmaker for a favor while money was on the table—that's what the morning after follow-up call was for.

To Jeff Connaughton, former lobbyist, White House lawyer, and Senate staffer, the disappearance of that small restraint is not a good sign.

"It used to be verboten to bring up an issue at a fundraiser," said Connaughton in a recent interview. "Of course they'd call the next day. But, over the years, primarily because Congress is so pressed for time and the need to raise huge sums of cash, it's literally become the Senator or Member going around the table, one-by-one, 'What's your issue?' How can anyone feel good about how that must look to the American people?"

Connaughton takes aim at the political money chase, the role of lobbyists on Capitol Hill, and the infinite influence of the financial services industry in *The Payoff: Why Wall Street Always Wins*. The book, published [Prospecta Press] last September, also traces Connaughton's personal story: from idealistic college student spellbound by a visit from Joe Biden to the University of Alabama, to jobs as a Biden fundraiser and staffer, to the Clinton White House, and then through the revolving door to cash in on his experience by co-founding one of the most lucrative bipartisan lobby shops in Washington.

Along the way he raised hundreds of thousands of dollars for Biden, Clinton and other Democrats, and made a small fortune for himself, acquiring the accoutrements of the successful lobbyist's life: house in Georgetown, speedboat on the Chesapeake, bespoke suits, and a nagging sense that he was part of a corrupt system.

Over the decades, Connaughton remained loyal—if not close—to Biden; with a political allegiance that he readily admits was less out of personal affection than the certainty that in Washington one must be branded as close to a powerful elected official, and the Delaware Democrat would be a most lucrative connection. He worked on Biden's 2008 presidential campaign; then, when Biden was named as Obama's running mate, worked on the pre-transition team. Following the election, Connaughton served briefly as part of Biden's vice presidential transition team.

But incoming President Barack Obama had launched, Connaughton wrote, an "anti-lobbying jihad," refusing to accept lobbyists into his administration (except for the ones he did accept, like Goldman Sachs lobbyist Mark Patterson, who served as chief of staff to Treasury Secretary Tim Geithner). As a consequence, Connaughton contemplated continuing his work at Quinn, Gillespie & Associates, where he could boast of close ties to a sitting vice president. But Ted Kaufman, Biden's longtime chief of staff, who had just been appointed to fill out the rest of Biden's Senate term, had a different idea and offered Connaughton a chance to go back through the revolving door, this time into public service.

In the foregoing months, Lehman Brothers had declared bankruptcy and the Dow had plunged. As Connaughton writes, "I was livid about the financial crisis and Wall Street's role in it. Ted was too. The economy was imploding because of Wall Street excess (and likely: malfeasance), and in the run-up to the financial meltdown the ruling class in Washington had done nothing to stop it." They decided to spend Kaufman's two-year term fighting to make Wall Street accountable for the crisis, and passing structural reforms that would prevent another one. So in 2009-10, Connaughton served as U.S. Senator Ted Kaufman's Chief of Staff.

There were some small victories, but overall, Connaughton's time in the Senate left him heartsick from the government's failure to prosecute Wall Street fraud and enact financial reforms to protect Americans. He attributes much of this failure to the revolving door ("if you work your way up and become a key government official—in Congress or the executive branch," he writes, "you can start test-driving Porsches in your final weeks in office.") He also attributes the failure to our current system of funding campaigns, which gives tremendous clout to those, like the financial services industry, with the resources to make or break lawmakers and candidates.

It's a system under which Connaughton got rich. While it's impossible not to note that, like many political whistleblowers, Connaughton didn't complain about the system until he had socked away a small fortune; it's also impossible not to give him tremendous credit for his leap back into public service at a time when he could easily have cashed in on his relationship to Biden, and become one of the most bankable lobbyists in town.

Instead, he worked with Kaufman on Capitol Hill, trying his best to take on the financial giants. And then, at the close of Kaufman's term, Connaughton left Washington. He moved to Savannah, Georgia, far away from Washington—which he writes, continues to "attract thousands of idealistic, energetic young people from across the country and lead[s] many of them to make compromises that [draw] them deeper into a corrupt system."

He recently appeared on an episode of PBS Frontline, "The Untouchables," during which he criticized Justice Department leaders. He continues to advocate for tougher financial sector regulations, and for lessening the impact of money in politics.

Connaughton spoke to Lab Fellow Sheila Kaplan earlier this month. The following is an edited version of the interview:

SK- Why did you write this book?

JC- "I've tried to lay my career for people to pick through it and draw whatever conclusions they want. It feels personal in some ways and in other ways it doesn't. I felt the best thing I could do was write the most truthful account of Washington as I experienced it.

"I stayed away from using the word corrupt, because it's not well-defined, and I can't empirically verify it regardless (who needs to, as I think, on Wall Street issues especially, the thing speaks for itself). Instead, I trained my sights on myself, on what I called the "diabolical tugs" I sometimes felt during my career, and tried to be my own worst critic, as symbolic of how bad things have become in D.C. over the past 25 years."

SK- In your book, you call former Senator Christopher Dodd (D-Conn.) "Machiavellian," and raise questions about the influence of Wall Street donations on his policies.

JC- "It was just common knowledge that Dodd was using his Banking Committee chairmanship to help fund his long-shot presidential campaign. ...At the same time, in 2007, while Dodd and his family literally were living in Iowa as he campaigned, he chaired only four hearings that came close to touching on the brewing financial crisis issues." [The Center for Responsive Politics, which tracks campaign contributions from Federal Election Commission records, reports that securities and investment firms were Dodd's number one donor, with $ 1,378,048 in contributions between 2005 and 2010. Dodd, now a lobbyist, declined to comment for this blog.]

"He was one of the most popular Senators. He's a great guy, everybody likes him. That is part of the Washington story. There is this social glue that holds everybody together. … David Brooks once wrote a column about how the elites in Washington never police other elites, there is too much of a social consequence."

SK- You co-founded one of the first bipartisan lobby shops. How did it work?

JC- "It did stay sequestered, we never pooled our campaign contributions. The Democrats decided who they would do events for, and the Republicans did the same.

"There are corporations who for decades in Washington have been sprinkling grant money around. Not just to think tanks, but to every kind of advocacy group, not-for-profit, that you can think of; to develop the ability to have multiple points of entry into the dialogue.

"You constantly look for third-party validators. …[We would say,] 'Who can we get that it is not the voice of the client to validate our point of view, or come close to our point of view, or deliver our message?' You'd call them [academics] and the first question out of the academic's mouth would be 'is this going to be a retainer situation?'

"Recently, I was talking to a senate democratic staffer who had just attended the Aspen ideas festival, and he was describing to me the kind of people who were there, who he had dinner with, all huge corporate money. …There wasn't a single representative of consumer groups or public interest groups. He was on his way to the Democratic Convention, where he had been invited to all sorts of corporate-sponsored parties. These staffers often move through a corporate-funded bubble, and so it's no surprise that they get more information from special interests than the public interest. And then the next phase of their career after working for Congress is too often to join the corporate bubble makers."

SK- Tell me about Obama's anti-lobbying campaign, which you describe in the book. It didn't seem to last long.

JC- "I thought it was a cynical and ineffective approach. He was demonizing lobbyists, who are just in the middle between special interests and government. Why can Obama talk to Bill Daley while he was at JP Morgan, and have dinner with Daley, take contributions from Daley, and eventually hire Daley to be his chief of staff, but not take money from or hire Bill Daley's lobbyist? It makes no sense at all.

[Obama's financial reform policies] "reflected the world view of Wall Street technocrats who had been brought in to the Obama administration from the beginning. This man who had been elected president on a change platform, when it came to Wall Street issues, was all about appointing disciples of Bob Rubin such as Larry Summers and Tim Geithner—the very architects of the financial crisis—and ensuring continuity with the bailouts and bank-friendly policies. It's no wonder that reformers in Congress made such little headway, because these Administration officials were adamantly opposed to true structural reforms."

SK- On your first presidential campaign in 1987, you used what you called the "Amway" approach to fundraising. Tell me about that.

JC- "I think fundraising has long been about incentivizing captains to bring in sub-captains, and reward each captain, above a growing pyramid of fundraising totals, with greater access to the candidate and a more concrete connection to campaign leadership. It's actually imperative to run a disciplined operation, one that keeps people motivated and incentivized that the more they do, the more recognition and access they'll get…the more likely they'll feel pride in telling their friends they have a genuine relationship with the candidate."

"Twenty five years ago, I'd practice my fundraising pitch on my sister, and it's still a running joke between us. I'd say, 'Roger, for $50,000 I can get you dinner with the senator in his house. For $25,000, I can get you dinner with the senator ...not in his house. For $5,000, you and I can have lunch and maybe the senator will drop by… but I doubt it.' And yet people responded to this, to the idea that it's far better to have dinner with the senator in his house than not in his house."

"I remember going to the 2004 Democratic convention in Boston. I was walking into one of the VIP events and I heard someone behind me muttering, 'I raised a million dollars for the campaign and I can barely even get to see Kerry. ...For Gore, if you raised half a million, you got treated like a king.'

"The best people, who can really raise money, are people who do business with a lot of subcontractors; people who have a rolodex of people they do business with, and you can imagine how the phone call goes. It is nothing about, 'Let me spend 20 minutes telling you the virtues of the candidate and 20 minutes on why I believe he's going to win.'

"The conversation is 'Write me a check to Smith for president. Do it for me.' And the person on the other end of the phone is in no position to say no. If you had to actually convince someone your candidate would win and be a great president, in most campaigns you'd never raise any money."

SK- You were disappointed with Obama on money and politics issues?

JC-"A true reform movement can only come from a presidential campaign, and that is what is so historically disappointing about Obama. He did have a moment in time and represented a promise. …He couldn't single-handedly get money out of the system, but he could have stood up to elite interests. Certainly when it came to Wall Street, he should have done that. After all, this was a devastating financial crisis that severely damaged the livelihoods of tens of millions of Americans. And yet, in my view, his abject failure to stand up to Wall Street has highlighted the power of money in D.C., and made even more people disillusioned."

http://www.ethics.harvard.edu/lab/blog/290-lobbyists-progress

The Fiscal Fallout: A View From Below

Daniel Weeks

When Congress closes its doors this week for the Easter recess, Senators and Representatives will return to their constituents "armed with excuses" that explain away the latest fiscal fiasco. For some in Congress, cutting $85 billion (14 percent) from discretionary programs largely aimed at helping those in need is simply necessary medecine. For others, sequestration should have been avoided, but now that it has come it's time to just move on. Still others maintain the cuts were overdue. And all agree the other side is to blame.

The pattern is a familiar one by now. Viewed from the inside, when budget bombs explode in Washington, DC, the flashing lights are merely camera bulbs, the fumes are what comes out of politicians' mouths, the smoke is from the lobbyist's cigar. The real effects are not felt at either end of Pennsylvania Ave: they are reserved for ordinary Americans who struggle to make a living outside the corridors of power and struggle to make their voices heard inside.

I am not much better than the political elite. I follow the budget debates from a place of relative detachment, confident in the knowledge that I am shielded from the shrapnel by my professional job and degrees. Like the politicians who put us in this fix, I often view the fiscal fallout abstractly: How many billions are we from achieving fiscal balance? What do the expert models and projections have to say? What's the ten year plan?

But not this time. When sequestration took effect on March 1st, I was far from home, in America's "homeless capital" of Los Angeles on a poverty research tour by Greyhound bus. With tape recorder in hand and a poverty-line budget of $16 a day on which to eat and sleep and meet my other needs, I hoped to gain a more personal understanding of how life is lived in the lower echelons of American society after the Great Recession, and what it means for the promise of equal citizenship in our democracy.

Four short weeks in poverty is hardly enough time to grasp the complex conditions of those who live the life each day, but it was hard enough for me. Unlike those I interviewed, I could choose to say goodbye to such basic insecurities as not knowing when my next meal would come or where I'd lay down my head—and I did, returning to the safety of my middle class life as I write these words. Nevertheless, as an American citizen and a person of faith, I am shaken by what I saw and challenged by the conviction that poverty is far more stubborn and institutionalized than I once thought, especially in light of the recent fiscal fallout.

--

Take Skid Row, "ground zero" of homeless L.A., where I spent two restless nights alongside several thousand of the city's homeless people earlier this month. Although the weather is mild, the sidewalks are wide enough to make your bed, and the police show little interest in putting you in jail (so long as you stay out of the trendier neighborhoods nearby), life is not easy for the quarter-million people who are homeless in L.A. in a given year. Their numbers are set to rise because of the sequester, as the U.S. Department of Housing and Urban

Development (HUD) cuts back low-income housing assistance for some 125,000 individuals and families nationwide.

For block after block in this homeless colony, the sidewalks are a jumble of bedrolls, faded tents, and cardboard creations. Homeless men and women—some on crutches or wheelchairs, some wearing military fatigues or prison attire—rest in the shade or push shopping carts piled high with the extent of their earthly possessions. While veterans already comprise as much as twenty percent of the city's homeless population, their numbers will likely rise as well when federal funding for veterans to transition into nonmilitary work is cut by the sequester.

Inside the windowless concrete shelter where sixty-odd homeless people and I are admitted for the night, the staff gets down to business. After a pat-down and search of our belongings, we're shown to the back where supper is a modest serving of macaroni along with a hotdog bun (no butter) and a handful of iceberg lettuce (no dressing). Ten minutes later, we're moved to the sleeping dorm where a few dozen cots (badly stained) are arrayed six inches apart awaiting the evening catch.

Silently, we take our places and prepare to pass the night with a borrowed blanket (no pillows) and what few belongings we may have brought along. On the cot to my right, an older black gentleman is audibly distressed—one of the estimated 25 percent of L.A. homeless who suffer from mental illness, including post-traumatic stress. Chances are good he is also among the half-to-three quarters of homeless who are not receiving mental health or other public benefits to which they are entitled. Neither the other shelter occupants nor staff seem to notice.

In a corner of the dorm next to the bathroom, a '90s vintage TV provides the evening entertainment; there is not a book, phone, or computer in sight. Come 8pm, the lights are turned off without warning and all I can hear is a roomful of heavy breathing and the sounds of cops and robbers on TV.

Sometime around 3am, I notice a few early risers gathering up their things to catch the bus to work (as I've learned in other cities, the line forms early at the temporary employment agency). Indeed, a majority of Los Angeles' homeless are either currently employed or were employed within the last year, further evidence that low-wage work does not pay enough to live a decent life. Making matters worse, nearly 4 million long-term unemployed will see their benefits cut under the sequester, according to the Department of Labor.

At 4am, the lights are turned back on and people silently gather up their things. Breakfast is a fruit cup and two slices of white bread (no butter) served in a paper bag as we exit the shelter and go our separate ways into the cool, dark morning. Another day in the land of the down-and-out.

Although sequestration is never mentioned by the homeless people with whom I passed the night, its effects will soon be felt in places like this when federal funding for emergency shelters is cut and an estimated 100,000 homeless people are sent back onto the streets. Add to that the countless other federal and state programs that are not specifically geared at homeless people but on which they and millions of other low-income citizens rely—like foreclosure prevention services, nutrition assistance for infants and mothers, job training and jobless benefits for the unemployed—and the risks to the already-insecure are greater still.

--

These and other challenges that I encountered in my research point to more than mere intransigence on the part of our political leaders; they point to a lack of democracy at home.Mounting evidence in political science and other fields shows that socio-economic status profoundly affects the amount of political power a citizen commands. As a recent study found, when the interests of affluent Americans diverge from their low-income counterparts, the latter are completely overlooked in the policymaking process. It seems economic and political inequality are increasingly one-and-the-same.

Against this backdrop, we see that poverty is more than an economic or social concern. It is embedded in the very structure of our society and grounded in an unjust distribution of political power. Put differently, poverty is a democracy problem and the poor have lost their place at the table of American democracy.

To political leaders today, it seems to matter little that poor people walk the streets of our nation's capital and sleep on benches on Capitol Hill and outside the White House gates (I spent a chilly night in each place and do not wish to return). Indeed, in every state and community in the land, poor people clear the trash, pick the crops, man the gates, mend the clothes, mind the children, tend the aged, and deliver the goods that keep America going. They are ubiquitous. They are indispensable. Yet they are silent.

As many have argued before me, budgets are more than mathematical equations: they are moral expressions of who we are and who we seek to be, as individuals, families, communities, and a nation. This Easter season, let's hold our elected leaders to a higher standard—for the sake of neighbors in need and our democracy.

http://www.ethics.harvard.edu/lab/blog/291-the-fiscal-fallout-a-view-from-below

Whale-Sized Institutional Corruption: Regulatory Capture and the JP Morgan Derivatives Scandal

Gregg Fields

"It's a complete tempest in a teapot." JPMorgan Chase CEO Jamie Dimon on its London Whale trading losses, April 13, 2012

Clearly, Jamie Dimon has no gift for meteorology. When he made his infamous "tempest in a teapot" comment, the brewing storm of multi-billion dollar losses on derivatives at JPMorgan might more accurately have been described as a trans-Atlantic hurricane.

In a withering report released earlier this month, the Senate Permanent Subcommittee on Investigations paints a portrait of a multi-trillion dollar financial institution that gambled wildly on risky derivatives, freely rewrote their value to minimize reported losses, then doubled down on its bets when the red ink began to spew. All of this occurred under the allegedly watchful eye of American regulators.

For many, the report was a sobering reminder that, five years after the economic crisis, reining in risky trading by banks is at best a work in progress. "Our investigation brought home one overarching fact: the U.S. financial system may have significant vulnerabilities attributable to major bank involvement with high risk derivatives trading," Sen. Carl Levin, the Michigan Democrat and chair of the subcommittee, said in an opening statement at a hearing on March 15, one day after the report was released. "The four largest U.S. banks control 90 percent of U.S. derivatives markets, and their profitability is invested, in part, in their derivatives holdings, nowhere more so than at JPMorgan."

(Some very quick background: In early 2012, JPMorgan's chief investment office—or CIO—in London "placed a massive bet on a complex set of synthetic credit derivatives," according to the report. These trades were "so large in size that they roiled world credit markets." The phrase London Whale was reportedly a nickname for a JPMorgan trader named Bruno Iksil, known for making huge bets on derivatives. Some co-workers also reportedly called him Voldemort.)

In reading the massive report, (click here to download) it is impossible to miss the role that institutional corruption—in the form of regulatory capture—appears to have played in enabling the London Whale scandal to occur.

Regulators in Captivity

The theory of regulatory capture is most often linked to George Stigler, a Nobel-winning economist. It refers to the process by which regulatory agencies come to be "captured" by the industries they are overseeing. From there, serving the needs of the industry takes precedence over protecting the public.

In the case of JPMorgan, it appears to have worked like this: JPMorgan's chief regulator was the Office of the Comptroller of the Currency. But as a practical matter, the report contends, JPMorgan called the shots. "The OCC tolerated resistance by JPMorgan Chase to regulatory requests and failed to establish a regulatory relationship that mandated the bank's prompt cooperation with OCC oversight efforts," the report reads.

The subcommittee examined more than 90,000 documents in the course of its investigation, and the report runs 300 pages long. Most of the attention has focused on how the trades by the bank's CIO—followed by an increasingly frantic salvage effort—went horribly wrong, yet undetected by the OCC. But while the report levels plenty of criticism at JPMorgan, it also castigates the OCC for disastrous neglect of its regulatory duties.

"Over the past two years, the OCC failed to notice or investigate bank reports of CIO risk limit breaches, failed to realize when monthly CIO reports weren't delivered, failed to insist on detailed trading data from the CIO needed for effective oversight, and failed to take firm action when the bank delayed or denied its requests for information," the report says.

Establishing Boundaries

How could an agency seemingly as powerful as the OCC be captured by an industry? It helps to remember that JPMorgan isn't your typical bank. It has assets of $2.4 trillion. At several points, the report suggests, the company successfully convinced the agency it was overstepping its mandate. "Along the way, at times, bank personnel lectured OCC examiners about being overly intrusive," the report notes.

Often, the bank would resist giving out information to regulators. Conversely, after some examiners complained, it responded by burying them with a database of 60,000 derivatives contracts that examiners found incomprehensible.

"While the OCC's difficulty in obtaining information offers additional proof of the bank's unacceptable conduct, they also highlight, once again, the OCC's failure to establish an effective regulatory relationship with JPMorgan Chase," the report found.

And on some occasions, when the numbers revealed an inconvenient truth, the bank forgot to report them. Because the actual value of derivatives can be difficult to determine, sometimes the numbers got "tweaked" to make the losses appear smaller.

All too often, the OCC simply took the bank's word for it. "Ultimately, the OCC's excessive trust in the bank allowed the bank to avoid scrutiny... and was a central reason for the OCC's failure to challenge the unsafe and unsound derivatives trading activity,' the report says.

The OCC was so successfully kept in the dark that it learned of the enormity of JPMorgan's problems from news stories that began appearing in early April of last year. "The OCC told the subcommittee that it was surprised by the stories and immediately directed inquiries to the bank to obtain more information," according to the report. For reasons that aren't entirely clear, the OCC accepted JPMorgan's assurance that everything was fine. The OCC "actually considered the matter closed in late April," the report concludes.

While You Were Out

It helped that, at times, the OCC appeared to be asleep at the switch. For instance, JPMorgan did tell the OCC when the trading loss reached $1.4 billion, big enough to trigger

alarms. The regulatory response: nothing. It seems the examiner who normally reviewed that report "was then on vacation, his subordinates failed to notice the size of the loss and no one made any call to the bank to ask about it," the subcommittee found.

JPMorgan's London Whale scandal isn't the only recent evidence of regulatory capture by Wall Street's financial institutions. Another is the failure of Washington to implement the so-called Volcker Rule, named for former Federal Reserve Chairman Paul Volcker. The rule would theoretically restrict banks' ability to trade in derivatives with their own capital—so-called proprietary trading—although conducting such services for clients would be permitted.

The Volcker Rule is contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act passed nearly three years ago. And it might have prohibited some of the London Whale trading. But the rule is yet to be adopted, in part because of relentless resistance by major banks. In fact, Dimon has been among its staunchest critics. (Dimon has acknowledged he was "dead wrong" when he made the tempest in a teapot comment, however.)

In May of last year, the OCC got a new comptroller—Thomas Curry, formerly a board member at the Federal Deposit Insurance Corp. and former commissioner of banks for Massachusetts. According to the subcommittee report, OCC officials initially assured him the JPMorgan losses were no big deal. Curry begged to differ.

Curry is seen by some as the reformer the OCC needs. Others don't seem so sure. In a February hearing, Sen. Elizabeth Warren pressed banking regulators on the dearth of prosecutions stemming from the 2008 banking crisis. "We do not have to bring people to trial," Curry said. "We have not had to do it, as a practical matter, to achieve our supervisory goals."

Sen. Carl M. Levin (D-MI)

What's important to remember, Sen. Levin said at the recent JPMorgan hearing, is that regulatory failure like that exhibited in the London Whale saga must end. Regulatory capture, after all, is an insidious form of institutional corruption. More than a mere economic theory, it's a threat to the wellbeing of millions of Americans.

"When Wall Street plays with fire, American families get burned," Levin said. "The task of federal regulators, and of this Congress, is to take away the matches. The whale trades demonstrate that task is far from complete."

http://www.ethics.harvard.edu/lab/blog/292-whale-sized-institutional-corruption

Understanding Conflict of Interest Networks

Sebastián Pérez Saaibi and Juan Pablo Marín Díaz

Social Network Analysis can be used to understand a wide variety of systems such as research, biological or technological networks. In particular, it is a great tool to observe and analyze conflicts of interest and assess the risks that arise in the evolving relationships between individuals or institutions. By using these tools, one could not only analyze patterns but also understand observed behaviors in networks of individuals.

In this blog post we will show how *Social Network Analysis* can be used to understand conflict of interests. For this purpose, we will use a real example of the network formed by the Management Board of the 50 largest non-financial companies in Colombia. We will describe several properties related to the topology of this network, as well as the possible implications of these metrics.

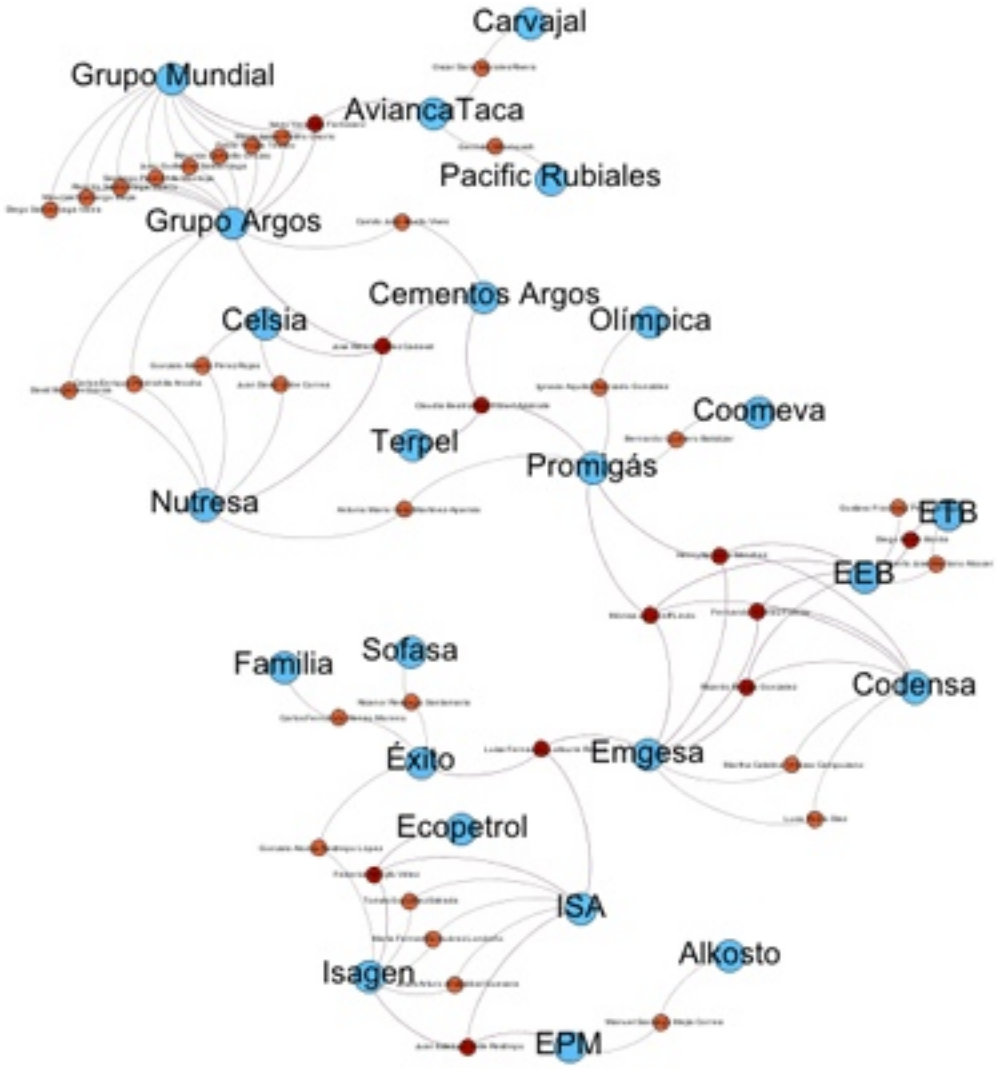
The original idea and diagnosis of the companies network was published in a joint effort ofaentrópico and La Silla Vacía. A brief description can be found here and the original piece (in spanish) can be obtained here.

The main idea is the following: The most important connections inside the 50 largest companies in Colombia are revealed and explained. Starting with a demographical stratification of the different companies, we explored some important aspects of their DNA, including education levels of their board members as well as their female representation levels. A network view of the participation of highly connected individual across several boards is presented on the article.

A subset of the complete network is shown below and will serve for demonstration purposes of how*Social Network Analysis* can be used to understand conflict of interests. In this network companies are depicted as blue nodes while board members are orange. Centrality of a node is illustrated by increasingly darker tones of orange.

As this is an affiliation network, it can be represented as a bipartite graph. This will be the focus of our analysis.

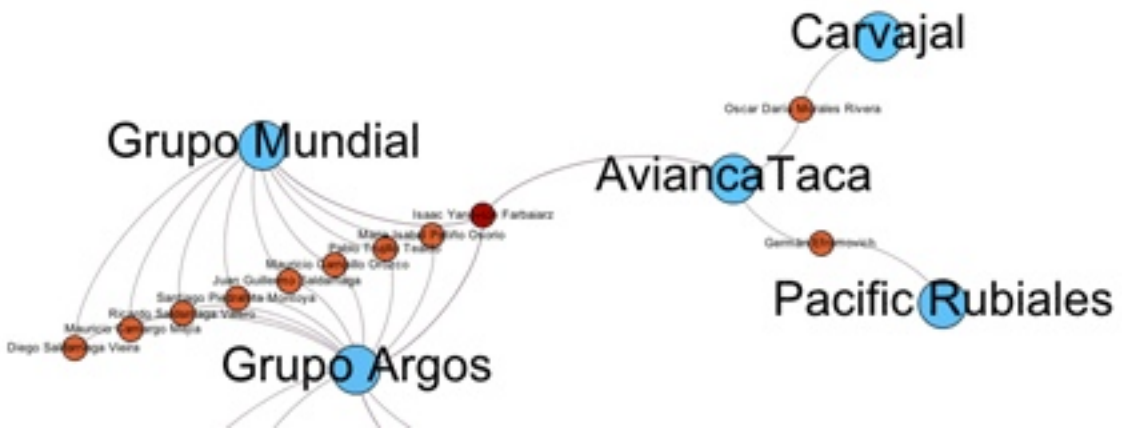
Management board networks



Interpretation of network properties

The network topology can give important insight on different aspects, including, but not limited to the structure of communities or information flows.

Clusters and bridges



A closer look to the top of the network reveals that **Grupo Mundial** and **Grupo Argos** have many members that belong to both boards, which reveals high connectivity between these two companies and thus they form a highly connected cluster. In this type of *cluster*, individuals tend to adopt the behavior of other individuals close to them and are resistant to outside influences.

There are other types of links offer different interpretations. If we look at **Isaac Yanovich** (darkest node) we see that he behaves as a bridge between two parts of the network. A *bridge* is a type of social tie that connects two different groups.

These nodes are of particular interest because they are *central* in the network in the sense that any information flow is expected to pass through them. In other words, any new information received by some node is very likely to come from a friend connected through a *local bridge*. Local bridges are important because they compose the shortest path between pairs of nodes in different parts of the network.

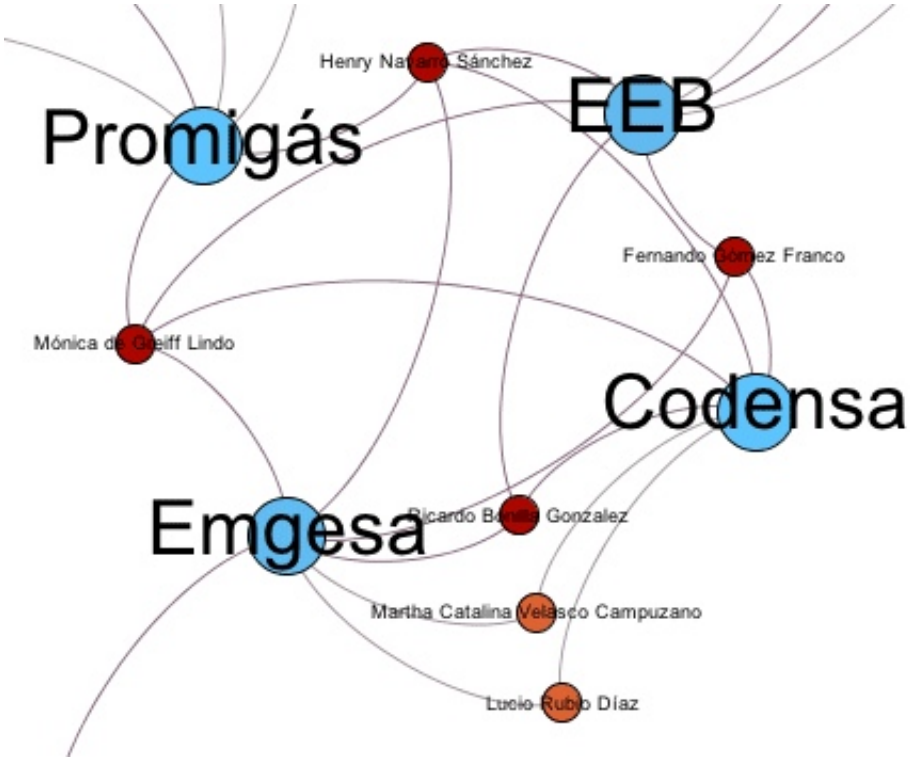
Nodes in a *local bridge* have riskier interactions in the network due to potentially contradictory norms and expectations from the different adjacent nodes associates.

Empirical studies of managers in large corporations have shown correlations of individual success within a company to their access to local bridges. Standing at one edge of a local bridge can also empower creativity and promote combination of multiple ideas.

Given their privileged access to a wide array of information sources, *bridge* nodes act as social gatekeepers and even prevent formation of triangles.

Triangles or triadic closures are important in networks as they are the simplest structure of a community. If two people in a social network have a friend in common it is very likely that they will become friends and start behaving similarly.

Triadic closures



Note that in the network of Colombian companies we can notice two types of *clusters*:

The first type, as shown in the previous example, is formed because of the similarity between companies (e.g. *Grupo Mundial* and *Grupo Argos*).

However, other clusters can be formed due to the presence of highly connected individuals. That is the case of **Mónica de Greiff**, **Henry Navarro**, **Fernando Gómez** and **Ricardo Bonilla** who are all linked to each other by simultaneously belonging to the management board of four different companies (**Promigás, EEB, Emgesa, Codensa**).

Clusters or closed communities are resistant to outside influences. Hence behavioral changes like the adoption of a new technology or the modification of an existing social norm can be slowed down and even blocked by the boundaries of a densely-connected community.

However, if there are incentives to adopt behaviors from neighbors, things can change dramatically and cascading effects can emerge. Given the appropriate conditions, certain behaviors can easily propagate through the network. This is the case of corruption incidents, where generally incentives to change the prevailing social norm tend to be much higher when these changes can benefit all the individuals in the network.

By using peer pressure, one could promote adoption of behaviors inside a community, enhancing the diffusion of a certain social norm for all individuals of the network.

Conflict of interest emerge mainly in *bridges*, where the structural balance of a group or community can be compromised because of emerging behaviors pushed by adjacent

communities. Sources of stress are often related to unbalanced triangles, where among 3 individuals, 2 adopt a behavior but the third one is still reluctant. However unbalanced triangles are not the norm since people try no minimize them by either changing their behaviors or breaking up links.

This post aims to be the starting point for a discussion on future research of conflict of interest based on *Social Network Analysis*.

Network Science Glossary

Affiliation network Two mode networks that allow one to study the dual perspectives of the actors and the events (unlike one mode networks which focus on only one of them at a time).

Bipartite graph: A graph that does not contain any odd-length cycles.

Bridge: An edge whose removal would lead to two distinct components. An edge is a local bridge whenever it is not in a triadic closure.

Cascading effect: An unforeseen chain of events due to an act affecting a system.

Centrality The various types of measures of the centrality of a vertex within a graph determine the relative importance of a vertex within the graph.

Cluster: Individuals that have a lots of connections with each other forming a closed community. This behavior has been observed in several networks: diseases, gossip, technology, etc.

Triadic Closure: The property among three nodes A, B, and C, such that if a strong tie exists between A-B and A-C, there is a weak or strong tie between B-C.

Topology: The arrangement of the various elements (links, nodes, etc.) of a network.

http://www.ethics.harvard.edu/lab/blog/293-understanding-conflict-of-interest-networks

How the Fed Came to See the Light: The Growing Role of Transparency in Monetary Policy

Gregg Fields

In 1913, Louis Brandeis, a future Supreme Court justice, wrote an article for *Harper's Weekly* that argued forcefully for greater transparency in government. "Sunlight," he said, "is said to be the best of disinfectants."

As it happens, 1913 is also the year the Federal Reserve Act was passed.

But the newly created central bank didn't seem to share Brandeis's esteem for open governance. Shrouded in mystery, the powerful and surreptitious Fed produced a league of investigative economists known as Fed-watchers. The rare utterances by the Fed and the Federal Open Market Committee—the arm that sets rates—were said to be written in a dialect called Fedspeak, each word scrutinized for hidden meaning. Books about the Fed had titles like *Secrets of the Temple*, a 1989 bestseller by William Greider.

The closed-mouth approach was emulated by central banks around the world. As Montagu Norman, who became governor of the Bank of England in the 1920s reportedly said: "Never explain, never excuse."

That philosophy was firmly in place when Janet Yellen began work as a staff economist at the Fed in 1977. It was a time when "the conventional wisdom among central bankers was that transparency was of little benefit for monetary policy and, in some cases, could cause problems that would make policy less effective," Yellen, now vice chair of the Fed, told the Society of American Business Editors and Writers in Washington on Thursday, April 4.

Much has changed, in no small part due to the financial crisis, when a besieged Fed had to reassure a panicked world. Communication and transparency would play a vital role in stabilizing the global economy. That newfound openness continues, and Yellen made clear she embraces the Fed's greater transparency. In today's world the Fed doesn't just say what it has done, it outlines what it plans to do.

"The effects of monetary policy depend critically on the public getting the message about what policy will do months or years in the future." she said.

The next Fed chief?

Yellen's views on transparency are important for a couple of reasons. One, as Brandeis suggested a century ago, transparency can be an effective deterrent to institutional corruption. While there's room for debate, there is no question that the secretive Fed, as an institution, has often been criticized for policies that seemed to favor banks over people. Furthermore, some have argued that its failure to contain the asset bubbles in things like real estate contributed to the banking crash. (The Fed's dual mandate is to stimulate employment

and contain inflation—policy goals that often clash. Fed members who prioritize job creation are known as "doves" while inflation fighters are referred to as "hawks.")

Whether the criticisms are justified isn't the entire point. The simple fact is that the public often didn't know much about Fed policies that directly affected them.

Yellen's views are also noteworthy because she is considered the front-runner to replace Ben Bernanke when his term expires next year. If that should happen, there's every reason to believe the Fed would continue on a path toward greater transparency. (In terms of policy, she is known for being a "dove.") Married to Nobel laureate George Akerlof, she would be the first woman to lead the Fed.

"But it isn't just Yellen's second X chromosome that makes her interesting," John Cassidy, author of 2009's *How Markets Fail: The Logic of Economic Calamities*, wrote recently in *The New Yorker*. "In a field noted for its conservatism and adherence to free-market orthodoxy, she has long stood out as a lively and liberal thinker who resisted the rightward shift that many of her colleagues took in the eighties and nineties."

To be sure, the Fed's move toward transparency was glacial. In 1994, for instance, the FOMC began issuing bulletins when it changed policies on interest rates. But no details as to why were provided. In the early 2000s it began providing its views on the economic outlook.

But the need for clear and prompt communication went into overdrive when the Great Recession slammed the world economy. Suddenly, the Fed had to communicate with a world that was fearful and angry. When cutting rates to zero provided limited relief, the Fed had to invent, and explain, new policies. An example is the so-called "quantitative easing," where it tried to stimulate the economy not by lowering rates but by pumping liquidity into banks.

Crisis management

"The situation in 2008 and 2009 was like nothing the Federal Reserve had faced since the 1930s," she said. "Beyond the task of describing the new policies, extensive new communication was needed to justify these unconventional policy actions and convincingly connect them to the Federal Reserve's employment and inflation objectives."

The result was a Fed that embraced transparency with the vigor it once resisted it. In 2010, Bernanke asked Yellen to lead a newly created subcommittee on communications. In 2011, Bernanke took the unprecedented step of holding press conferences after the FOMC's quarterly meeting. They are streamed live on the Internet. It was, at the time, considering a revolutionary break with tradition.

In early 2012, the FOMC released a statement outlining its longer-term goals and monetary policy—detailing, for instance, how it planned to let interest rates remain at record lows several years.

In the process, Yellen said, transparency was transformed from an experiment in accountability to a vital policy tool. That, she said, serves the public interest. For example, it takes the guesswork out of deciphering the Fed's long-term goals and strategies, reducing market uncertainty. "It's a revolution in our understanding of how communication can influence the effectiveness of monetary policy," she said.

No simple solutions

Clearly, transparency is no economic cure-all. Today's unemployment report—which showed just 88,000 new jobs created last month—shows the recovery is far from complete. Furthermore, financial regulators have come under fire for the sluggish pace at which the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010, is being implemented.

When I asked Yellen about Dodd-Frank, she said the sheer size of the mandate—the law is over 2,300 pages long—has created quite a logjam.

"It has been an enormous challenge to implement all that is in Dodd-Frank," she said. The Fed made a list after the law passed, she said, and identified 257 separate projects required by Dodd-Frank. Furthermore, adopting financial rules requires a great deal of time-consuming cross-agency cooperation, both in Washington and around the world. "We're working with regulators all around the globe to see if we can move together jointly," she said.

Looking ahead, Yellen said it's possible that an improved economy may eventually take the urgency out of Fed communications. "But I hope and trust that the days of 'never explain, never excuse' are gone for good, and that the Federal Reserve continues to reap the benefits of clearly explaining its actions to the public," she said.

http://www.ethics.harvard.edu/lab/blog/294-how-the-fed-came-to-see-the-light

Wheel of Fortune: As Regulators Spin Off Duties, Ex-Regulators Cash in as Consultants

Gregg Fields

In 2008, shortly after becoming chief of staff for the newly elected President Obama, Rahm Emanuel pondered the implications of the crumbling economy and pronounced: "You never want a serious crisis to go to waste."

It would appear that a select core of consultants employed by federal banking regulators took his advice to heart. A riveting Senate subcommittee hearing this week revealed how the foreclosure crisis may have wreaked unfathomable pain on millions of Americans, but for banking consultants certified by regulators, it meant a multi-billion dollar payday.

From an institutional corruption standpoint, the so-called Independent Foreclosure Review, initiated in 2011, bears scrutiny from several angles. From a revolving door position, the consulting firms who raked in huge fees are brimming with former regulators and other insiders. On the issue of transparency, what the consultants actually found remains largely undisclosed—even though the information is in the hands of regulators who ostensibly serve the public. As for conflicts of interest, there's the subject of whether regulators' first loyalty is to the public or the institutions they oversee. And there are unsettling symptoms of dependence corruption: The banks were paying the consultants who were examining them. Finally, there's the overriding issue of just why regulators are doling out contracts rather than do the job themselves.

What's clear is that this unprecedented effort to funnel public oversight functions to profit-driven firms on a massive scale was rife with problems that precluded achieving the primary public policy goal—assisting distressed homeowners. In a report released earlier this month, the Government Accountability Office listed a litany of issues and advised that "the foreclosure review process offers an opportunity for the regulators to leverage this experience to help ensure that similar difficulties are better addressed in future efforts." It was the second time the GAO issued a report critical of the foreclosure review.

Hope and Promise

Time will tell if the GAO's hopes are realized. But first, some quick background on the promising beginning when the foreclosure review effort was announced.

In 2011, 14 large mortgage servicers—including most of the country's major banks—were ordered by the Federal Reserve and the Office of the Comptroller of the Currency to hire the consultants to review foreclosures filed in 2009 and 2010. The mission: look for legal errors, shoddy paperwork and other problems, to determine possible damages. Sampling was allowed, to ascertain the error rate.

"These comprehensive enforcement actions, coordinated among the federal banking regulators, require major reforms in mortgage servicing operations," John Walsh, acting Comptroller of the Currency at the time, said. "These reforms will not only fix the problems we found in foreclosure processing, but will also correct failures in governance and the loan modification process and address financial harm to borrowers."

No question, many of the consultants hired knew banking—they were in fact former regulators themselves. Perhaps the most prominent consultant was Promontory Financial Group, founded by Eugene Ludwig, who formerly headed the OCC in the Clinton administration.

Though it was only founded in 2001, Promontory has quickly become known as a Washington power player. Just recently it also hired Mary Schapiro, who left as head of the Securities and Exchange Commission last December. Press reports regularly refer to Promontory as a "quasi-regulator" for its role as a conduit between government and bankers.

Regulators initially wanted the job done in 120 days. In fact, it's a task that will never be completed. The Independent Foreclosure Review was scuttled prematurely in January, and a settlement with most of the banks, covering 90 percent of the cases, was announced. The agreement was touted as valued at $9 billion. However, homeowners are actually only entitled to $3.6 billion in cash, the rest of it in things like advice on avoiding foreclosure.

Regulators had let it be known that some recipients would get up to $125,000. But this week the Fed and OCC issued a payout schedule that showed a bare handful of people will receive that amount. Most of the recipients had mortgage servicing issues, but didn't face foreclosure. For the majority of those the payment is just $300.

At Thursday's hearing of the Senate's subcommittee on financial institutions and consumer protection, both regulators and consultants defended their reviews, though acknowledging certain flaws. But Sen. Elizabeth Warren, the Massachusetts Democrat, said the process smacked of cover-up.

Little Specific Information

Warren said she and Rep. Elijah Cummings, a Maryland Democrat, had made 14 specific requests for documents from the OCC and the Fed since January. "You have provided only one full response, three partial or minimal responses and no responses to nine requests," Warren said. "You've provided little specific information, such as the number of improper foreclosures."

Sen. Sherrod Brown, an Ohio Democrat who chairs the subcommittee, said that the role of former regulators as consultants raises the troublesome issue of revolving door syndrome. Even if consultants and regulators mean well, the constant flow of regulatory talent to lucrative jobs at shops like Promontory produces what Brown called "cognitive capture." In other words, the adversarial element of the banker-examiner relationship is supplanted with more symbiotic thinking. With "the influence of the revolving door, bright-line rules become all the more important," he said.

Besides its former regulators on staff, Promontory's advisory board includes Alan Blinder, the highly regarded Princeton economist and former vice chair of the Fed, Arthur Levitt, the former chief of the SEC, and Stephen G. Thieke, who was executive vice president of the

Federal Reserve Bank of New York in the 1980s before becoming a managing director of JPMorgan. The company's co-founder, Alfred Moses, was once special counsel to President Carter.

Such close ties might call into question the influence the independent consultants have with regulators. But Daniel Stipano, the OCC's deputy chief counsel, maintained that's a non-issue.

"In all of these cases, the OCC considers the qualifications" of the consultants, Stipano said at the hearing. "The OCC also oversees and monitors the work of the consultants."

But that system failed—badly—during the Independent Foreclosure Review, both sides agreed, in one of the hearing's few moments of consensus. Consultants testified that it was immediately apparent that the 120-day deadline was unrealistic for reviewing 4 million home loans. Some consultants began sending work abroad, Brown said.

"We had a history of requiring banks to retain consultants in the past," said Richard Ashton, deputy general counsel for the Fed. With foreclosures, "we thought that model could be adopted. What we found out, in practice, was the scope was so extensive it just was not effective."

Brown, meanwhile, repeatedly asked why, if the program was so badly flawed, billing was allowed to rise to $2 billion before the plug was pulled. "I don't think that decision was driven by compensation being paid to consultants," Stipano, of the OCC, said.

The Outsiders

The Senate hearing was titled, "Outsourcing Accountability?" And its focus on outside consultants reflected a growing reality that has institutional corruption implications. Specifically, regulatory agencies are increasingly reliant on consultants because they lack the institutional resources to do the job themselves. This has the effect of introducing a profit-oriented constituency into an oversight function that is purportedly accountable first and foremost to the public.

"The problem with having the OCC do the job itself is, it's just beyond the means" of any banking agency, Stipano said. He said the agency might have needed to triple its staff to handle the foreclosure reviews, something that wasn't feasible.

After a recess, Brown returned to a situation that hinted at what students of institutional corruption sometimes call dependence corruption. The dynamics: The consultants are there at the behest of the regulators. But they're actually the client of the banks, who are paying the fees. (At Thursday's hearing, PricewaterhouseCoopers, one of the lead consultants, said it billed over $400 million conducting foreclosure reviews.)

"You work for the banks, they pay you, but you're supposed to represent the public interest," Brown said to several consultants who'd been asked to testify. "That's almost an inherent, automatic conflict of interest." It's a pattern that resembles the highly criticized pre-crisis pattern with credit rating agencies, which gave glowing ratings to toxic mortgage securities being offered by their clients.

Konrad Alt, managing director of Promontory Financial, conceded there's an issue. "There is an inherent conflict, and you are right to focus on it," he said. But he added that, "there

are checks, and the primary check is regulatory oversight. We met with regulators constantly."

Clearly Not Transparent?

Warren, however, added that conflict of interest concerns extend to regulators as well. When the foreclosure review was announced in 2011, it was hailed as an effort to bring relief to besieged homeowners. But in practice regulators appear to be siding with banks, she said. As one example, consultants gathered data on foreclosures that appear to have violated laws. But the OCC is keeping that and most other information collected to itself. Given the dearth of details, it's impossible to judge whether the settlement is fair or not, Warren said.

Stipano, the OCC official, said revealing information like error rates on foreclosures would violate confidentiality agreements it has with financial institutions, although it could occur in the future.

"So you've made the decision to protect banks, but not to help families that have been foreclosed illegally," Warren said. "You know individual cases where banks violated laws and you're not going to help the homeowners. Without transparency we can't have any confidence in your oversight or that the markets are functioning properly at all."

http://www.ethics.harvard.edu/lab/blog/295-wheel-of-fortune

Capital Opportunities: A Watchdog Journalist's Take on Washington's Legalized Corruption

Gregg Fields

Charles Lewis didn't plan a career as a crusading journalist in Washington. In fact, he had planned on going into politics himself. The Delaware native arrived in D.C. in 1974, as an intern for the late Sen. William Roth, a Republican.

The Watergate scandal was cresting, and it sparked a disenchantment that steered Lewis to reporting. "I didn't really become obsessed with corruption," Lewis said Thursday night, in a lecture sponsored by the Edmond J. Safra Center for Ethics. "But I began to notice patterns."

His journalism career included stints at ABC News and the 60 Minutes news program. But even as his career flourished, the former Eagle Scout became unsettled by a growing belief that Washington—and corporate journalism—operated by rules that all too often provided cover for abhorrent public governance. And one recurring pattern he noticed was that typically no laws were broken. "Most of the problems seemed to be legal," he said.

In 1989, Lewis left TV and founded the Center for Public Integrity, one of the pioneers of the nonprofit investigative journalism movement. "I don't necessarily recommend walking out of your job not knowing what you're going to do next," Lewis, who funded the startup himself, said. "But that's what I did."

The CPI has since won innumerable awards and salutations, and Lewis himself received a prestigious MacArthur Fellowship in 1998. But the CPI will perhaps forever be best known for revealing how the Clinton White House rewarded major donors with stays in the Lincoln bedroom.

"We are the skunk at the garden party," he acknowledged to *American Journalism Review* in a 2005 profile. The article noted that he got his start poking at power early, with a high school newspaper column that anonymously took administrators like the principal to task.

Reporting For Duty

When he founded CPI, Lewis was as frustrated with the clubby world of inside-the-Beltway journalism as with questionable conduct by government officials. An example: the dearth of reporting related to the Iran-Contra scandal. In Iran-Contra, high officials in the Reagan administration secretly sold arms to Iran in part to covertly raise money for funding Nicaragua's Contra rebels, which Congress had explicitly barred.

"Most reporters found out about it from the Attorney General announcing it," he said. The scandal led to the indictment of several top Reagan administration leaders, including Defense Secretary Caspar Weinberger. Weinberger would be pardoned by President George H.W. Bush prior to trial. Although the scandal dates back more than 25 years, the reality is

that the coverup continues, Lewis said. "We still don't have all the Iran-Contra documents," he said.

Lewis left the executive director's job at CPI in 2005 and is currently a professor at American University in Washington, where he is executive editor of the Investigative Reporting Workshop.

In his talk, Lewis emphasized that, in most cases, egregious conduct by Washington's officialdom isn't illegal. That's the problem. "The thing that bothers me is this word corruption," he said. "Most people think it means illegal. It doesn't mean that, if you look it up. You can call it systemic corruption. I call it legal corruption." (And for the record, the Edmond J. Safra Center prefers the term "institutional corruption.")

Around We Go

An example of the kind of corruption Lewis was referring to: the unrelenting revolving door, where government officials leave to work for much bigger salaries at entities they formerly regulated. When the CPI looked at the U.S. Trade Representative's office, it found that 47 percent of people who quit went to work for foreign governments or corporations. In another case, he found that 80 percent of departing employees from the Superfund hazardous waste cleanup program left for jobs with contractors to the Environmental Protection Agency.

Besides the revolving door, he found that regulatory capture, a common institutional corruption syndrome, is very real in Washington. The U.S. Forest Service, for instance, was "basically shilling for the timber industry."

And the conflicts of interest arising from campaign contributions were symbolized when Congress refused to toughen food inspection standards—pleasing powerful agribusiness interests—despite rising numbers of E. coli infections. "Funny, that legislation requiring the USDA to do it just never made it out of committee," Lewis said.

Furthermore, a close examination of defense spending showed it primarily went to companies that gave lavishly to the political process, and frequently employed former military officials to do their bidding. "Essentially, what we found was 40 percent of all defense contracts have no competitive bidder," he said. "There's all this transparency issue."

Money Changes Everything

It is the defining role of money in Washington which Lewis finds the most intriguing. For instance, when magazine publisher Malcolm Forbes ran for president largely on a "flat tax" platform, Lewis took Forbes's financial disclosure forms to an accountant. The conclusion: a flat tax would cut Forbes's tax bill in half.

On a broader level, Lewis concluded that all the money funneled to candidates simply undermines democracy. "I noticed that the presidential candidate who raised the most money the year before the primaries was getting the nomination every time," he said. "It meant money was dictating our choices even before there was a single vote." He later added: "Money and power go together—always."

That conclusion led to "The Buying of the President," a series of books, beginning with the 1996 campaign, that document the financial forces that determine who occupies the Oval

Office. His assessment: "We have a really fundamentally broken system here." In Washington, he said, "we always say it's the most expensive election in history—until the next election."

Despite having reached some somber conclusions regarding Washington corruption, Lewis actually spoke with a gentle and self-deprecating tone. He acknowledged not having the answer to the institutional corruption problems plaguing Washington. "It's not enough to throw the bums out in the next election," he said. "It's actually a much more endemic problem."

But he did offer a theory as to why Frank Capra never made a sequel to *Mr. Smith Goes To Washington*. "It becomes a Stephen King movie," he quipped.

http://www.ethics.harvard.edu/lab/blog/296-capital-opportunities

Just Asking: An Appeal for Voluntary Disclosure

Brooke Williams

Scholars at these think tanks have attracted media attention as experts on everything from China's defense spending, to drones and oil pipelines, to new toll lanes and Medicaid. Just in the past week, they've collectively released dozens of policy and research papers. They're shaping decisions that impact our day-to-day lives.

But who is funding their work? At 16 of the top 50 think tanks in the country, as ranked by James McGann for his report at the Think Tanks and Civil Societies Program at the International Relations Program, University of Pennsylvania,[1] it's tough to say. Unlike others on the list, they don't disclose donors. Indeed, some promise anonymity.

To be sure, the 16 think tanks vary widely, from a shop in Los Angeles advancing a free market, libertarian agenda, to a progressive group in Washington, D.C. whose executives have ties to the Obama administration and are among the most frequent visitors to the White House. However, they all have two things in common: they're considered to be among the most influential think tanks, and they don't provide the public with details on where they get money.

So we asked.

On April 16, we mailed letters to the top executives of 16 think tanks asking them to voluntarily disclose a list of any corporations, corporate foundations, and foreign governments that donated in the past five fiscal years, and how much these entities had given the think tanks. We will provide updates on their responses.

These letters are part of an ongoing project at the Edmond J. Safra Center for Ethics that is examining how corporations and foreign governments donate to think tanks and shape public discourse and policy and from behind the scenes, often leaving the public in the dark about how and why they're involved. In addition to asking, we are gathering data on corporate and foreign government donors from tax filings and other records in an effort to make at least some of the information publicly available.

Although more narrow in scope, this type of request worked well for author Stephanie Epstein and Charles Lewis, founder and then-executive director of the Center for Public Integrity, a nonprofit journalism organization in Washington, D.C, for "Buying the American Mind" in 1991. They asked a handful of think tanks to disclose donations from the Japanese government or interests. Five think tanks reported receiving $5.4 million in donations from Japanese interests between 1985 and 1990. Epstien found that those receiving that funding were the same think tanks promoting policies favorable to Japanese interests.[2]

Most think tanks in this country are nonprofit organizations, and the law does not require them to disclose donors. Even so, many do. While following up on the letter we sent, we've asked some of the 16 institutions why they choose not to disclose.

At the Competitive Enterprise Institute in Washington, D.C., which seeks to advance "principles of limited government, free enterprise, and individual liberty," Sam Kazman, general counsel for CEI, says it is about protecting the privacy of donors who don't want to

be named. He pointed to five Supreme Court rulings, as well as several from lower courts, addressing "the importance and the constitutionally-protected status of donor confidentiality."

"If you think about the situation in the South in the 1950s, you can imagine what the impact of compulsory disclosure would have meant for groups like the NAACP," Kazman said.

Kazman said CEI does not accept money from foreign governments.

The Center for American Progress, a progressive think tank in Washington, D.C., takes credit for shaping national debate on its website, but does not say who is paying for it.

CAP spokeswoman Andrea Purse said CAP "follows all financial disclosure requirements with regard to donors."

"Our policy work is independent and driven by solutions that we believe will create a more equitable and just country," she said.

At the National Bureau of Economic Research in Cambridge, Massachusetts, President James Poterba said scholars must disclose all sources of funding in every paper it publishes. Period.

That said, he acknowledged NBER does not reveal the names of donors who contribute to its general operations. The most recent tax filings show nearly 82 percent of $33.3 million NBER received in 2010 was in government grants. Poterba said the remaining $6 million came from foundations, corporations and individuals, which the organization does not name.

NBER is different from many other think tanks since it does not take positions or make policy recommendations, though Poterba said he certainly hopes lawmakers are reading the papers.

Poterba said our request for voluntary disclosure has caused his organization to consider, "Should we be doing something different here?"

"We'll certainly think about this question," he said.

At the American Enterprise Institute in Washington, D.C., unnamed corporate donors can "gain access to the leading scholars in the most important policy areas for executive briefings and knowledge sharing."

"We respect the privacy of those who choose to contribute and therefore we do not publicly list donors," AEI spokeswoman Judy Mayka said in an email.

At the Manhattan Institute for Policy Research in New York City, donors who give $25,000 can "engage in one-on-one meetings with Institute Scholars," among other things. Spokeswoman Lindsay Craig, said in an email that the think tank doesn't name them because "donor information is private."

http://www.ethics.harvard.edu/lab/blog/297-justask

---

[1] "2012 Global Go to Think Tanks Report and Policy Advice," James G. McGann, Ph.D., Director, Think Tanks and Civil Societies Program, University of Pennsylvania, page 49

[2] "Buying the American Mind: Japan's Quest for U.S. Ideas In Science, Economic Policy, & the Schools," Stephanie Epstein, Center for Public Integrity, chapter IV, pages 36, 37

Exploding Influence: How Lax Oversight Won by Industry Lobbyists Lessens Safety

Sheila Kaplan

The Boston Marathon bombers may have acted alone. The owner of the deadly West, Texas fertilizer plant did not.

Explosions rocked two American cities last week. In Boston, the Marathon bombing killed three people and wounded dozens more; and in West, Texas, a blast and fire at a fertilizer plant killed at least 14 people and injured at least 170, according to news reports.

In each case, investigators mobilized. In Boston, the city shut down while law enforcement authorities hunted for a suspect—ultimately finding a bloody trail that led to his hiding place in a dry-docked boat. (The other suspect was killed earlier in a firefight with police.)

In West, where the disaster at Adair Grain Inc.'s fertilizer plant blew the roof and walls off a nearby apartment complex and carved a crater in the town, investigators are still trying to figure what happened, and who is to blame. When they do, it's likely that trail will lead to Washington, D.C., and a suspect called institutional corruption.

Three excellent news articles show why.

As Bloomberg News reporters Mark Drajem and Jack Kaskey reported on April 19,

"The Texas plant that was the scene of a deadly explosion this week was last inspected by the Occupational Safety and Health Administration in 1985. The risk plan it filed with regulators listed no flammable chemicals. And it was cleared to hold many times the ammonium nitrate that was used in the Oklahoma City bombing."

"For worker-and-chemical safety advocates who have been pushing the U.S. government to crack down on facilities that make or store large quantities of hazardous chemicals, the blast in West, Texas, was a grim reminder of the risks these plants pose. And they say regulators haven't done enough to tackle the problem."

The reason is suggested later in the story—by President Barack Obama. As Drajem and Kaskey wrote, "During his campaign, Obama promised to 'secure our chemical plants by setting a clear set of federal regulations that all plants must follow.' Just days before the election he mentioned it as an example of where government regulation is needed, despite industry pressure.

"Well, I think it's a classic example of special interests lobbying," Obama told MSNBC television. "There has been resistance from the chemical industry."

U.S. Senator John Cornyn (R-Texas), told Bloomberg News he was 'confident' the blast would lead to a review of the government's chemical plant safety rules," Drajem and Kaskey reported.

But stronger oversight of the industry will face continued resistance.

In an article published last week, entitled "Fertilizer trade group opposed stricter security rules," Jim Morris, an incoming Edmond J. Safra Lab Fellow and a senior reporter for the Center for Public Integrity, a non-partisan investigative reporting group, wrote that like many, "the Fertilizer Institute, a trade group, has extended its condolences to the people of West, Texas." Morris continued, "The Washington-based institute, however, has lobbied against legislation that would require high-risk chemical facilities—including some of its members—to consider using safer substances and processes to lower the risk of catastrophic accidents and make such facilities less inviting to terrorists."

According to Morris, Senate records show the institute has spent $7.4 million on lobbying since 2006. On its website, Morris reported, the organization notes that it supports existing rules enforced by the Department of Homeland Security and opposes any expansion of the rules "to mandate inherently safer technologies."

In a 2011 letter to the chairman and ranking member of the House Homeland Security Committee, the institute and nine other groups maintained that "America's agricultural industry has limited resources available to address all security related matters and it is very important that those resources are spent wisely to coincide with the appropriate level of risk for each particular facilities…," Morris reported. He also noted that after 9/11, the Environmental Protection Agency drafted legislation to steer companies toward disaster prevention, but that the Bush White House opposed it.

And, in an article published by the Sunlight Foundation, a DC-based nonprofit group that advocates greater government transparency,[1] staff writer Lindsay Young blames Congress and the special interests that target it for lax oversight.

"Consider the Agricultural Retailers Association," Young wrote, "a trade group whose members include suppliers of pesticides and fertilizers, and the Fertilizer Institute, which bills itself as the voice of the fertilizer industry."

"Since 1998, the specific issues that appear most frequently in their lobbying disclosure reports are bills dealing with the safety and security of chemical facilities. During that period, the Agricultural Retailers Association has spent a cumulative $2.9 million on lobbying while the Fertilizer Institute has spent even more, some $14.4 million," she wrote.

Young wrote that, in its lobby disclosure form on file with the Senate, "the Agricultural Retailers Association clearly states its opposition to EPA regulation of fertilizer safety. The group listed 'Work with EPA to clarify their new Emergency Planning and Community Right-to-Know Act interpretation of fertilizer retailer to exclude facilities that blend fertilizer,' among its specific lobbying issues."

She also noted that West Fertilizer Co., where the explosion took place, was a retailer that blended fertilizer—although she quoted Richard Gupton of the Agricultural Retailers Association saying that neither Adar Grain nor West Fertilizer are members.

--

Today the White House announced that President Obama and the First Lady will attend a memorial service for the West, Texas, victims.

[1] Professor Lawrence Lessig, director of the Edmond J. Safra Center for Ethics, is a member of the Sunlight Foundation's advisory board.

http://www.ethics.harvard.edu/lab/blog/298-exploding-influence

Insider Accounts of Institutional Corruption

Garry C. Gray

I have a vivid memory of the moment when I discovered that a company I worked for was scamming people in the name of the local wheelchair basketball association.

I was fourteen years old and my job was to phone people in the community to ask if they'd like to support the association by purchasing coupon books. It seemed like a win-win, and I remember that many people were happy to help out. Rarely was anyone suspicious enough to ask how much of the proceeds the association actually received. As soon as I said the words "wheelchair basketball" I had primed them into the spirit of giving, or otherwise declining regretfully. I eventually discovered from another employee that the association received only 10% of the funds. I was appalled.

The whole business model depended on people making the good-hearted assumption that the wheelchair basketball association would be receiving a substantive portion of the proceeds. There was no doubt in my mind that coupon book sales would have been dismal had we openly and directly disclosed their meager 10% cut. Nevertheless, I realized that the "good worker" could shrug off remarks that the practice was unethical, by citing the fact that everything was legal, or pitching the "they didn't ask" argument. But no amount of insight or rationalization could alleviate the uneasy feeling in my gut that only we, the insiders, knew what was going on, and the public trusted us.

My employment there didn't last long, but it did have lasting effects on my research years later. Becoming an insider seemed to be the ultimate strategy to examine the research questions I was asking. It was the ideal way to generate understanding about implicit and normalized behaviors inside organizations, and the ways that local cultures influence everyday decision-making. However, as researchers, the methods we select are a function of time, resources, access, and training, as well as ethical considerations that guard against possible harms to research subjects. In other words, in many—if not most—cases, it is not possible for scholars to become true insiders who can generate insights first-hand through a combination of experience, immersion, and direct observation, as inspired by Bronislaw Malinowski and Margaret Mead in their early ethnographic studies.

Alternatively, the insider account offers another path to discovery. Insider accounts can be extremely fruitful, especially if the researcher is skilled at palpating the contours and nuances of the insider's opaque world. This is what Lawrence Lessig strived to do when he interviewed Jack Abramoff as part of the "In the Dock" series at the Edmond J. Safra Center for Ethics at Harvard University. Corruption in Congress, particularly as it has manifested in the interactions between lobbyists and public officials, has become a systemic problem that extends far beyond Abramoff's individual behaviors. Abramoff was an insider willing to talk about this.

Abramoff's insider accounts have provided a lens for analyzing the rationalizations, patterns of interactions, and insider tricks of the trade that are used to perpetuate the social organization and structure of institutional corruption in lobbying and Congress. In my recent article, Insider Accounts of Institutional Corruption: Examining the Social

Organization of Unethical Behaviour published in the British Journal of Criminology (2013), I draw on Abramoff's insider accounts to not only provide this analysis, but also to demonstrate the use of insider accounts as an empirical pathway into examining the world of professional misconduct and unethical behavior.

Although insider accounts are not representative, they do reveal structures, loopholes, and contexts that are conducive to unethical behavior. The article describes five techniques that Abramoff employed to his advantage: 1) the creation of fronts through non-profit organizations and advocacy groups, 2) indirect gifting, 3) revolving doors of employment, 4) corrupt riders, and 5) creating conditions to rationalize unethical behavior. Drawing on the weaknesses of the system, he actively established and exploited dependencies by members of Congress and their staff. These actions, he explained, are widely practiced and constitute a system of institutional corruption that is still operating today.

Whereas the formula that telephone solicitors might use is relatively straight-forward to understand, Abramoff has described a series of complex and nuanced techniques designed precisely to obscure unethical behavior from the public eye. One of the difficulties of researching unethical behavior is that these practices are often embedded within seemingly lawful institutional activities. The scholar must then consider how it might be possible to discover, tease apart, and disrupt these less visible normalization patterns of unethical behavior.

Insider accounts, while difficult to obtain, provide key insights into the subtle and often taken-for granted routines of professionals. They can make visible practices that insiders may enact unreflectively, but which an outsider analyzing the account may be able to discern. In this way, they can be a window to sophisticated and insidious modes of institutional corruption that threaten the integrity of our public institutions, and the trust they depend on for continued legitimacy.

http://www.ethics.harvard.edu/lab/blog/299-insideraccounts

Institutional Corruption and the Big Bang Theory

Gregg Fields

Like long-ago explorers of the Nile, those searching for the source of institutional corruption face a complicated task. Downstream, it's comparatively easy to spot the currents of cash, conflicts and captured regulatory agencies.

But where are the headwaters? This week, a proposed banking reform law provided valuable insight into how the process starts.

The bill unleashed a series of explosive reactions from Wall Street, where it was viewed as an invasion of their economic ecosystems. Powerful trade and lobbying groups, plus a recently minted industry-funded study, blasted the proposal. And in Congress, where financial industries are the number one donor, there was a deafening silence—not one co-sponsor signed on, according to the *Financial Times*.

So while the fate of the proposal remains uncertain, and its merits or lack of them can be honestly disputed, its hostile reception provided a rare glimpse at the moment of conception for a process that in the past gave rise to institutional corruption. Exhibit A would be the regulatory failures prior to the 2008 economic collapse.

Exhibit B might be what hasn't happened since. Five years after the crisis, safeguards against future publicly financed bank bailouts are yet to be instituted, amid perpetual Washington infighting and industry lobbying that totaled $482 million last year, according to opensecrets.org. By leaving taxpayers vulnerable to funding future bailouts, the public interest clearly hasn't been served—a key indicator for institutional corruption.

"If big banks want to continue risky practices, they should do so with their own assets," said bill co-sponsors Sens. Sherrod Brown, an Ohio Democrat, and David Vitter, a Louisiana Republican, in a prepared statement. "Our bill will ensure a level playing field for all financial institutions by ending the subsidy for Wall Street megabanks to have adequate capital to back up their liabilities."

TBTF, The Sequel

The legislation in question is nicknamed TBTF, for Terminating Bailouts for Taxpayer Fairness Act. It's something of a playful acronym because it takes aim at another TBTF—the so-called too-big-to-fail regulatory policy. Too big to fail holds that some banks are so systemically important that allowing them to fold would imperil the economy. Critics contend it's a license to, economically speaking, drive recklessly.

The battle for hearts and minds began in earnest Wednesday morning, when Brown and Vitter announced their proposal in an op-ed in *The New York Times*. "Progressives and conservatives can debate the proper role of government, but this is one principle on which we can all agree: The government shouldn't pick economic winners or losers," they wrote.

Too big to fail was the justification for government bailing out banks in 2008. The new law would require banks to raise their levels of capital, or net worth. That wouldn't end too big to fail. But it would theoretically diminish the chances of bailouts because banks would have more resources to weather a downturn. The capital standard would be most rigorous, at 15 percent, for banks over $500 billion in assets: JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley, according to Federal Reserve figures.

"Our number one goal is to protect taxpayers from financial risks and the best way to do this is by implementing a systemic solution, increasing the minimum amount of capital the mega banks are required to have," Vitter said. (Under the bill, the U.S. would also walk away from the international Basel III banking reform measures.)

Almost immediately came the response from the Securities Industry and Financial Markets Association, or SIFMA. Among other things, it questioned whether banking regulation was the responsibility of the Senate. Reforms regarding too big to fail have been mandated by the Dodd-Frank Act, it noted. And abandoning Basel III "would be an abdication of U.S. leadership," it said.

"We should focus on completing the remaining rulemakings mandated by Dodd-Frank instead of enacting new legislation that would undermine the U.S.'s standing in the global financial system,"SIFMA said.

How Things Don't Work

It's worth questioning, however, whether relying on Dodd-Frank is essentially voting for the status quo. The law passed nearly three years ago, and has become something of a poster child for institutional inertia. According to the Davis Polk law firm, which tracks Dodd-Frank, 63 percent of the law's rulemaking deadlines haven't been met.

In some cases, critics say the 2,300-page Dodd-Frank law corrupts the regulatory process by scattering oversight of banks among an almost unlimited number of agencies. These include the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Reserve, the FDIC and the Commodity Futures Trading Commission. Regulatory capture is easier because banks can play one agency against another as they adopt inter-agency rules. Also, regulators are often outgunned by industry. SIFMA, for instance, has successfully sued the CFTC—which Dodd-Frank charged with regulating derivatives, without allocating any resources—to overturn new rules that got adopted.

The financial industry is also developing an arsenal of intellectual capital that makes the case against reforms. On April 9, a leaked draft of the Brown-Vitter proposal appeared in news reports. On April 10, the Clearing House Association, a trade group owned by the world's largest commercial banks, released a fortuitously timed study by Oxford Associates. It concluded that raising capital standards for banks could mean a significant drop in economic growth—perhaps a loss of 1 million American jobs over nine years.

"We urge policymakers to carefully consider the economic and employment tradeoffs as they debate further increases to bank capital levels," said Paul Saltzman, president of the Clearing House Association.

Curiously, the industry-funded study's findings clash with previous studies by organizations like the International Monetary Fund and the Bank of England. The IMF's 2012 study conceded tighter regulation might increase banks' costs. "Yet banks appear to have the ability

to adapt to the regulatory changes without actions that would harm the wider economy," the IMF study said.

In explaining the disparate conclusions, the Clearing House said, "Oxford sought to improve upon the assumptions of prior studies to better align them to the economic and regulatory reality in the United States."

The dueling studies aren't the only conflicting narratives. For instance, several critics on Wednesday described the proposal as a "bank breakup" bill, even though it doesn't call for that.

Good-Bye To All That

Ultimately, some Washington insiders were already writing the bill's obituary. Sen. Tim Johnson, chairman of the Senate Banking Committee, has previously said he believes Dodd-Frank should be implemented before Congress tackles other financial regulatory issues, according to Bloomberg. The opensecrets.org website ranks securities and investment firms first in campaign contributions to Johnson, who's from South Dakota, while commercial banks are third.

Furthermore, the ranking Republican on the Senate Banking Committee, Mike Crapo of Idaho, recently told Bloomberg he believes capital requirements are the job of regulators, not Congress. Crapo's top two contributors are JPMorgan and Goldman Sachs, according to opensecrets.org.

Curiously, the one point of consensus regarding the bill was that too big to fail should be scrapped. "We continue to believe that no institution should be too-big-to-fail and that taxpayers should never again be put at risk in a future financial crisis," SIFMA said.

But Brown and Vitter noted that, while Washington dithers, banks deemed too big to fail are actually getting bigger. According to Brown, the four biggest banks are today $2 trillion larger than before the crisis.

http://www.ethics.harvard.edu/lab/blog/300-bigbang

Bad Apples and Dirty Barrels: Outliers and Systematic Institutional Failures

Susann Fiedler

In 1999 three psychologists followed up on a fraud scandal involving Rene Diekstra, a world-famous Dutch clinical psychologist, by investigating the question of how psychologists in the Netherlands were affected by the scandal. In a paper published under the title, "Framed and misfortuned: identity salience and the whiff of scandal," the authors show that Dutch social psychologists were more affected when they put themselves (i.e. as being a psychologist) in the same category as Diekstra (Stapel, Koomen, & Spears, 1999).

Ironically, one year later the first author of this paper will sit in his kitchen and create a data set proving an outcome that he predicted but didn't find when running the experiment with actual participants. In so doing, Diederik Stapel laid the foundation for becoming "the biggest con man in academic science" (see for an extensive report the *New York Times Magazine*). The article details the extent of Stapels' fraud and how he first crossed the clear boundaries of scientific ethics. As of publication Retraction watch reports 51 retracted articles that are assumed to be based on his fabricated or manipulated data sets, which have been cited 1,334 times overall (see Google Scholar). The official report of the committee investigating Stapel concludes that for another 13 papers fraud cannot be ruled out, and therefore more retractions are expected.

Though entitled "The Mind of a Con Man," the piece is more than just a story of a bad apple willing to break the ethical rules of his guild. It is also a story about the dirty barrel of science, characterized by an ill-defined incentive system which does not ensure that science is in a Popperian way self-correcting. Not only did it take over 10 years to uncover his fraudulent research - because the current scientific machinery leaves many blind spots for scientific misconduct - but science as an institution also unintentionally encourages proceedings that undermine the goal of accumulating knowledge. As bad as the behavior shown by Stapel is for the image of science, the real threat to the overall scientific contribution are the decisions every single researcher is making on a daily basis. The incentive system presents itself as a clear social dilemma. On the one side, personal payoffs (e.g. publications, funding, income, and career chances) are not necessarily related to the publication of solid and replicable findings, but to the marketing of surprising and statistically significant findings. On the other side, the scientific community as well as the broader population maintains the notion that the published research results are a portrayal of true effects in the real world. Seeing the preferential publication of research confirming previous results and reaching statistical significance (see for a current estimation of the extend of the problem Fanelli, 2012; Francis, 2012; Renkewitz, Fuchs, & Fiedler, 2011), and the degree of freedom accorded to researchers (Simmons, Nelson, & Simonsohn, 2011), let us allow this myth to die fast. The culture of competition for funding, jobs, recognition and fame introduces conscious and unconscious biases within the research process.

On a daily basis, every scientist has to make choices concerning research designs, analysis methods and reporting. Following Popper's idea of the scientific method, researchers should thereby propose " bold hypotheses, and [expose] them to the severest criticism, in order to

detect where we have erred" (Popper, 1974).[i] Unfortunately, researchers concern themselves instead with how they can get their research published, whereby publishing often requires hiding the messiness of the real world, through skillful data analysis and incomplete reporting of results, in favor of a compelling and easily understandable story. The behavior stimulated by these incentives is seen in a study published by John, Loewenstein, and Prelec (2012), where 36% of the responding researchers admitted to having at least once made use of one of the questionable research practices put forward by the authors.[ii] The behaviors described by the authors skirt the line of unethical behavior and are part of a grey area previously not defined transparently enough as scientific misconduct.

The extent to which the results in psychology and other behavioral sciences are corrupted by these behaviors is still not clear; that they are corrupted, is. Currently, new ideas are being developed to increase the trustworthiness of our results again,[iii] and psychologists are overcoming their paralysis introduced by the fraud scandals[iv] and replicability problems by actively addressing the challenging issues.

By rewarding the scientific value of ideas and the quality of the methodological execution of research, instead of sexy results that might not be replicable, we reduce the discrepancy between the collective goal of accumulating knowledge and the personal goal of job security and success. In so doing, not only is the incentive for fraud reduced but the mind set of each single researcher is changed. By creating incentives for contributing a solid and trustworthy finding, a scientific environment as promoted by Popper will be fostered wherein the goals of the individual researcher and those of society become once again aligned.

References

Fanelli, D. (2009). How many scientists fabricate and falsify research? A systematic review and meta-analysis of survey data. *PLoS One, 4*(5), e5738.

Fanelli, D. (2012). Negative results are disappearing from most disciplines and countries.*Scientometrics*, 1-14.

Feld, L. P., Necker, S., & Frey, B. S. (2012). Scientific Misbehavior in Economics-Evidence from Europe. *Working Paper*.

Francis, G. (2012). Publication bias and the failure of replication in experimental psychology.*Psychonomic Bulletin & Review*, 1-17.

Fuchs, H. M., Jenny, M., & Fiedler, S. (2012). Psychologists are open to change, yet wary of rules.*Perspectives on Psychological Science, 7*(6), 639-642.

John, L. K., Loewenstein, G., & Prelec, D. (2012). Measuring the prevalence of questionable research practices with incentives for truth telling. *Psychological Science, 23*(5), 524-532.

Popper, K. R. (1974). Replies to my critics. In P. A. Schilpp (Ed.), *The philosophy of Karl Popper* (pp. 963-1197). La Salle: Open Court.

Renkewitz, F., Fuchs, H. M., & Fiedler, S. (2011). Is there evidence of publication biases in JDM research? *Judgment and decision making, 6*(8), 870-881.

Simmons, J. P., Nelson, L. D., & Simonsohn, U. (2011). False-Positive Psychology. *Psychological Science, 22*(11), 1359-1366.

Stapel, D. A., Koomen, W., & Spears, R. (1999). Framed and misfortuned: Identity salience and the whiff of scandal. *European Journal of Social Psychology, 29* (2-3), 397-402.

[i] Popper asks here not *if*, but *where* we have erred.

[ii] Similar findings are reported by Daniele Fanelli (2009) and Feld, Necker, and Frey (2012)

[iii] Researchers in the field of psychology estimated the likelihood of replicating a published finding at 53%(Fuchs, Jenny, & Fiedler, 2012)

[iv] Since the Stapel scandal broke, two more cases of scientific misconduct have become public (please find the story here)

http://www.ethics.harvard.edu/lab/blog/301-bad-apples-and-dirty-barrels

Performing the Job of a Congressional Staffer: Informing the Public Without Endangering Your Boss

Paul D. Thacker

A few weeks back, I wrote a piece for Slate calling out President Obama for not living up to his pledge to provide a more transparent government. In the process, I noted that several nonprofits have been ignoring the President's failure in this matter, with one even coming to aid the administration when Congress has demanded information during a federal investigation of a failed program called Fast and Furious.

Why a small nonprofit would feel the need to rush to aid the most powerful man running the world's most powerful country is beyond bizarre. But the partisan nature of Washington sometimes fouls people's thinking.

Specifically, Congress has been demanding documents explaining why the Department of Justice—perhaps guided by the White House—provided false and misleading information to the Senate Judiciary Committee, whose staff were investigating Fast and Furious. Providing false and misleading information to Congress can result in prosecution.

The Fast and Furious investigation has been called "partisan" by self-appointed watchdog Melanie Sloan who runs Citizens for Responsibility and Ethics in Washington (CREW). Ms. Sloan later filed an ethics complaint against Representative Darrell Issa (Rep-CA) when he released portions of documents sealed by a court. At the time, the administration was stating that officials in Washington knew little, if anything, about the program, and to prove them wrong, Representative Issa released documents that had the signature of officials in Washington who approved the failed program.

Still, the White House would not disclose all the information requested by Congress, forcing the House to find the Attorney General in contempt of Congress. The whole issue has now moved to the courts where the House and Department of Justice will litigate whether the documents must, in fact, be turned over to Congress.

This back and forth between Congress and the administration is fascinating because it provides a lens into how congressional staffers investigate possible wrongdoing, doing so without running into their own legal problems.

Fast and Furious: A Failed Program

First, some history: in early 2010, agents with the Bureau of Alcohol, Tobacco, Firearms, and Explosives (ATF) met with investigators working for Senator Charles Grassley (Rep-IA). In these meetings, they explained that their agency was part of a bizarre attempt to track weapons into Mexico by letting them fall into the hands of gun traffickers. The Senator then sent a letter to the Department of Justice asking for an explanation. Some months later, the Department of Justice responded with information that was false and misleading.

At this point, the investigation had to begin following two tracks. First, congressional investigators wanted to understand why the administration was running a program that allowed guns into Mexico. Second, investigators working for Grassley had to figure out why the administration was lying. Was it just a mistake, or were official in Justice trying to willfully hide something from Congress? The answer to the first question eventually became pointless when the administration shut down the Fast and Furious program.

However, Congress persisted in asking questions about the false letter that Justice sent Senator Grassley. Justice later withdrew that letter, but did not offer enough documents to explain why they had sent it in the first place.

Because Republicans are in the minority in the Senate, Grassley eventually exhausted his ability to demand documents from Justice. However, Republicans are in the majority in the House, meaning Representative Issa could send subpoenas to Justice demanding internal documents explaining why Justice lied.

To make the point that officials high in Justice probably knew what was going on at the time Fast and Furious was running, Issa put information from Fast and Furious wiretaps in the congressional record, noting that these wiretaps were signed off by top Justice officials. Someone inside Justice apparently leaked the wiretaps to Issa's staff. In response, Melanie Sloan filed an ethics complaint against Issa complaining that he may have violated the law by releasing these court sealed documents.

But is this true?

Protecting Your Boss and Advancing an Agenda: How Staff Release Documents and Information

The power of Congress to investigate is implied rather than stated in the Constitution. But the media is incredibly important to this process because without the media, you cannot apply pressure to an agency or company. To advance this agenda, staff regularly release information to the media, operating under the "Speech or Debate Clause."

This process of releasing information is shrouded in much secrecy, and even discussions between lawyers who represent Congress can lead to different opinions about what can be released and how. But the main ways to release information without incurring a lawsuit include: speaking from the floor and placing information into the congressional record, speaking during a Committee hearing and putting documents into the Committee record, or releasing information through official Committee action. Official Committee action is difficult to describe in detail because official action invariably includes reviewing the Committee rules, which vary across Committees.

A few examples should illustrate this process.

In the mid-nineties, Representative Henry Waxman (Dem-CA) received documents that were apparently stolen during litigation with tobacco companies. The documents showed that tobacco companies had manipulated nicotine levels. To make the information public and protect himself from possible reprisal, Mr. Waxman published the documents in the congressional record. Nonetheless, the companies attempted to compel Mr. Waxman to disclose who leaked him the documents. That subpoena was later quashed as Mr. Waxman was protected by "speech or debate."

In a separate matter, I once wanted to release information, while on the Senate Finance Committee, regarding a physician who had taken enormous sums from several pharmaceutical companies, unbeknownst to the federal government, which was supporting his research. To ensure that Senator Grassley would not be compromised by a defamation lawsuit, we published the information during a Committee hearing. A reporter later wrote a front-page story on the information, creating support to pass legislation called the Sunshine Act.

In another case, the Committee wanted to make public information about a potentially dangerous drug. The information we had included documents from the drug company. Again, to protect against any possible legal retaliation, we published the information in a committee report, which is an official Committee action. The report was later covered by the New York Times and multiple other outlets, including Good Morning America. Just last year, the Washington Post published a front-page story on drug industry support for medical research that referenced multiple documents in that report. Again, those documents were under court seal.

However, Members can run into problems when disclosing information. The one example legal counsel discusses most often with staff concerns Senator William Proxmire (Dem-WI). In the mid-seventies, Senator Proxmire began giving out "Golden Fleece" awards—prizes he granted to federal research projects that he felt were goofy and a waste of taxpayer dollars. But one time, he screwed up.

In the late seventies, the Senator gave a Golden Fleece to Ronald Hutchinson, a scientists given a $500,000 federal grant to study why monkeys clench their jaws. Giving the award from the floor of the Senate wasn't enough for Senator Proxmire. He later sent out a press release and gave interviews on the topic. Mr. Hutchinson sued the Senator and his staffer for libel, pointing out that the press release and public statements weren't protected by speech or debate. The suit went all the way to the Supreme Court in Hutchinson v. Proxmire, with Hutchinson winning a $10,000 judgment against the Senator.

A couple years later, House Counsel Stanley Brand told the Washington Post that, when he advises Members on how to protect themselves against lawsuits for making controversial statements, he tells them, "Make it on the floor, don't repeat it and if someone asks you about it, don't talk about it.

In fact, no action was taken against Mr. Issa for releasing the wiretap information he was given by a whistleblower inside Justice. And when I contacted his office, a staffer told me that the matter never resulted in any action.

http://www.ethics.harvard.edu/lab/blog/302-congressionalstafferinformingpublic

Banking on Tomorrow: Why Today is Never Good for Financial Reform

Gregg Fields

Ever since the economic crisis, there has been one point of broad agreement: banking reform is needed. There is even a 2,300-page law, the Dodd-Frank Wall Street Reform and Consumer Protection Act, which demands it.

But the crisis occurred five years ago. Dodd-Frank is about to turn three. And yet, political and regulatory gridlock in Washington has resulted in surprisingly little progress toward overhauling how banks look, act, or are overseen.

The biggest banks, whose implosion produced the Great Recession, are today even bigger. The top four institutions have added nearly $2 trillion in assets since Washington bailed out Wall Street in 2008. And their profits have soared even as the rest of the country endures one of the most tepid economic recoveries in recent history.

This week, a conference organized by the Federal Reserve Bank of Chicago compellingly illustrated why financial reform remains, at best, a work in progress. As speakers from government, industry, and academia spoke, the only clear consensus was that no one agrees on how to proceed. The stalemate has produced the kind of public policy paralysis that is frequently an indicator of the phenomenon known as institutional corruption.

Thomas Curry, who heads the Office of the Comptroller of the Currency, the primary regulator of national banks, said the sheer size of the mission is part of the problem. Dodd-Frank, he noted, requires some 200 new regulatory rules to be written—most of which haven't been, according to Davis Polk, a law firm that tracks the law's progress.

Dodd-Frank demanded 70 studies of the law's impact. And there are more than 1,000 other provisions of Dodd-Frank that will directly affect financial institutions, Curry said. "Carrying out these mandates has been a major preoccupation for the regulatory agencies," he said. "The job is still not complete; important rule writing remains."

Unfinished Business

Indeed, one of the most glaring unwritten rules is the one named for former Federal Reserve Chairman Paul Volcker. The Volcker Rule is designed to prevent banks from gambling with their own capital on risky investments like derivatives, those complex instruments whose ability to plunge in value pushed banking to the brink. Once considered a crowning achievement of Dodd-Frank, the Volcker Rule remains—well, conceptual.

What's taking so long? At least part of the problem appears to be that, in Washington today, there is no end to the number of agencies that regulate financial services. Different sectors of the banking industry are regulated by the OCC, the Federal Reserve, the FDIC, the SEC, the Commodity Futures Trading Commission, and Congress. Furthermore, there is the wild card of federal courts, where an agency's rules can be legally challenged—and frequently are overturned.

Turf wars among agencies, and the deep pockets of an industry that spends more than $9 million a week on lobbying, according to opensecrets.org, can produce protracted paralysis, Curry acknowledged.

"A certain amount of professional disagreement among agencies is inevitable," Curry conceded. "Before and during the financial crisis, it was sometimes the case that one agency identified a risk that it thought warranted joint action, and others disagreed. Sometimes, that meant action was not taken in a timely manner. We can't let that happen again."

Dodd-Frank supposedly takes a step in a unifying direction by forming the Financial Stability Oversight Council, which comprises the country's top financial regulators. But critics have questioned if it will diminish political influences on regulation, since the FSOC's chairman, by law, is the U.S. Treasury Secretary, a political appointee.

And on a practical level, there is ample evidence of endless inter-agency inaction on Dodd-Frank reforms. An example is the "too big to fail" policy, where some banks are deemed too crucial to the economy to be allowed to collapse.

The reckless behavior that brought on the banking crisis produced calls to end "too big to fail." But no one seems to know how to do that, and the language of Dodd-Frank is so complex that even academics who study the law disagree on whether it ends "too big to fail" or, in fact, codifies it.

Too Big To Jail?

The diffusion of regulatory power virtually precludes a unified response to the problem. Furthermore, U.S. Attorney General Eric Holder, in a comment earlier this year, suggested that big banks can't be reined in by government without risking collateral damage to the rest of the economy.

"I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute—if we do bring a criminal charge—it will have a negative impact on the national economy, perhaps even the world economy," he told a Congressional committee in March. In further hints at the daunting dogmatic divides crimping reform efforts, some speakers at the Fed conference, which is focused on so-called Systemically Important Financial Institutions, or SIFIs, said size isn't the problem, anyway. "It is essential that the concept of 'too big' be distinguished from 'too big to fail,'" said Rodgin Cohen, a partner at Sullivan & Cromwell law firm and a widely influential figure in financial and regulatory matters. "It should be recognized that 'big is bad' represents a departure from every other sector," he added. "In no other industry are the largest entities subject to greater requirements because of their size."

And the reality is that, even when regulators want to take actions that would protect the public, their institutional powers have been curtailed by a couple of decades of feverish deregulation. Mary Schapiro, who headed the SEC until late last year, related a personal example. During the crisis, a money market fund sponsored by the doomed Lehman Bros. investment house became illiquid, sparking a panicked run throughout the entire money fund industry. Calm was restored only after the Treasury stepped in with a temporary liquidity guarantee for investors.

Speak Up

To Schapiro, the episode revealed a clear need to impose reforms on money funds—such as requiring greater capital cushions against losses. But her idea went nowhere, drawing fierce opposition from the industry. She abandoned the idea when three of the five SEC commissioners sided against her. "I have long said I consider money market reform to be an important unfinished business," Schapiro, who now works for Promontory Financial Group, a kingpin consulting firm in Washington, said Thursday.

While Schapiro ultimately failed at reforming money market funds, she indicated she didn't regret going to battle. "When regulators identify a potential systemic risk . . . we must speak up," she said.

http://www.ethics.harvard.edu/lab/blog/304-banking-on-tomorrow

The Shadow Knows: Ben Bernanke Battles Non-Bank Banks

Gregg Fields

In the years since the economic crisis, so many Wall Street acts of galling greed and endless avarice have been brought to light that they've lost their ability to shock.

Nevertheless, from an institutional corruption perspective the roots of the debacle are still somewhat shrouded in mystery. How could regulators have not detected the tsunami about to crash into shore? How could the relatively insignificant market in subprime mortgages bring down financial titans that, economically speaking, had towered over the world for decades?

In an insightful speech on Friday, May 10, Federal Reserve Chairman Ben Bernanke provided fresh perspectives into the regulatory failures that preceded the crash, and outlined his agency's efforts to revitalize financial oversight. His remarks touched on several topics familiar to students of institutional corruption, such as the need for transparency and the proper enforcement authority, and resources, for regulators.

The bottom line, he added, is that there is no substitute for constant vigilance. It's a marked contrast to the pre-crisis years, when Washington—where financial industries are among the most dominant campaign donors and lobbyists—turned a blind eye toward abuses that would later wreck the economy.

"Systemic risks can only be defused if they are first identified," Bernanke said, speaking at a conference organized by the Federal Reserve Bank of Chicago. "That said, it is reasonable to ask whether systemic risks can in fact be reliably identified in advance; after all, neither the Federal Reserve nor economists in general predicted the past crisis."

Out of the Shadows

Bernanke took the helm at the Fed in 2006, on the eve of the worst financial crisis since the Great Depression. His tenure has been marked by an abrupt departure from historic Fed protocol. Traditionally, the agency was notoriously secretive. Under Bernanke, Fed monetary policy and economic goals are regularly relayed to the public. Bernanke's predecessor, Alan Greenspan, virtually never gave interviews. Bernanke holds quarterly press conferences. "He has led the Fed to new levels of responsiveness and transparency," Charles Evans, president of the Chicago Fed, said.

While transparency is often considered an antidote to institutional corruption, however, Bernanke's open style has its critics, as does his policy of near-zero interest rates—an effort to revive a moribund economy. "The time has come for the Fed to recognize that it cannot stimulate growth and that a stronger recovery must depend on fiscal actions and tax reform by the White House and Congress," Martin Feldstein, Harvard professor and chairman of the Council of Economic Advisers under President Ronald Reagan, wrote in *The Wall Street Journal* this week.

As Nobel laureate Paul Krugman put it in *The New York Times* on Friday, May 10: "For whatever reason, many people in the financial industry have developed a deep hatred for Ben Bernanke."

Obviously Not Transparent

Of course, some may view the financial world's dislike of Bernanke as a good thing. Prior to the collapse, the cozy relations between Wall Street and Washington appear to have contributed to regulatory capture, characterized by the frenzied deregulation of banking.

In his talk, Bernanke said one explanation for the regulatory shortcomings preceding the crash was a lack of transparency. Specifically, much of the financial risk was created in the world of what's called shadow banking. The definition of shadow banking is often debated, but typically refers to organizations that perform financial functions but are outside the regulated banking system. Hedge funds, insurance firms, and money market funds are often cited as examples.

In the years prior to the crisis, the shadow banking system thrived, growing from an estimated $26 trillion in assets worldwide in 2002 to $62 trillion by 2007, according to the Financial Stability Board, an international regulatory body.

By way of contrast, commercial banks in the U.S. have assets of roughly $13 trillion, according to the Fed's most recent statistics. The shadow banking system's growth, Bernanke said, is at least partly attributable to the fact that "financial activities tend to migrate from more-regulated to less-regulated sectors."

Although shadow banking is perfectly legitimate and performs vital financial services, it operates without the explicit guarantees of federally insured banks. But in an era of deregulation, investors didn't seem to realize the difference. Meanwhile, shadow banks and those backed by the government became tangled in an interconnected web that ultimately ensnared both, Bernanke said.

"Investors were lulled by triple-A credit ratings and by expected support from sponsoring institutions—support that was, in fact, discretionary and not always provided," Bernanke said. "When investors lost confidence in the quality of the assets or in the institutions expected to provide support, they ran." Panic ensued.

Complexity Theory

Bernanke's comments reveal just how complex the issue of institutional corruption is when it comes to modern financial regulation. For instance, while there has been a great deal of emphasis on what regulators failed to see, the systemic risks of shadow banking flourished in places where regulators weren't allowed to look.

Additionally, in a world where money moves over the Internet, it isn't clear how regulators can hope to keep regulated banks and shadow banks from commingling. And of course the role of government backing raises the risk of moral hazards. FDIC insurance, for instance, was supposed to protect depositors. Yet, the bailouts of Wall Street actually protected shareholders, private investors, insurance firms like AIG and even most bank executives, very few of whom lost their jobs. (Virtually none have been prosecuted.)

As for the future, Bernanke held out hope that new powers granted by the Dodd-Frank Wall Street Reform and Consumer Protection Act will enhance regulators' ability to shine lights into shadow banking's darker corners.

Specifically, it creates the Financial Stability Oversight Council, which comprises the top financial regulators. The theory is that this will bolster inter-agency cooperation and reduce the regulatory squabbling that has been known to occur.

Furthermore, the FSOC is allowed to designate non-bank companies as a Systemically Important Financial Institution, or SIFI. As such, it would be subject to stricter regulatory scrutiny. (As with almost everything involving Dodd-Frank, however, progress is slow. The SIFI designation process is underway, Bernanke said.)

Furthermore, the Fed is stepping up—and recalibrating—its monitoring of financial institutions. It is now placing greater emphasis on systemic risks, the kind that could bring the whole industry crashing down. Historically, it focused on the health of individual institutions.

Whether this will eliminate the kinds of regulatory failures that preceded the economic crisis isn't known. Nevertheless, the efforts appear to reflect the recognition by the Fed that oversight as practiced previously simply didn't work.

"This new regulatory framework is still under construction, but the Federal Reserve has already made significant changes to how it conceptualizes and carries out both its regulatory and supervisory role and its responsibility to foster financial stability," Bernanke said.

http://www.ethics.harvard.edu/lab/blog/305-the-shadow-knows

Diagnosing Institutional Corruption

D. James Greiner

According to petwave.com, "Dogs infested with sarcoptic mites will present to the veterinarian with a history of the sudden onset of intense itchiness, and probably also with red, raw skin sores and thick crusted areas caused by self-trauma from the dog's effort to alleviate the itchiness."[1]

The problem is, of course, that lots of things can cause dogs to scratch too much, including allergies, hormonal imbalances, fleas, ticks, and perhaps most intriguingly, boredom.[2] So how would a veterinarian know that sarcoptic mites are the problem, meaning that Fido needs a topical cream to kill mites as opposed to, say, an extra walk every day or a new tennis ball? There are apparently a few intriguing[3] or disgusting options,[4] in addition to the more straightforward idea of examining skin scrapings from the dog under a microscope to see if mites are visible. But in practice, vets actually use few of these methods to detect sarcoptic mites. Instead, vets diagnose the affliction by instructing the dog's owner to apply a topical cream that kills mites, then observing if the dog's scratching problem resolves in the next two weeks or so. If it does, the vet concludes that mites were at issue. If it does not, then the vet searches for another cause.

I confess that when I reviewed the materials for Professor Christopher Roberson's recent presentation to the Lab on "Blinding as a Solution to Institutional Corruption," I did not immediately think of the mange. Nevertheless, the point of this blog post is that those of us who care about institutional corruption might learn something from vets, and that Professor Robertson's lecture shows us how this is so.

Stepping back for a moment, how do we know whether an institution is corrupt? Begin by returning to the definition of institutional corruption that Professor Lessig offered at the Lab's creation, namely, an economy of influence that weakens the ability of the institution to further the institution's purpose.[5] A classic form of corruption occurs when an institution created to serve one purpose alters its procedures or its output so as to serve, at least partially, a second purpose; the second purpose might be money or funding. So, in an example that Professor Robertson uses in one of his papers, the institutions of biostatistics and pharmacological investigation are in part designed to figure out whether medical treatments, particularly drugs, improve health. But under the current system, pharma companies fund such research, and they want studies of drug effectiveness to produce positive results. As biostatistical and pharmacological researchers compete for funding, they may produce results that are more positive for pharma companies than the underlying science would support.

So, we (think we) know what institutional corruption is, or at least we have a rough idea. Now, the hard part: For any institution or set of institutions, how do we know whether corruption (so defined) is present?

I can think of three ways to diagnose institutional corruption; there are probably others. The first is one that Professor Lessig employed in his 2009 inaugural lecture for the Lab: examine closely what an institution says or does (*i.e.*, the institution's actions or outputs). If those actions or outputs are "incorrect," then we might suspect that institutional corruption is to

blame. In the Lab's inaugural lecture, Professor Lessig provided us with at least two governmental decisions, the level of added sugar in a balanced diet and the responses to global warming, as examples of "easy public policy question[s] that the government gets wrong."

This method of diagnosis is unquestionably helpful, but it has drawbacks. The primary drawback is that it assumes that we know what the correct answer is. Thus, it tends to be helpful in settings in which the right output for an institution is, as Professor Lessig suggests, "easy." On the level of added sugar example, it is obvious that a balanced diet is not one in which 25% of caloric content comes from added sugar, and if the Food Nutrition Board says that 25% is fine, we might suspect institutional corruption.

<u>When Fido scratches to the point of creating "red, raw skin sores and thick crusted areas," Fido might have mites.</u>

In many other settings, however, the right answer can be less clear or perhaps even unknowable. Process theorists, for example, believe that good public policy cannot or should not be defined by measuring governmental outputs against a correctness scale, but rather by whether the processes that gave rise to those outputs are in some sense just. One need not go this far to believe that looking only at an institution's outputs could make it difficult to distinguish corruption from insufficient technical expertise, bad judgment, bad management, insufficient enforcement power, alternative theories of justice, or any other reason that an institution might not produce the outputs that an observer sniffing for corruption believes to be correct. Further, why should we trust the observer's sense of what is correct over the institution's? The observer itself may be responding to inappropriate (corrupting) incentives, or might itself suffer from any of the other pathologies mentioned above. The point here is not that examining institutional outputs is unhelpful, but rather that this method of discerning whether corruption is present has limits.

A second method of diagnosing institutional corruption is to examine the institution's innards closely. Professor Lessig's 2009 inaugural lecture for the Lab again provided us with an example of this method. In the sugar example above, Professor Lessig documented how the ultimate decision by the Food Nutrition Board to adopt a definition of a balanced diet that included 25% added sugar came after an additional sugar industry insider became a member of the voting body.

<u>If one looks closely at Fido's skin samples, one might actually see sarcoptic mites.</u>

This methodology, too, has limits. Corrupting influences, like sarcoptic mites, can sometimes hide well. Sometimes institutions disclose the fact that they are hiding things, citing reasons, mostly bad but some good, for keeping what they do secret. As a Department of Justice litigator, I occasionally argued that a court could not and should not compel public disclosure of documents that would reveal an agency's deliberative processes on the grounds that public disclosure of deliberations would chill the frank exchange needed for good decision making. Such an argument might hold some water; one might ask, for example, whether an open and honest debate would result if Harvard Law School's tenure deliberations were available online. In other instances, institutions become good at hiding what they hide. And secrecy can make it hard for an observer to see corruption at work. Meanwhile, in other situations, information about potentially corrupting influences is hard to collect, either because those in the best position to collect it have are the alleged corruptors

(would we expect big pharma to make the amount of money it spends on payments to and perquisites for doctors readily available?) or because the information's disperse nature makes it hard to gather (would we expect that anyone would know how much money particular industries contribute to campaigns in all 50 states, including at the municipal level?).

A third method of diagnosis is what the opening paragraph of this post illustrated, diagnosis by treatment. How do we find out if an institution is corrupt? We imagine the nature of that corruption and specify an intervention that would combat it. We then intervene in the specified manner. If the institution changes in some way, say, by altering the nature of its outputs, then we might guess that the institution was corrupt (and that, as a bonus, we might be on to a way to counteract the effects of the corruption). Note that the intervention could take several forms. It might prevent the corruption from occurring in the first place, meaning the intervention gets at the root cause. Or the intervention might address some element on the causal pathway from the corrupting influence to an institutional outputs, meaning that the intervention not eliminating the corruption but is rather rendering that corruption ineffective.

When Fido gets better after his owner rubs mite-killing salve on his skin, we conclude that Fido had mites.

Back to Professor Robinson's recent presentation. Several of Professor Robinson's papers explore the concept of blinding as a solution to corrupting influences. Litigation expert witnesses should receive assignments, produce reports, and communicate with clients through neutral intermediaries.[6] Industry should conduct research on the effectiveness of medical treatments through the NIH.[7]

But, say the institutions at issue, we are not corrupt. There is no problem to solve. Yes, money flows, but everyone needs money to live, and the money does not influence our outputs. Litigation expert witnesses insist that they are as pure as driven snow, and the litigators that hire them frequently contest the standard narrative that their experts are "whores"[8] who will say anything for money (the other side's experts are a different matter, of course). Statisticians who evaluate drug or medical device effectiveness contend that they follow the numbers, nothing more or nothing less (regardless of the fact that the numbers show that industry-funded studies reach results more favorable to industry than do independently funded studies).

It is not enough to give contentions of purity the back of one's hand. Everyone *does* need money to live. And it is not easy to see how we will stretch tax dollars to fund expert testimony, pharma research, political campaigns (all the way down to the local level), and all of the other areas in which, say, money *might* exercise a corrupting influence. Diagnosis by treatment is an additional option here. If decision makers of a particular type appear vulnerable to the corrupting influence of knowing the source of funds received (note that ordinarily it is the knowledge of who paid, rather than the payment itself, that can corrupt), then use the following method: blind some such decision makers, leave others unblinded, and compare results. (Note that one would do best to randomize the blind here, but that touches on a different set of issues regarding implementation.) If the blind has no effect, then one might question whether knowledge of the source of payments is in fact corrupting this type of decision maker.

Diagnosis by treatment has its drawbacks. It is an alternative source of information, not a panacea. In particular, intervening in the world and collecting results is time-consuming,

complicated, and hard. Who willingly participates in an experiment designed to see if she is corrupt? At present, almost all of my research time consists of setting up, running, and analyzing the results of randomized control trials in the field. The hardest part of field experiments is persuading people to engage in them. And none of my RCTs are explicitly and overtly designed to diagnose institutional corruptions. With corruption as a motivating factor in an RCT proposal, the persuasion necessary in any rigorous field operation becomes that much harder.

Yet my view is that those of us who care about institutional corruption are, at present, underutilizing the method of diagnosis by treatment. Few diagnostic methods have a comparable potential to resolve arguments about the existence vel non of institutional corruption. Field operations may be frustratingly slow and hard to do, but they are necessary if we are to prove when corruption exists in the face of protestations that we are hunting hobgoblins.

A suggestion to Professor Robinson: Change the title of the presentation to "Blinding as a Diagnosis Method and as a Solution to Institutional Corruption."

---

1. http://www.petwave.com/Dogs/Dog-Health-Center/Skin-Disorders/Sarcoptic-Mange/Diagnosis.aspx

2. http://pets.webmd.com/dogs/guide/dogs-and-compulsive-scratching-licking-and-chewing

3. Apparently, one can rub the edge of the dog's ear while watching for a reflex scratching action in its hind legs. http://www.petwave.com/Dogs/Dog-Health-Center/Skin-Disorders/Sarcoptic-Mange/Diagnosis.aspx. It is hard to believe that this method would have high diagnosticity.

4. It would be better, perhaps, not to inquire too closely regarding a technique that bears the moniker "fecal flotation." http://www.petwave.com/Dogs/Dog-Health-Center/Skin-Disorders/Sarcoptic-Mange/Diagnosis.aspx.

5. http://www.ethics.harvard.edu/images/resources/pdfs/d3.pdf, page 3.

6. Christopher T. Robertson, 85 N.Y.U. L. Rev. 174 (2010).

7. Christopher T. Robertson, The Money Blind, 37 Am. J. L. & Med. 358 (2011).

8. J. Morgan Kousser, Are Expert Witnesses Whores? Reflections on Objectivity in Scholarship and Expert Witnessing, Pub. Hist., Winter 1984.

http://www.ethics.harvard.edu/lab/blog/306-diagnosing-institutional-corruption

Good, Clean Data

Brooke Williams

In our recent story for *The New Republic*, Ken Silverstein and I examined think tank scholars who simultaneously work as registered lobbyists. We knew of situations worth examining: a resident think tank fellow also representing Polish oil interests, and the director of a homeland security program lobbying for defense contractors, to name a couple. But we wanted to go beyond the anecdotal and gain context. Was this part of a larger system in which registered lobbyists have access to think tanks from the inside?

Due to limited and dirty data, trying to answer this question turned out to be a challenge. Think tanks only disclose officers, directors, trustees, key staff, and top five highest paid employees in annual filings to the Internal Revenue Service. And while most think tanks list scholars and staff online, they're in various formats. Some are behind search engines or listed on a bunch of separate web pages.

As a part of my long-term project, I am grabbing names of scholars and staff listed online, then cleaning, parsing, and importing them into a database, which I will be making freely available in a searchable, meaningful way. But for this story, I stuck with data from tax filings, when they were available, for the 25 top think tanks as James McGann ranked them in his report for the Think Tanks and Civil Societies Program at the University of Pennsylvania.

I downloaded the names of think tank people from Guidestar.org, which has digitized the IRS Form 990s. However, since the original files were .pdfs, the data required cleaning, standardizing, parsing, and verifying before they could be linked to lobbyist records.

The name field contained unwanted spaces, characters and punctuation, as well as misspelled names. At least one person was missing. Once I trimmed the spaces and removed punctuation, titles, suffixes, and prefixes, I researched people whose names appeared to be misspelled to ensure the data were correct and consistent.

It's worth noting the IRS began releasing 990s in a digitized format this year—and other journalists have already made them easily searchable. But unfortunately, the digitized data don't include names of directors, officers, trustees, and key employees.

Once the think tank names were ready, I downloaded registered lobbyist data and prepared them for a cross-check. This required parsing a name field and performing integrity checks on the results.

When the two data sets were ready, I linked the name fields by first and last name and began examining the results. I didn't include the middle name because it wasn't always in both data sets. One by one, I verified or eliminated.

First, taking into account different filing periods, I queried for those people listed in both data sets during the same years—as we were only interested in those cases. I removed instances where the person was a registered lobbyist for the think tank itself.

Next, I verified whether they were indeed the same person. (As it turns out, some think tank executives and registered lobbyists share seemingly uncommon names.) This required varying levels of research, from reading online biographies and making phone calls, to

scouring federal records showing prior government positions. Next, I verified in the paper versions of the 990s and lobbying disclosure reports that each individual was, in fact, listed on the think tank's rolls and registered to lobby simultaneously.

In the end, as our article described, the data showed at least 49 people have simultaneously worked as scholars, officers, trustees, and directors at think tanks while registered to lobby on behalf of outside clients. Especially given the limited scope of data for this analysis, the number suggests there will be plenty more potential conflicts of interest to examine once we cross-check the rest.

In the meantime, it seems even one example is significant. The Center for American Progress says it has implemented a "no lobbyists" policy in response to our *New Republic* story. Stay tuned for the next one.

http://www.ethics.harvard.edu/lab/blog/308-goodcleandata

Institutional Corruption: Linking and Learning from Regulatory Capture

Donald W. Light

This is the third is a set of blogs devoted to strengthening the concept and theory of institutional corruption (IC). A previous blog urged that IC would be greatly strengthened by drawing on moral philosophy to establish a normative, external foundation for both defining when IC is occurring and for developing legitimate reforms for institutional integrity.

A second blog pointed out that all IC occurs within a dynamic, historically changing field of countervailing powers (C-Ps) and therefore an adequate account of IC needs to include the identification of those C-Ps and how they are affecting IC. These usually include corruptors, the corrupted, and those affected in multiple ways.

Could IC also benefit from linking to regulatory capture, a much older and richer concept and body of work? And how could we show the relevance of IC to economists, political scientists, and policy-makers involved in capture thinking? This question is particularly relevant because The Tobin Project is actively trying to update and strengthen capture theory and research. What follows is a short, limited review and reflection that needs to be more extensive.

In his "Short, Inglorious History" of regulatory capture, Richard A. Posner defines it as the "subversion" of agencies by regulated firms, "turning the agency into their vassal." Posner maintains that capture differs from regulation intended by a legislative body to serve the private interests of firms, a distinction that I will argue would be dealt with more effectively if capture theory were to draw on IC theory, because ruling out legislative intent rules out the core contribution of Thompson and Lessig on ways in which industry captures or corrupts Congress and the legislative process. If capture theory confines itself to forms of subversion or control that occur only *after* a group of firms or an industry uses millions of dollars and hundreds of lobbyists to create an economy of influence that helps legislators to "see" things their way and set up regulations to enhance their wealth or power, then capture theory misses the main act of how a set of concentrated stakeholders frame regulation. Further, capture alone is value neutral——it may be good or bad from a given stakeholder's point of view. Corruption clearly indicates that something worthy or good has become "tainted" or "morally debased," to use words in the dictionary, or made to no longer function properly, as when a file is corrupted.

Further on, Posner writes about George Stigler and economists' view that regulation is something that an industry purchases. By "purchases," they must mean through institutional practices that corrupt the democratic process, such as those described by Larry Lessig and by Mal Salter in his book on Enron. Once again, IC theory has a breadth and normative base that capture theory lacks, though this economic view implies that capture includes the legislative framework as well. IC theory also applies to many institutions that are not involved in regulation. For these reasons, IC theory is more comprehensive and inclusive than capture theory. If IC research and analysis were to include the historically dynamic account of countervailing powers, it would address Posner's complaints that capture theory

is rather static in its outlook. Posner concludes glumly that "the term 'regulatory capture' should be retired." Here we have reasons for why it should be subsumed and revitalized, rather than retired.

Capture theory offers some insights for IC, and perhaps the central one comes from Mancur Olson, that public interest and passion for regulatory reform is diffuse and short-lived, and the resulting public benefits (like less pollution) are diffuse. But the effects on those regulated are concentrated, as are their efforts to alter or bend or corrupt the program (public housing) or regulatory institution (EPA) that is aimed at creating a public good. Olson's theory implies that capture is inevitable. Is Institutional Corruption inevitable too? One implication is that even were Congressional elections to be publicly funded, the concentrated interests of companies that pollute, or construction companies that build public housing, or drug companies that provide drugs, would still find plenty of ways to alter, bend, or corrupt democratic procedures and legislation to advance their interests. This implication of Olson and this school of thought warrant discussion.

Another set of interesting distinctions can be found in Daniel Carpenter's essay on Corrosive Capture. He defines *regulatory capture* as raising entry barriers, such as licensing. This excludes those who are not, or cannot be licensed. Changing FDA rules from allowing new drugs on the market unless the staff raised an objection before 1962, to requiring prior testing and approval, would be another example of raising entry barriers that privilege one set of products and producers over others. I would recommend calling this *entry capture* and save "regulatory capture" for a broader use.

"Corrosive capture" consists of actions that weaken regulatory oversight and independence once entry barriers have had their effects. In recent decades, we've seen "capture" evinced in the weak application (or non-application) of regulatory tools. Corrosive capture can also occur through "boundary manipulation" and the revolving door syndrome. Two other interesting forms are the federal pre-emption of state regulatory bodies or rules, and enabling companies to choose the regulatory setting they prefer through "regulatory arbitrage." This strategy is key to keeping the EMA (European Medicines Agency) weak, because companies can always choose any one of the European state regulatory bodies instead of the EMA, and if it approves their new drug, all other countries must accept that decision, even if the drug has few benefits and is very expensive. One can see here how corrosive and regulatory (or entry) capture blur together so that the distinction needs further discussion. But the idea of corrosive capture brings capture theory rather close to corruption theory and suggests a need for dialogue.

A third distinction made in the Tobin Project work is *cultural capture* that shapes the assumptions, terms, and accounts that all parties come to accept. As I pointed out in a general essay on strengthening IC theory, this kind of capture or corruption is the most powerful and least developed. For example, industry has succeeded, through story after story, in having most Congressmen and regulators believe that new drugs benefit patients so that the goal is to approve them as quickly as possible. Nevermind that 90 percent of new drug products are found to be little or no better than existing ones. Nor evidence from rigorous, quantitative studies at Harvard and Yale that faster reviews lead to significantly more products having serious side effects. Once the premise and account is taken for granted as accepted truth, facts to the contrary get ignored or discredited. Senator Sherrod Brown has called this "cognitive capture" —— capturing people's minds.

If Institutional Corruption is to gain wider use and recognition, it needs to be more embracing and inclusive. The Tobin Project is broad and includes work on preventing capture, similar to work at the Edmond J. Safra Lab on preventing corruption or investigating exemplars of institutional integrity. Perhaps an invitational workshop at which IC and capture scholars explore shared interests would benefit both groups.

http://www.ethics.harvard.edu/lab/blog/309-institutional-corruption

Bangladesh: Savar Solutions and Fast Fashion may not be Compatible

Heather White

Please watch the original footage that accompanies this blog post.

In the aftermath of the Rana Plaza fire there has been a lot of finger-pointing as to who bears the majority of the blame for the disaster that left over 1,100 workers dead.

Most professionals working in the garment industry will agree that routine violations of health and safety laws are the norm in the lowest GDP countries in Asia producing for America's favorite brands.

The $20 billion dollar question is whether consumers are going to continue to reward American corporations for doing business in derelict factories where their "business partners" (to use Disney's term) give their workers the kind of choices presented to the Rana Plaza workers that fateful day: "Go to work in a building that has been condemned and closed by the local police, or be penalized one month's salary." (It is interesting that a bank also located in Rana Plaza followed police orders and closed.)

What kinds of pressures are imposed on factories in Bangladesh that factory owners literally force their workers to risk death in order to get shipments delivered on time?

The pressure of Fast Fashion imposed by buyers for American companies is one of the causes.

Our favorite U.S. brands are engaged in a new business model called *Fast Fashion* that was first pioneered by Chinese factory owners operating outside of Florence, Italy 10 years ago. Using illegal trafficked workers from China who had been snuck into the country (they paid $13,000 to scary middlemen called snakeheads who guided them step by step overland from Central China). Chinese factory owners would accept an order from local Italian garment firms and not stop production until the order was completed. Most factories employed 50 workers or less, which meant there were no shift replacements. Workers put in 30+ hours at a time and people literally died at their sewing machines. Don't ask what happened to their bodies, that discussion is for another day. But there's a saying in Italy, "No one from China ever dies here." Meaning if a Chinese worker dies in Italy, someone else immediately appears to take their identity papers and their name, and if they die, someone else appears, and so on.

In today's globalized economy what works well in one part of the world may catch on elsewhere, and fast fashion or *pronto moda* worked extremely well in Italy. In fact it succeeded to the point that experts credit it with saving the textile industry in Tuscany during the downturn in the 1990's.

There you have the historical origin of the term *fast fashion*; and fast fashion is a big part of the problem in Bangladesh's apparel industry.

In the past ten years American brands happily adopted the *FF* model of quicker turnarounds, using digital technology to squeeze lead times from 9 months from order placement to production in Asia to store delivery in the U.S. to 90 days and less. Some retail firms now claim they can get goods ordered and on store shelves in five weeks.

H&M reports they now have 12 seasons a year and many other brands now have 8 seasons. This causes chaos at the factory level. One of the managers at a $30 billion American apparel company I interviewed for my Edmond J. Safra research said " The buyers allow the factories to squeeze labor as a variable cost since they can't adjust shipment schedules. This makes mandatory overtime violations much worse."

A third party auditor for one of the European companies that has signed the recent Savar accord (to improve factories in Bangladesh) said, "They give their suppliers the OK to violate local overtime laws as long as the factory agrees to participate in an "engagement process". Nothing changes, which is exactly what they want—business as usual. I eventually became disgusted."

The level of fast turnaround wreaks tremendous pressure on factories—who are fined by the Buyers if they ship even one day late. Yet Buyers claim the right to change designs and colors up to days before production begins with no allowances for later delivery, even when new materials have to be purchased to meet the change demands. The time pressure causes the factories to require overtime from workers to meet the deadlines. The overtime hours often go beyond the legal maximums for which workers are often not paid. The O/T wasn't originally calculated in the cost of the goods, which are already at razor thin margins, and the Buyers refuse to pay a penny more.

The system of order chargebacks to already squeezed factories in the world's lowest GDP countries also hinges on the unethical. American apparel buyers have already ferreted out the lowest cost suppliers in the world's poorest nations, yet they insist on further discounts if shipment is a day late—for any reason. So this is another pressure on factory managers in Bangladesh who cannot afford to lose even an hour of production on the tight schedules imposed by foreign buyers.

The above scenarios give some idea of the time pressures imposed on Bangladesh factories scrambling to meet the demands of buyer-imposed fast fashion. But that isn't the extent of the demands, because global brands now require world-class working conditions as well, at least on paper, to meet the expectations of consumers and stakeholders.

Against this backdrop we find the social auditing industry in Bangladesh, which is taking a lot of heat right now for this recent disaster, the earlier Tazreen fire and also the Ali Enterprises fire in Pakistan.

When factoring in fast fashion, does one really expect that safety measures and legal compliance are going to be a supplier's priority, if they cause shipment delays?

Prior to the onset of fast fashion, Bangladesh's record on labor standards was already near the bottom globally, which didn't dissuade U.S. apparel firms from entering in record numbers.

However, the demands of the anti-sweatshop movement in the U.S. required that some attention be paid to Codes of Conduct and improving supplier standards. A newly emergent social audit sector, comprised mostly of for-profit firms, was happy to oblige and the sector has grown into a multi-million dollar industry, despite the UN's John Rugge stating, *"We keep*

hearing now, from just about everywhere... Monitoring doesn't work. "Just about everyone, at least off the record, will tell you that monitoring doesn't work because people cheat."

In Bangladesh the millions would have been better spent on exterior fire escapes.

A review of my archived social audit reports from Dhaka factories going back to 2007 reveals widespread conflicts of interest and corruption between auditors and factories. The big winners however are ultimately the U.S. brands, whose local profit margins far exceed those of local manufacturers or the commercial monitoring firms.

In Bangladesh, most NGO advocates will tell you that factory auditing generally leads to no interruption of the business model, no matter how many negative audit reports are generated or alarm bells sounded. That doesn't mean that auditors don't shake down factories for payments on a regular basis, threatening to issue a negative report if thousands are not paid to a designated third party not connected to the audit firm. (One of my reports states "All transactions are done in cash and members of senior staff were seen carrying cash out in jute sacks." Think burlap bags filled with money.)

In general, sourcing guidelines gave plenty of leverage to factories and auditors to play with time for years. A U.S. $400 billion company's ethical sourcing tool allowed factories with "orange assessments" to continue operating for two years up to receiving a fourth orange assessment, at which point order placement was to be stopped. But in reality, few brands will commit to working with any factory for a period as long as two years.

One of the reports states about the orange assessments, "This gives the auditors an opportunity to negotiate with factories for kickbacks for the buyer's orders to continue. Factories prefer to pay a smaller sum to the auditors rather than investing in improving labor standards. This practice is common because it deals with the disorder immediately and the factory is able to continue its normal operations/orders. In the process, compliance is no longer a priority."

Continuing normal operations in every case trumped requiring minimal fire safety standards. Despite 6-8 stories being the average height of garment factories in Dhaka and its environs, there are almost no exterior fire escapes. Video footage of surrounding factories reveals that despite 15 years of scrutiny by American brands of their Bangladesh suppliers, not one six-story factory had an exterior fire escape. No factory should have passed any audits, or been given two years to make improvements when failing on this most basic life-preserving measure.

It remains to be seen whether this latest consortium being formed by American and European buyers will have an effect, while continuing both *fast fashion* business as usual and average wages to workers of less than 20 cents per hour.

http://www.ethics.harvard.edu/lab/blog/310-bangladesh-savar-solutions-and-fast-fashion-may-not-be-compatible

The Perils of Public-Private Partnerships

Jonathan H. Marks

Imagine, for a moment, that you are a local public health official. Budgets are tight. Childhood obesity is on the rise. And there is no playground in the heart of your city. When a story appears in the local paper about the need for such a playground, a fast food company comes to the rescue.

Their vice-president for nutrition and public policy calls you, and offers to give you $100,000 for the construction of a playground. The VP emphasizes that the money will not come directly from the company, but from a charitable foundation the company recently established. There are only two conditions, the VP assures you, and neither is onerous. There will be a bronze plaque at the gate to the playground saying that it has been constructed with a donation from the foundation and with the support of the company. And you have to smile for a photograph with the VP while you each hold a corner of a large blown-up image of the donation check.

You are a thoughtful public health official. You've read the literature on childhood obesity. You know exercise is important and that a playground is likely to be beneficial for the city's most vulnerable children. But you also know that many public health experts believe that fast food is a major contributor to the rise in childhood obesity. You feel uncomfortable about the proposed partnership, but you also find it hard to resist.

What do you do?

This is not just a hypothetical question—one that ethics professors like me pose to their students in order to promote class discussion. (And, yes—it does prompt a great discussion!) It is also the kind of question faced by many public officials—particularly at the local level, in city governments and public school systems. When these officials look to leaders at the national level for guidance, they see that the partnership model has been embraced by the federal government. Most notably, U.S. Secretary of Agriculture Tom Vilsack has said that "[b]y partnering with USDA, corporations win, USDA wins, and the American consumer wins. That's a win-win-win situation!"[1]

I believe that such a characterization downplays the significant ways in which the missions of potential public and private partners diverge. These tensions create serious potential perils for the public partner, and they should not be glossed over or ignored.

In my recent working paper for the Edmond J. Safra Center for Ethics at Harvard,[2] I push back against the partnership as a default paradigm for interactions between government and industry, and offer some guidance to public health officials contemplating public-private partnerships related to food and health. In the paper, I don't provide a definitive answer to the kind of question posed above. Rather, I offer some tools that might help public officials as they grapple with this challenge.

I invite these officials to think systemically about potential partnerships, and with sensitivity to the threats they present not only to integrity and trustworthiness (often described as attributes or properties of an individual or institution), but also to trust and confidence (often described as attitudes toward individuals or institutions.)

When you adopt such an approach, the potential perils become readily apparent. Will the construction of the playground burnish a brand that the food company uses to market the kinds of energy-dense foods and beverages that public health experts believe play a significant role in rising levels of childhood obesity? Worse still, might the partnership confer a "health halo"—or positive health association—that increases consumption of those products? (This is sometimes described as a "secondary" gain or benefit for the industry actor, even though this partner may have intended to achieve precisely that effect.) Such a partnership might rightly be considered to undermine the mission and integrity of the public official for whom the promotion of public health should be the primary goal. But even absent these effects, the arrangement might undermine trust and confidence in the official and his or her agency. A loss of trust and confidence in one area might undermine an agency's work in other areas too.

In my paper, I explore a couple of examples at the local and national level that vividly demonstrate these hazards. One involves a $10 million donation to the Children's Hospital of Philadelphia from a foundation established by the American Beverage Association, just as the city council was considering a soda tax proposal.[3] The other involves the USDA and its role in a series of partnerships with fast food chains that were designed to increase the amount of cheese on several menu items. This led to a headline in *The New York Times: "While Warning About Fat, U.S. Pushes Cheese."* [4]

These examples underscore the importance of looking for tensions first, rather than synergies, when public health officials are considering public-private partnerships. Such officials should think not only about the systemic effects of such partnerships, but also the cumulative effects of their relationships with industry. (In my paper, I offer further guidance about how they might begin to conduct such an assessment.)

Partnerships with industry will be most tempting for public officials when they are designed to achieve a goal that is central rather than peripheral to the official's mission. But if a public health official has insufficient resources to achieve a core objective, s/he should be both frank and vocal about the lack of public funding. I recognize that, in the current economic and political climate, legislators are likely to resist calls for additional funding. But it would be a mistake to downplay the perils of public-private partnerships in order to avoid those conversations, no matter how difficult they may be.

References:

1. U.S. Department of Agriculture, "National Strategic Partners,"http://www.choosemyplate.gov/partnering-program/national-partners/partner-list.html (last accessed May 21, 2013)

2. Jonathan H. Marks, "What's the Big Deal?: The Ethics of Public-Private Partnerships Related to Food and Health," Edmond J. Safra Research Lab Working Papers, No. 11, http://ssrn.com/abstract=2268079

3. Jeff Fields, "Big Beverage Gives $10 Million to CHOP," Philadelphia Inquirer, March 16, 2011,http://www.philly.com/philly/blogs/heardinthehall/118077483.html (last accessed January 31, 2013).

4. Michael Moss, "While Warning About Fat, U.S. Pushes Cheese Sales," The New York Times, November 6, 2010, http://www.nytimes.com/2010/11/07/us/07fat.html?pagewanted=all (last accessed, March 1, 2013).

http://www.ethics.harvard.edu/lab/blog/311-the-perils-of-public-private-partnerships

Further Disclosure

Brooke Williams

In April, we asked 16 think tanks to voluntarily disclose the names of all corporate and foreign government donors. Some of the results are in, and they range from disheartening to promising.

Knowing who funds think tanks is important, because many are helping to shape public policy as trusted, independent research institutions while at the same time catering to private interests. In donor pitches, many of the most influential think tanks in this country put a price on everything from public policy papers to meetings with lawmakers.

So far, 11 think tanks have responded to our letter and subsequent phone calls and emails. One promised to release a donor list within the next few months, two assert they already disclose funders, and the rest say it is not the public's business.

The National Bureau of Economic Research in Cambridge, Massachusetts, plans to publish a list of all corporations that contribute to its general operating budget in July.

James Poterba, president of the think tank, said in a letter that he spoke with the board of directors, and there was "general agreement that the NBER should move to a complete-disclosure regime." He said they are notifying donors first. The think tank doesn't receive donations from foreign governments, he said, and scholars list funders in each paper published.

"I am grateful to you for drawing my attention to an issue that our organization had not considered in some time," he said.

At the Center for Strategic and International Studies, Andrew Schwartz, senior vice president of external relations, said the think tank already discloses donors.

"We're not obligated to do it but we are very transparent about who funds each report and study," he said in an email. "It is listed in each work we produce."

He did not respond to questions about whether or not CSIS discloses all donors or just some, and if this includes any foreign governments.

"Just as another aside for your reference," he wrote, "we have recently had a successful building campaign and plan to publicly acknowledge the donors to our building in this new setting at the appropriate time when we move in and get settled."

Think tanks that declined to turn over donor details include the Center for American Progress (you can check out their internal, confidential list, thanks to Lab fellow Ken Silverstein), American Enterprise Institute, Hudson Institute, Center for the National Interest, Manhattan Institute, Competitive Enterprise Institute, and the Independent Institute.

The Reason Foundation, based in Los Angeles, pointed to the fact that it annually publishes a list of donors who gave $1,000 or more in its magazine. The list, however, includes donations from "Anonymous" at each level of giving.

Also on Reason's list of contributors is Donors Trust, a group that enables anonymous giving to free-market think tanks. An examination of tax filings shows Donors Trust and its sister organization, Donors Capital Fund, have given to 9 of the 16 think tanks we contacted requesting voluntary disclosure.

The letters are part of my ongoing project at the Edmond J. Safra Center for Ethics, in which I examine how corporations and foreign governments donate to think tanks to try and shape public discourse and policy from behind the scenes, thereby leaving the public in the dark.

http://www.ethics.harvard.edu/lab/blog/303-furtherdisclosure

Dispatch from Chile: The Ethics of Health Priority Setting, or Searching for True North Without a Compass

Adriane Gelpi

Imagine that you are the Minister of Health for Chile, a middle-income country with a nearly universal health system. You face a predicament that pops up regularly. The Chilean health system provides a politically popular package of health interventions to meet the medical needs of its citizens. At the moment, 80 conditions are covered, leaving those suffering from other conditions without access to care for their serious medical needs. You would like to add another benefit to the existing package of services, but the Minister of Finance has given you a hard ceiling on the budget. You cannot add a service without subtracting another, a politically perilous move.

So the task before you is to decide how to allocate the available health resources in the best way possible. But questions immediately arise: how do you define "best"? Many goals for this allocation could be reasonable. For example, you may decide to focus on outcomes, including maximizing overall heath gain, controlling expenditures, addressing diseases with high prevalence, a concern for social justice, a focus on vulnerable populations, or investment in capacity.

What should be covered? What will not be covered? More fundamentally, on what criteria will you base your decision? And once you know what substantive criteria will matter, how will you structure the *process* of allocating new benefits? Then once made, how will you justify the decision you reached?

As this example shows, ethical issues enter questions about health resource allocation at every stage of deliberation.

In fact, given the life and death consequences of health care issues, asking such questions about health resource allocation really amounts to a more wrenching question. In the words of economist Victor Fuchs, health priority setting asks, "who shall live?"

Participants at the Conference on Ethics of Priority Setting, March 22, 2013.

Conference in Chile: Ethics of Priority Setting in Health

Growing recognition of priority setting for heath as an ethical concern has motivated countries to seek out guidance. For that reason, in late March 2013, Professor Norman Daniels and I found ourselves on a long overnight flight from the snowy early spring of Boston to the sunny early autumn of Santiago.

Daniels, a philosopher at the Harvard School of Public Health, and I, a Safra Lab Fellow and PhD Candidate in Health Policy and Ethics, were traveling to Chile to lead a two-day conference on the "The Role of Ethics in Priority Setting for Health," co-organized by the Chilean Ministry of Health and Carla Saenz, PhD, Regional Bioethics Advisor of the Pan American Health Organization.

Held at the United Nations in Santiago, the conference brought together a wide range of attendees: from academics to physicians to Ministry of Health officials to bioethicists to economists. Attendees also came from abroad: one from Argentina, another from Peru. All showed up driven by an interest in thinking through how countries could make better and fairer decisions about health coverage.

Many Ministers of Health have no training in public health ethics in general, or priority setting in particular. In part, this reflects the broader fact that the ethics of priority setting for health is a nascent field. While understandable, this knowledge gap is not benign; it has real-world implications. If health ministers lack the analytic tools to evaluate the ethics of allocation decisions, it is more likely that ethical concerns will play a limited role in setting priorities for health systems. Expanding training in public health ethics, through conferences such as this one, will arm ministers with more tools to fully analyze the problems they face.

Structure of the Conference

The first morning Daniels and I opened the conference. We each delivered a distinct, but coordinated, keynote address: first, Daniels presented a broad overview of the need for an ethics of fair priority setting, and I built on this theoretical foundation by describing some real-world challenges that will arise when implementing any new process of fair policymaking.

Dr. Ximena Aguilera, one of the architects of Chile's benefits package, provided an overview of the plan's origins and historical evolution. Demand for expanded services, and the political gains that accompany such expansions, make it tempting to add more and more treatments. Yet without a corresponding increase in the budget, expanding the number of covered diseases would lead to shallower and worse treatment options. Nonetheless, political penalties would follow from the removal of any intervention from the existing list.

The next two days of sessions centered on group discussion of three case studies, developed by officials from the Chilean Ministry of Bioethics. Through the case studies, conference participants wrestled with specific and pressing policy issues facing the Chilean Ministry of Health.

Two of the cases discussed:

- *Rare Diseases*: should governments cover treatment for diseases that affect only a tiny portion of the population? Many of the existing treatments for such conditions are extravagantly costly and may have limited efficacy. Why should such patients suffer because they have the bad luck to get a rare disease? Many of these diseases lack effective treatments because of the lack of pharmaceutical incentives to invest in research and development. Should the government subsidize such research?
- *Beds in Intensive Care Units*: By law, Chilean hospitals now allow all patients, regardless of whether they are covered under private or public insurance, to receive care at the closest hospital. This system has led to unintended problems, as publicly covered patients who end up in private hospitals often remain there once the acute period is over because there are insufficient ICU beds in the public hospitals. The government absorbs the higher costs of treatment in a private hospital.

Many Questions, Few Answers

Two cross-cutting themes emerged from the discussion of the cases are worth mentioning:

Searching for Shortcuts: Human Rights and Cost-Effectiveness Analysis

Faced with one of the difficult cases, many participants asserted that human rights should dissolve the predicament. Given that Chile recognizes a human right to health care, one professor of public health argued that providing the patient the care he has a right to is the only ethical choice. What other conclusion would we draw?

Such comments reflect the common temptation to rely on what many to seem to view as objective measures, such as cost-effectiveness analysis and human rights, to answer the hard questions about priority setting quickly. Both approaches share a single pre-defined goal: in the case of cost-effectiveness, the goal is maximizing QALYs; in the case of human rights, the goal is to ensure the protection of certain legal entitlements.

In Latin America, the right to health is often enshrined in the constitution. Thus, many in the audience seemed to view human rights as a trump card, and a solution to priority setting issues. Yet this fallback to human rights language can be a way to avoid acknowledging the need for tradeoffs. It is not a criticism of human rights theory to note that it does not answer all the questions about how real-world Ministries of Health should face real-world problems, such as staying within a budget. No human right to health care will magically expand the budget or allow all pressing medical needs to be covered.

Ethical evaluation and justification is still necessary, regardless of one's commitment to human rights or the results of a cost-effectiveness study.

Citizen Participation and Advocacy

A second topic of vigorous discussion concerned the proper role of the public in the priority setting process. There was consensus in the group on the facts: they all agreed that in Chile certain powerful advocacy groups had effectively leveraged their might to get their pet disease covered by the benefit package.

For example, one speaker described how the Chilean Multiple Sclerosis Association bypassed the standard decision-making process to obtain coverage for MS. As a well-funded and organized group, they knew how to repeatedly "knock on the door" of the Ministry. They requested multiple hearings about the need to cover MS. Over time, these arguments bore fruit and MS was added to the list of covered conditions.

Yet opinions diverged about how to interpret the influence of special interest groups on the priority setting process. There is no problem, one high level official argued. "This is a good thing because the public should be able to express their voice, and in this case their voice resulted in getting their demands met. This is democracy."

When asked if the MS example offered a good model for citizen participation, one official answered, "Yes. It is important that the citizens have a voice."

Others, including me, expressed concern at this positive spin on the MS case. Even worse than its ad hoc nature, the case of MS clearly reflects the direct connection between money and social power and political results. The relative socioeconomic power of the MS group made it possible for them to gain an audience with the Ministry in the first place, and then to persuade the government to add treatment for MS to the benefit package.

This anecdote also highlights the importance of political context in shaping ethical perceptions. In Chile, the Pinochet dictatorship only fell in 1990, and it still casts a long shadow. Given this legacy of authoritarianism, we might argue that such demonstrations of citizen power offered a sign of progress, not corruption. In the face of this history, Chile's growing responsiveness and openness to the arguments of its citizenry was an explicit source of pride to certain attendees. The MS anecdote underscored this perceived political improvement.

Seeking guidance from the general public is critical, but the challenge is to do so fairly. For example, Chilean government has held "social round tables" in the past, which sought out public opinion. They have always conducted social surveys of societal preferences about priorities in health. From these efforts came the finding, noted by Dr. Aguilera, that Chilean society strongly values prioritizing children over the elderly. Public opinion can insure that policies reflect social preferences, and also increase trust in the Ministry and normative and political legitimacy.

Such examples of interest groups influencing policy, it should be noted, are not at all unique to Chile. (Further, as other Safra Center research has shown, it is not unique to health care either). Many countries lack systematic priority setting processes and therefore make decisions about health policies in an ad hoc manner, choosing whether to cover a treatment or not based on the arbitrary application of varying criteria.

Priority Setting in Health as a Problem of Institutional Corruption

The Chilean conference reaffirmed the often-asserted truism that reasonable people will disagree about fair decision making processes. While some disagreement may be inevitable, common approaches to ensuring fair priority setting process are often are inadequate. For example, many guidelines, or frameworks, aim to generate lists of "good" factors that will promote fair policymaking, along with "bad factors" that should be excluded from a fair process. A Ministry can then evaluate its own process against the checklist of good principles and features to avoid.

However, a process can meet all the defined criteria and still fall short. For example, public participation is a noble goal. But as the Chilean MS case shows, public participation can subvert other important priorities.

The Chilean conference highlighted just how complex public health resource allocation can be. Lists of criteria--substantive or procedural, positive or negative—alone cannot prevent rationalization of decisions unduly influenced by special-interest pressure groups. In fact, the enumeration of such lists may increase the possibility of post-hoc ethical justification of illegitimately reached decisions, i.e. ones that invoke reasonable principles without having considered the universe of relevant arguments and facts.

While there is no easy solution to this problem, I propose that viewing priority setting in health through the lens of institutional corruption (IC) may be illuminating. The definition of IC includes the concept of a force causing magnetic deviation from the "true north" of an institution. This image begins identify a different way of describing the problem of health priority setting. The IC lens frames undue influences as magnetic forces that pull a Ministry of Health away from its true mission. This is valuable because while we can see this pull exerting influence in real cases of health resource allocation, we have lacked a holistic analytic framework for diagnosing such problems.

Still unanswered, however, is the question of how the "true north" for Ministries of Health should be defined.

One goal for future research, then, is to begin to enumerate the myriad ways that a health priority setting process can go astray or deviate from what we would intuitively think is a proper allocation procedure. This enumeration can begin prior to defining a "true north" and without a clear vision of idealized decision making, although such theoretical work would be complementary. Indeed, institutions will need to make decisions about their goals and procedural decision making processes without an overarching theoretical framework.

Eventually, the inductive process of identifying these deviations could help define what proper priority setting might look like, and aid in developing practices that expunge the sorts of undue influences that distort policy making.

Viewing priority setting for health as a problem of institutional corruption, therefore, is far from condemnatory. Rather, such a reframing provides a path towards more ethical processes by opening up possibilities for innovation and creativity.

In other words, one lesson from Chile is that we need to "build the compass" that will help define "true north" for public health policymaking institutions. Once armed with such a compass, countries like Chile can begin to align their practices in a way that will keep the ship of state on an ethical course.

http://www.ethics.harvard.edu/lab/blog/313-dispatch-from-chile

Tackling Institutional Corruption in Financial Markets

Justin O'Brien sets out an agenda to embed warranted confidence

The most striking aspect of the announcement by the British Banking Association of its plans to overhaul the process by which the daily London Interbank Offered Rate (Libor) is set is its piecemeal nature. From July 1 there is to be a three-month delay before publication of individual submissions.

The move is aimed at restoring trust in the validity and utility of the benchmark, used to price trillions of dollars in derivative contracts. The British Banking Association claims it will reduce the risk of the kind of manipulation that has already prompted multi-billion dollar settlements against three international banks—Barclays, UBS and RBS.

These settlements, however, are just the tip of the iceberg. As the Financial Stability Oversight Council noted in its most recent report:

> Recent investigations uncovered *systematic false reporting and manipulations* of reference rate submissions dating back many years. This *misconduct* was designed to either increase the potential profit of the submitting firms or to convey a misleading picture of the relative health of the submitting banks. These actions were *pervasive*, *occurred in multiple bank locations around the world, involved senior bank officials at several banks, and affected multiple benchmark rates and currencies*, including LIBOR, EURIBOR, and the Tokyo Interbank Offered Rate (TIBOR). Each of the banks that faced charges engaged in a *multi-year pattern of misconduct that involved collusion* with other banks [emphasis added].

A confluence of endogenous and exogenous factors makes the Libor scandal truly a perfect storm for banking industry. The global investigation is ongoing making it inevitable that New York-based institutions will become implicated. The critical question is whether adequate defenses can be put in place to provide protection against further catastrophic failure of oversight.

Fixing Libor and associated benchmarks, therefore, is the most pressing issue in the regulation of global finance. By its very nature, it necessitates transnational cooperation. It also requires the integration of technical and normative considerations.

For the rhetoric of anchoring finance to the needs of society to have sustenance necessitates substance, a criterion that has been demonstrably lacking to date.

The situation is rendered unsustainable if those responsible are not held to account and the systems put in place in the aftermath of crisis paper over the cracks rather than address the structural dynamics that inform the operation of a given regulatory regime. These include which institutional actors have voice, authority and legitimacy and how given preferences are mediated, evaluated and made manifest. Critically, these battles tend to be most obtuse at the crucial implementation stage, which is largely but erroneously conducted on a technical basis and largely outside sustained public gaze.

The deleterious effects of such an approach have underpinned the intervention of the former Chairman of the Federal Reserve, Paul Volcker. He used a recent speech in New

York to call for the establishment of a new commission. Its remit would be to ascertain and balance legitimate private and public interests.

The call reflects profound pessimism. The finance sector has failed to internalize the effects of failure of oversight or accept blameworthiness, preconditions for the building of sustainable future frameworks. For Volcker the situation is exacerbated by the institutional corruption of the regulatory process.

In a telling rationale, Mr Volcker noted the current regulatory architecture in the United States is a 'recipe for indecision, neglect and stalemate, adding up to ineffectiveness. The time has come for change.'

The need for change also animated the unexpected but exceptionally powerful intervention of Pope Francis. The pontiff noted that the 'worship of the golden calf of old (cf. *Exodus* 32:15-34) has found a new and heartless image in the cult of money and the dictatorship of an economy which is faceless and lacking any truly humane goal.'

For Pope Francis this state of affairs has practical ideational roots. It derives from corruption, fiscal tax evasion and 'ideologies which uphold the absolute autonomy of markets and financial speculation, and thus deny the right of control to States, which are themselves charged with providing for the common good. A new, invisible and at times virtual tyranny is established, one which unilaterally and irremediably imposes its own laws and rules.'

What unifies these approaches is the need to render subservient means to ends through a process of ethical and political renewal. Both Pope Francis and Paul Volcker suggest in their different ways fundamental flaws, which must be addressed if warranted confidence in capital market conduct is to be returned. This necessitates conceptual as well as practical reform. As could be expected, the Pope stressed the normative dimension.

> There is a need for financial reform along ethical lines that would produce in its turn an economic reform to benefit everyone. This would nevertheless require a courageous change of attitude on the part of political leaders. I urge them to face this challenge with determination and farsightedness, taking account, naturally, of their particular situations. Money has to serve, not to rule... In this way, a new political and economic mindset would arise that would help to transform the absolute dichotomy between the economic and social spheres into a healthy symbiosis.

The Anglican community has expressed a similar combination of unease and exhortation. In an open letter to the leaders of the G8, about to be staged in a luxury resort in economically ravaged Northern Ireland, the Archbishops and Bishops of the Church of Ireland made pointed reference to the fact that 'the levels of youth unemployment in wealthy countries is not only an economic disaster, it is also a moral tragedy.'

Significantly, and equally pointedly, they note that 'it is perhaps one of the strangest and saddest aspects of the world post 2008 that governments, especially governments of wealthy countries, have not promoted serious discussion of alternative economic models beyond those of a particular form of financial capitalism.'

Secular and religious sensibilities come together in the persona of the Archbishop of Canterbury, Rev Justin Wilby, who has emerged as a significant powerbroker in the United Kingdom, where he serves on the British Banking Standards Commission.

Established in the immediate aftermath of the Barclays settlement, the parliamentary commission has been critical in forcing substantive debate on the purpose of regulatory intervention. In the process it has reclaimed the lost normative foundations of the disclosure paradigm. How to embed ethical restraint given the failure of technical measures alone has informed its deliberations and interim reports, which have been as critical of regulators as the industry itself.

With impeccable timing, its final report is to be released on Friday, just in time to inform the G8 agenda.

To be successful as an agent of change, however, requires a recognition from the financial services sector itself that the bifurcation between the economic and the political and social spheres has been disastrous to societal cohesion and indeed its own self-interest. This necessitates much more fundamental reform than that offered by the British Banking Association, which is to be stripped of its oversight under a review process overseen by the Treasury department. The question is whether the regulatory agencies have the mandate, resources or political support to effect cultural change.

One suggestion is that within the European Union the oversight function should be transferred to the Paris-based European Securities and Markets Authority, an indication that the City of London is losing legitimacy and authority. Changing location of oversight without securing commitment is however problematic. The International Organization of Securities Commissions (IOSCO) has advocated a global set of principles governing benchmark setting and administration. Unfortunately, these principles remain vague and rooted in technicalities rather than moral obligation.

Reforming Libor and by extension the financial industry necessitates a renewed social compact of the kind that underpinned the initial architecture of the disclosure paradigm. It is time for the return of political agency. It is time for a New Deal before the tsunami of litigation and warranted distrust destroy the foundations of the financial system itself. As Roosevelt pointed out in 1933, there is an urgent need to put 'an end to a conduct in banking and in business, which too often has given to a sacred trust the likeness of callous and selfish wrongdoing.' Without that kind of political will, reform will be an illusion. It is time to fashion it, tempered by the knowledge that the societal implications of failure are already apparent in the unemployment figures.

Professor Justin O'Brien, an Australian Research Council Future Fellow is Director of the Centre for Law Markets and Regulation at UNSW Law, Sydney and Visiting Fellow at the Edmond J. Safra Center for Ethics, Harvard University, which has just published his paper 'Culture Wars: Rate Manipulation, Institutional Corruption and the Lost Normative Foundations of Market Conduct Regulation'
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2277172

http://www.ethics.harvard.edu/lab/blog/314-tackling-institutional-corruption-in-financial-markets

The Emperor's New Clothes: A View into the Current State of Municipal Ethics

Carla Miller

My favorite fairytale when I was growing up was the famous Hans Christian Andersen story, The Emperor's New Clothes. In it, people deny the obvious fact that the Emperor was naked; they had to applaud his "new clothes" or they would be considered stupid by the group. And then a young child cries out "but the emperor is naked." I wanted to be that little child. I wanted to be brave when I saw something wasn't right, to shout out, not whisper, until others saw the truth. Years later, I got my chance, starting as a federal prosecutor.

"Here's a new file for you to chew on," said the U.S. Attorney. "Four of my attorneys have rejected it and don't see a case." Part of the evidence was a videotape of the President Pro Tem of the Florida Senate promising a restaurant owner—a felon and former member of the mafia—that he would get a state liquor license, and then the senator leaving the room with a brown grocery bag stuffed with cash. Surely, there was something wrong here. This led to a one-year grand jury investigation, several convictions and 14 additional investigations of city officials. The tentacles of institutional corruption in the city were pervasive but only the most egregious incidents resulted in criminal convictions.

A few years later, when I was in private practice, one of the men I convicted called me from federal prison. He was crying, almost delirious with grief, and wanted to talk. I felt incredible empathy for him. A promising career spun out of control—what could have been done to prevent this? Anything?

A colleague became mayor on an anti-corruption platform and I volunteered to help draft the first ethics code for our city, Jacksonville, Florida. I wrote sections creating an Ethics Officer and requiring ethics training (maybe this would help?). In 1999, I was asked to be the city's first Ethics Officer, which I agreed to do as a volunteer. I wanted our program to be top-notch and I started a review of all U.S. municipal ethics programs. I developed a national website as a resource for other cities, was an officer of the national government ethics body (www.cogel.org) and worked to implement an anti-corruption office in my home city. After studying hundreds of examples, it became clear that local government ethics programs in the U.S. focus almost exclusively on legal compliance. (If you follow the law, all is OK.)

Current literature and research on institutional corruption typically deals with the "Big Boys"—Congress, the pharmaceutical industry, major banks. Issues focus on conflicts of interest and global connections that necessitate complex computer programs to track abuses. Most of this is over the heads of average Americans. They don't understand it. They don't get it. But they hope someone figures it out and handles it.

What they do get is what happens in their own local governments, the things that affect their lives directly, like lobbyists influencing council members so that a mega-store gets built near a residential area. Like the head of a city department using influence to "win" their spouse a million dollar no-bid contract. Like taxes going up to pay for out of control pension programs negotiated between unions and politicians. To borrow from Tip O'Neill, all politics is local. There are close to 40,000 local governments in the U.S. with varied approaches to ethics and anti-corruption programs. Let's take a look at some of them.

The first approach could be called the "Turtle approach." That is, pull your head in and pretend no problems exist. It's enough if we comply with the law, and besides, we've always done it this way. This would seem to result from complete lack of awareness of the dependencies and influences that comprise institutional corruption or, alternatively, the recognition of the benefit of maintaining such a system.

The default approach of lawyers is what I call the "Hammer approach." It's characterized by things like 40-slide PowerPoint presentations that go over all of the conflict of interest laws in detail. Copies of the laws are distributed and people sign acknowledgement forms so you can prove "they were told." Unfortunately, or by design, this overlooks the actual corrupting influences in the system. Most of the tips and hotline calls I have received as Ethics Director were about situations clearly corrupt as defined by the Center but technically legal. ("You aren't saying we broke the law, are you?") Having officials timely file their financial disclosure forms does not mean that all is well; it could be a thin veneer of compliance over a corrupted system. The legal approach is certainly a necessary component, but needs to be analyzed in light of the research of Yuval Feldman as to legal ambiguity and rule-following behavior.

Many cities attempt a "Values" approach and bring in experts to run seminars on basic ethics concepts. This is considered more advanced than just training on the law. This confuses the concept of personal integrity with the institution's integrity, as outlined by Dennis Thompson, founding director of Harvard's Center for Ethics and the Professions, now the Edmond J. Safra Center for Ethics. There may be elements of this approach that could be

useful, as hypothesized by William English, who is researching the reliance on personal ethics where incentive architecture is not feasible.

A more complex approach is the "Decision-Making Labyrinth" which involves conversations about the law, the stakeholders, and the process used to arrive at a decision. One time I saw a lecture with an outline of how you should make a decision that filled an entire blackboard. Who makes decisions like that? The more complicated a process becomes, the more it can be manipulated by those with special interests.

And lastly, we have the approach most often used after a scandal, the "Window-Dressing Exercise." Here, you roll out an ethics code and appoint local VIPs to a blue ribbon commission. You can spot this type of program, as it is typically connected to big press releases. Many times, the VIPs are culled from the same in-group responsible for the institutional corruption in the first place. After months of meetings, a few rules are put in place. Do they serve the public and get at the root of the corruption? Rarely.

While these frenzied "ethics" activities are taking place, the key power-brokers of the city are executing multi-million dollar contracts and channeling money to favored friends and business partners. Citizens intuitively know that their interests are not being protected, which leads to mistrust of local government. When this is combined with their mistrust of Congress, there is a cascading effect of disillusionment and disengagement. The very best players in this local government environment progress to Congress. Therefore, I would argue that in order to handle institutional corruption at the national level, it is crucial that we address solutions for municipalities.

There are many competent and well-intentioned people working in municipal ethics programs and they create positive effects. It is not their feathers that I wish to ruffle. My comments stem more from frustration at the shotgun approach in developing comprehensive programs. How is corruption defined? What structures are best suited to handle it? What educational tools are most effective? Who do you train, in what sequence, with what and why?

If the approach is disorganized and delivered in formats and structures that bore people or worse, inculcate hostility towards "ethics," we are going backwards. This diminishes public trust and wastes limited resources that could be used to help people. The fact that we have sporadically trained officials and addressed random issues is not enough. We need a transformational approach based on research that has some chance of success.

When I first discovered the Center's website and Professor Lessig's 2009 lecture on the framework of institutional corruption, it was a turning point. The brick wall I had been running into had been named and defined. That is the foundation for being able to dismantle it.

I look forward to working with others at the Center. Their work has already shifted my viewpoint on what can be accomplished in the fight against institutional corruption. The Center's research can be applied directly to municipal governments so that citizens and officials can be equipped with effective tools to stand up and say "the emperor is naked."

I know with 40,000 municipalities, that this is somewhat ambitious. But, as JFK stated, "Those who dare to fail miserably can achieve greatly."

I believe in the mission of the Edmond J. Safra Center for Ethics and hope to contribute to the effort—to the hope that together, we can "achieve greatly" in the fight against institutional corruption.

Attributions: Scan and text by George P. Landow

http://www.ethics.harvard.edu/lab/blog/315-the-emperors-new-clothes

The Tower of Institutional Corruption: The Bank for International Settlements In The Nightmare Years

Gregg Fields

In 1963, the political theorist Hannah Arendt produced "Eichmann in Jerusalem: A Report On The Banality of Evil," a chronicle of the trial of Hitler's infamous, murderous henchman. Arendt stated the controversial viewpoint, "The trouble with Eichmann was precisely that so many were like him, and that the many were neither perverted nor sadistic, that they were, and still are, terribly and terrifyingly normal."

A riveting—if at times dispiriting—new book by British journalist Adam LeBor puts Arendt's theory in a different context. It's titled "The Tower of Basel: The Shadowy History of the Secret Bank that Runs the World." (PublicAffairs, Perseus Books Group).

The book might have been subtitled, "The banality of institutional corruption." The shadowy organization that LeBor refers to is the Bank for International Settlements. For those who haven't heard of it, the BIS isn't the kind of place where you go to get free checking. It is a central bank for central banks.

And it is unquestionably powerful and influential. Among other things, it hosts the Basel Committee on Banking Supervision, the international agency that has been trying—with mixed results—to bolster capital levels for financial institutions around the world. And it also hosts the Financial Stability Board, which acts as a coordinator of economic regulatory authorities around the globe. According to LeBor, BIS members regularly meet in private meetings—every other month on a Sunday at 7 p.m.—over lavish meals to hash out, in essence, how to run the world.

The BIS is secretive, no question. As one example, its website notes that its archives are open to the public—provided the records are over 30 years old, "with the exception of a limited number of records."

Despite some high hurdles, LeBor succeeds at peeling away at least some of the BIS's facade to reveal a great deal of how it operates. Its founding statutes call for the BIS to "promote the cooperation of central banks and to provide additional facilities for international financial operations," LeBor writes. That benign sounding mission would later become the justification for participating in some of the most horrendous crimes in human history.

Setting The Stage

The BIS was formed in 1930, largely to process the World War I reparations required of Germany. It also performed the function of providing liquidity to European governments, which were struggling with economic instability, currency fluctuations and the Great Depression. Central banks of most large European countries joined to create the BIS. (The

U.S. Federal Reserve did not join until 1994, although its allotted shares were held by American banking interests.) Basel, in neutral Switzerland, was a natural headquarters pick.

BIS describes itself as the world's oldest international financial institution, which was a novel business model in 1930. One mechanism used to perform its duties was having countries assign their gold reserves to BIS accounts—though the gold itself might be stored elsewhere—and payments between countries were processed by officials in Basel.

By now, you've probably guessed where this is going. Adolf Hitler rose to power and Germany within a few years was unleashing its formidable war machine across Europe and setting the stage for what would become the Holocaust.

It would be reasonable to assume that the BIS then went out of business. Clearly, there weren't going to be any reparations forthcoming from the Third Reich. But the BIS became, in essence, an ATM for Berlin, LeBor argues, treating the murderous regime as if it were just another government. (The British-born LeBor, a foreign correspondent based in Budapest, clearly has the credentials for this work. His previous book, Hitler's Secret Bankers, examined collaboration of Swiss bankers with Nazis and was short-listed for Britain's prestigious Orwell Prize.)

He devotes a great deal of Tower of Basel to an episode which, though highly controversial at the time, is often overlooked by history. After Germany annexed the Sudetenland province of Czechoslovakia in 1938, Czechoslovakian leaders transferred much of the country's gold to two accounts at the Bank of England for safekeeping, LeBor writes. One account was in the name of the BIS and another was in the name of the National Bank of Czechoslovakia itself.

In early 1939, German officials demanded Prague hand over 14.5 metric tons of gold, supposedly to back Germany currency now circulating in the Sudetenland. In essence, LeBor notes, Berlin was demanding Czechoslovakia "supply the gold to pay for the loss of its territory."

A month later, Germany invaded Prague and Czechoslovakia ceased to exist. Three days later, the Reichsbank demanded the National Bank of Czechoslovakia order the gold in its BIS account transferred to Germany. They were also ordered to request the Bank of England transfer the 27 metric tons of gold in the National Bank of Czechoslovakia account there to Germany.

"The BIS transfer order went through," LeBor writes. He adds that "Nazi Germany had just looted 23.1 metric tons of gold without a shot being fired."

The Bank of England did refuse to transfer the gold in the National Bank of Czechoslovakia account there. Nevertheless, the BIS transaction gave the Third Reich a new source of funding with which to finance its war effort.

The process was repeated throughout the war years, as Germany used plundered wealth to stoke its war machine. Accompanying the looting of central bank assets were proceeds from the "Aryanization" of Jewish-owned businesses that were stolen from their owners. Meanwhile, Germany gained ever greater influence at the BIS, leading to the completely reasonable assumption that it had a firmly pro-Nazi slant.

Its multi-national staff—the president from 1940-46 was an American named Thomas McKittrick—got along well, LeBor reports. When the battles got within shooting distance—

Basel borders Germany and France—the bank simply retreated to temporary quarters in the Swiss interior.

Institutional Blindness

LeBor's recounting of the nightmare years of World War II is fittingly chilling. And perhaps unwittingly, LeBor's investigation raises a troubling question: At the BIS, where did the institutional corruption actually begin, and could it have been prevented or stopped?

One fact is undeniable: From the beginning, the BIS achieved immunity from essentially all banking regulation and international laws. Although it functioned as a central bank, it wasn't actually connected to a government. It was virtually self-governing. Located in neutral Switzerland, it gained another layer of protection by not being subject to even the notoriously secretive Swiss banking laws. For years it didn't bother to put a sign on its door. That autonomy continues.

The lack of transparency and accountability thwarted officials in Washington and Europe who wanted the BIS to be shut down. (At the Bretton Woods Conference in 1944, where plans for the post-war monetary system were developed, Norway, the U.S. and others worked to have the BIS dismantled. The effort ultimately failed.)

What is most shocking in LeBor's book is the moral blindness of BIS officials. Their goal was, apparently, to simply grease the wheels of global commerce. Their eyes were shut to the horrors in front of them.

After the war, the BIS reinvented itself as a natural team captain for the rebuilding of Europe. It didn't merely survive—it thrived. Its curved headquarters opened in 1977 and its multilingual workforce quickly earned it the nickname the Tower of Basel, a reference to the Tower of Babel story in the Bible.

Clearly, the BIS is far from the only institution shown to have been, at best, indifferent to the slaughter of Europe's Jews and the Nazis' other crimes against humanity. As a story in The New York Times recently noted: "The list of institutions and industries that have been accused of whitewashing their links to the Third Reich is long, including various governments, the Vatican, Swiss banks and American corporations like IBM, General Motors and DuPont."

Judging by other reviews, I'm also not the only reader to feel LeBor writes a bit too conspiratorially about the modern-day BIS. "Mr. LeBor's polemical tone makes his book compelling, though at times you wonder if he wrote it in a hut in the Idaho backwoods while waiting for the United Nations and the staff of Goldman Sachs to invade and carry off his firstborn," is how The Wall Street Journal put it.

But Lebor's important new book shows that the Third Reich didn't rely on bombs and bullets alone. It was also aided by the banality of institutional corruption.

http://www.ethics.harvard.edu/lab/blog/319-tower-of-institutional-corruption

The Bipartisan Lobbying Center: How a Washington Think Tank Advocates for Political Unity - and its Top Donors

Ken Silverstein

The Bipartisan Policy Center (BPC), says its website, "drives principled solutions through rigorous analysis, reasoned negotiation and respectful dialogue," and "combines politically-balanced policy making with strong, proactive advocacy and outreach." The BPC, which is often described in press accounts as a "centrist think tank," is highly influential and the media and Congress treat its reports and pronouncements as consequential and weighty.

The BPC's reputation is further enhanced due to the large number of former government officials and Members of Congress who serve on its board and as "senior fellows." For example, on May 8, 2013, a story in *Politico* said that two former Senators had thrown "their energy policy weight… to make the case that the private sector—rather than federal government—should decide on whether to export natural gas." One of the former Senators was Byron Dorgan, a Democrat from North Dakota, who was identified in the story with the reassuringly neutral title of co-chairman of the BPC's Energy Project. The story cited Dorgan's recent Congressional testimony, during which he had said, "We believe the market should make the decision about the exports of natural gas."

The story didn't mention that Dorgan is a "senior policy advisor" and co-chair of the lobbying practice at Arent Fox, one of Washington's premiere influence peddling shops. Nor did it say that energy companies, including America's Natural Gas Alliance, heavily fund the BPC. That's typical of the free ride the press gives to the BPC, which routinely advocates, under the guise of independent scholarship, for policies that benefit its donors.

The BPC was founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole and George Mitchell, who all cashed in on their government experience by working for Beltway law and lobbying firms, and advising major corporations. The think tank's funders include foundations, corporations and trade associations, with donors in the last two categories including FedEx, General Dynamics, Northrop Grumman, the American Bankers Association, BP, Chevron, Citigroup, ConocoPhillips, the Nuclear Energy Institute, and Shell.

A number of prominent BPC "senior fellows" work as lobbyists: These include:

- Robert Bennett, the former GOP Senator from Utah, who is also a "senior policy advisor" at Arent Fox and who registered to lobby last January, immediately after he was exempted from the law that bars former elected officials from lobbying for two years after retiring from public service. Bennett, a former member of the Senate Banking Committee, also formed his own consulting firm to advocate on behalf of major financial institutions. His clients have included Americans Standing for Simplification of the Estate Tax (ASSET), a front group working to slash the inheritance tax.

- Dan Glickman, the former Secretary of Agriculture and ex-Democratic House member from Kansas, who represented the Motion Picture Association of America and whose lobbying clients while at the firm of Akin Gump Strauss, Hauer & Feld included Dow Chemical, American Financial Group Inc., Alliance of American Insurers, Mortgage Insurance Companies of America, and the Walt Disney Company.
- Trent Lott, the former Republican Senator from Mississippi, who has lobbied for numerous companies, including energy giants ExxonMobil, Chevron and Shell, and America's Natural Gas Alliance.

The BPC has programs in health care, economic policy, infrastructure, national security and energy. The latter is led by Dorgan, Lott and William Reilly, who headed the EPA under George Bush Sr., and whose board affiliations have included ConocoPhillips and DuPont. Corporations are the dominant group among the energy project's membership list, including CEOs and executives from Marathon Oil, ExxonMobil, Anadarko Petroleum Corporation, Exelon Corporation, and Southern Company. For window dressing there is one environmentalist, Ralph Cavanagh of the Natural Resources Defense Council.

The majority of BPC's funding comes from "philanthropies" and its energy work is supported by grants from the William and Flora Hewett Foundation and Climate Works Foundation, Rosemarie Calabro Tully, spokeswoman for the think tank's energy project, told me. "Foundation funding is generally provided to support a specific project, while corporate funding is directed to support BPC's general operations," she said.

Last February, the BPC issued a report, "America's Energy Resurgence: Sustaining Success, Confronting Challenges," which included over fifty policy recommendations. The chief outside consultant on the report was William Klinefelter, a lobbyist whose major clients include ExxonMobil.

So it's hardly a surprise that the report paid lip service to alternative energy but heavily promoted the fossil fuel industry. For example, in terms of oil and gas, it called on Congress to "expand access to oil and gas exploration and production in the Eastern Gulf of Mexico," and said the Interior Department "should accelerate the timetable for leasing areas off the coasts of the Mid-and South Atlantic states." In other words, full speed ahead for offshore drilling.

A *Wall Street Journal* story on the piece quoted Lott—his status as a former Senator and affiliation with the BPC were noted, but not his work as an energy lobbyist—as saying, "I would say to the leaders, Reid and McConnell, if you're looking for something that historically has been bipartisan, something where you could come together and do good for the country, energy is it." It said that Lott had recalled the "good old days of bipartisan cooperation," and that energy would be "a good place" for Congress to start that again. Other BPC personnel testified on the Hill and promoted the report's industry-friendly recommendations.

Meanwhile, the BPC's Energy Project is holding a series of events to discuss its positions on energy. The affairs are hosted by BPC Senior Fellow and former Republican Senator Pete Domenici (who in 2006 was voted "Worst in the Senate" by Republicans for Environmental Protection due to his efforts to promote oil drilling in the Arctic National Wildlife Refuge) and David Goldwyn (who served at the Energy Department under Bill Clinton, then ran a consulting firm that provided "political and business intelligence" to oil companies, then

became the State Department's Coordinator for International Energy Affairs under Obama, and now has returned to the private sector as an energy consultant).

Speakers and panelists at the BPC's first event on June 12, 2013 included a number of energy industry analysts (for example, Edward Morse, Global Head of Commodities Research at Citibank) and former Louisana Senator Bennett Johnston. He has lobbied for energy interests ever since retiring and has also been a Chevron board member and policy advisor to The Heartland Institute, a clearinghouse for climate change denial.

The keynote speaker was Senator Lisa Murkowski from Alaska, one of the most pro-energy industry members of Congress. "We…know that this is an issue on which we must take the long view, recognizing that it will play out across decades," she said, according to a transcript of her remarks. "We will need the best and brightest working on this question, and I see many of you gathered here today. I'm glad to join you—and glad to be part of this conversation—because we really must approach it in a balanced and bipartisan manner."

And even more importantly to the BPC, in a manner that helps out its donors and the staff's lobbying clients.

--

Note: For more on the BPC, see this *Nation* piece about its work on behalf of US-based retailers who, even in the aftermath of several garment factory disasters in Bangladesh, have refused to sign a binding plan to improve working conditions. Also see this story by David Halperin, who discusses its work on behalf of energy companies.

Research assistant: Diego Arene-Morley

http://www.ethics.harvard.edu/lab/blog/320-the-bipartisan-lobbying-center

Corrupting Practices Harm Patients

Donald W. Light

In just a few months, the countervailing powers of academics, researchers, and the British medical profession have mounted the final campaign against the corrupting practices of hiding negative trial results that earned prominent attention recently in *The New York Times*. Led by Peter Doshi and Ben Goldacre, the campaign includes formal endorsement by the British Medical Association, the Medical Research Council, and the editorial boards of three of the world's leading medical journals. Thirty years of distorting medical knowledge and clinical guidelines seem to be ending; but imagine the difference if the AMA, the IOM and the NEJM joined them.

While transparency is important in its own right, the real goal is to reduce unnecessary injury and sickness to patients that results from hidden or misleading information about the harm:benefit ratio—the chances of being harmed from toxic side effects compared to the chances of being helped by taking a new drug. Harm to patients is mentioned in passing, but it deserves greater attention as reflecting the root of this and related practices that distort medical knowledge—substantially more sales and profits from selected positive spin than full disclosure would generate. The BMJ has just published my letter making this case.

As rational economic actors, pharmaceutical companies suppress or selectively publish results from clinical trials to make their drugs look less harmful or more effective than they really are so that more doctors will prescribe them and increase profits. That means more patients are exposed to a worse harm:benefit ratio than they are led to believe.

This applies to other Edmond J. Safra research projects on pharmaceutical policy as well. For example, the bottom line for ghost managing and ghost writing articles is more sales but more adverse events and less benefit for patients who are misled to believe drugs are safer and better than they are.

The bottom line for paying experts and clinicians is more sales but more adverse events and less benefit for patients who are misled to believe drugs are safer and better than they are.

The bottom line of off-label marketing that skirts FDA prohibitions is more sales but more adverse events and less benefit for patients who are misled to believe drugs are safer and better than they are.

Evidence of an epidemic of harmful side effects from drugs that usually have few or no advantages to offset their risks is made in an article for the Edmond J. Safra special issue of the *Journal of Law, Medicine and Ethics* on pharmaceutical policy. Emphasizing that epidemic magnifies the importance of policy research on data transparency, ghost management, payment disclosure, and prescribing for unapproved uses.

http://www.ethics.harvard.edu/lab/blog/321-corrupting-practices-harm-patients

Risky Drugs: Why The FDA Cannot Be Trusted

Donald W. Light

A forthcoming article for the special issue of the *Journal of Law, Medicine and Ethics* (JLME), edited by Marc Rodwin and supported by the Edmond J. Safra Center for Ethics, presents evidence that about 90 percent of all new drugs approved by the FDA over the past 30 years are little or no more effective *for patients* than existing drugs.

All of them may be better than indirect measures or placebos, but most are no better for patients than previous drugs approved as better against these measures. The few superior drugs make important contributions to the growing medicine chest of effective drugs.

The bar for "safe" is equally low, and over the past 30 years, approved drugs have caused an epidemic of harmful side effects, even when properly prescribed. Every week, about 53,000 excess hospitalizations and about 2400 excess deaths occur in the United States among people taking properly prescribed drugs to be healthier. One in every five drugs approved ends up causing serious harm,[1] while one in ten provide substantial benefit compared to existing, established drugs. This is the opposite of what people want or expect from the FDA.

Prescription drugs are the 4th leading cause of death. Deaths and hospitalizations from over-dosing, errors, or recreational drug use would increase this total. American patients also suffer from about 80 million mild side effects a year, such as aches and pains, digestive discomforts, sleepiness or mild dizziness.

The forthcoming article in JLME also presents systematic, quantitative evidence that since the industry started making large contributions to the FDA for reviewing its drugs, as it makes large contributions to Congressmen who have promoted this substitution for publicly funded regulation, the FDA has sped up the review process with the result that drugs approved are significantly more likely to cause serious harm, hospitalizations, and deaths. New FDA policies are likely to increase the epidemic of harms. This will increase costs for insurers but increase revenues for providers.

This evidence indicates why we can no longer trust the FDA to carry out its historic mission to protect the public from harmful and ineffective drugs. Strong public demand that government "do something" about periodic drug disasters has played a central role in developing the FDA.[2] Yet close, constant contact by companies with FDA staff and officials has contributed to vague, minimal criteria of what "safe" and "effective" mean. The FDA routinely approves scores of new minor variations each year, with minimal evidence about risks of harm. Then very effective mass marketing takes over, and the FDA devotes only a small percent of its budget to protect physicians or patients from receiving biased or untruthful information.[3] [4] The further corruption of medical knowledge through company-funded teams that craft the published literature to overstate benefits and understate harms, unmonitored by the FDA, leaves good physicians with corrupted knowledge.[5] [6] Patients are the innocent victims.

Although it now embraces the industry rhetoric about "breakthrough" and "life-saving" innovation, the FDA in effect serves as the re-generator of patent-protected high prices for minor drugs in each disease group, as their therapeutic equivalents lose patent protection. The billions spent on promoting them results in the Inverse Benefit Law: the more widely most drugs are marketed, the more diluted become their benefits but more widespread become their risks of harm.

The FDA also legitimates industry efforts to lower and widen criteria prescribing drugs, known by critics as "the selling of sickness." Regulations conveniently prohibit the FDA from comparing the effectiveness of new drugs or from assessing their cost-effectiveness. Only the United States allows companies to charge what they like and raise prices annually on last year's drugs, without regard to their added value.[7]

A New Era?

Now the FDA is going even further. The New England Journal of Medicine has published, without comment, proposals by two senior figures from the FDA to loosen criteria drugs that allege to prevent Alzheimer's disease by treating it at an early stage.[8] The authors seem unaware of how their views about Alzheimer's and the role of the FDA incorporate the language and rationale of marketing executives for the industry. First, they use the word "disease" to refer to a hypothetical "early-stage Alzheimer's disease" that supposedly exists "before the earliest symptoms of Alzheimer's disease are apparent." Notice that phrasing assumes that the earliest symptoms will become apparent, when in fact it's only a hypothetical model for claiming that cognitive lapses like not remembering where you put something or what you were going to say are signs of incipient Altzheimer's disease. The proposed looser criteria would legitimate drugs as "safe and effective" that have little or no evidence of being effective and expose millions to risks of harmful side effects.

No proven biomarkers or clinical symptoms exist, the FDA officials note, but nevertheless they advocate accelerated approval to allow "drugs that address an unmet medical need." What "unmet need"? None exists. This market-making language by officials who are charged with protecting the public from unsafe drugs moves us towards the 19-century hucksterism of peddling cures of questionable benefits and hidden risks of harm, only now fully certified by the modern FDA.[9]

The main reason for advocating approvals of drugs for an unproven need with unproven benefits, these FDA officials explain, is that companies cannot find effective drugs for overt Alzheimer's. Their drug-candidates have failed again and again in trials. The core rationale of the proposed loosening of criteria is that "the focus of drug development has sifted to earlier stages of Alzheimer's disease…and the regulatory framework under which such therapies are evaluated should evolve accordingly." Yet they admit there are no "therapies" in this much larger market where (with the help of the industry-funded FDA) companies will not have to prove their drugs are effective. In fact, these FDA officers propose to approve the drugs without ever knowing if they are therapeutic or not. Their commercialized language presumes the outcome before starting. The job of the FDA, it seems, is to help drug companies open up new markets to increase profits for the FDA's corporate paymasters.

These two FDA officials maintain that "the range of focus must extend to healthy people who are merely at risk for the disease but could benefit from preventive therapies." Yet they admit we do not know who is "at risk," nor whether there is a "disease," nor whether anyone

"could benefit," nor whether the drugs constitute "preventive therapies." Similar FDA-encouraged shifts have been made for drugs treating pre-diabetes, pre-psychosis, and pre-bone density loss, with few or no benefits to offset risks of harm. This week, based on policy research at the Edmond J. Safra Center for Ethics, a letter of concern was published in the New England Journal of Medicine. The authors write that approval for drugs to treat "early stage Altzheimer's disease" must meet "a much higher bar—evidence of slowed disease progression." But without clinical manifestations or biomarkers for an alleged disease, how will such progression be measured?

Advice to readers: Experienced, independent physicians recommend not to take a new drug approved by the FDA until it is out for 7 years, unless you have to, so that evidence can accumulate about its real harms and benefits.[10]

Disclaimer: The assessment and views expressed here are solely the author's and do not necessarily reflect those of persons or institutions to which he is associated. The comments and suggestions of Gordon Schiff, an expert in prescribing at Brigham and Women's Hospital, and Robert Whitaker are gratefully acknowledged.

References

1. Lexchin J. New drugs and safety: what happened to new active substances approved in Canada between 1995 and 2010? Archives of Internal Medicine 2012 (Nov 26);172:1680-81.

2. Hilts PJ. Protecting America's Health: The FDA, Business and One Hundred Years of Regulation. New York: Alfred A. Knopf; 2003.

3. Rodwin M. Conflicts of interest, institutional corruption, and Pharma: an agenda for reform. Journal of Law, Medicine & Ethics 2012;40:511-22.

4. Rodwin M. Reforming pharmaceutical industry-physician financial relationships: lessons from the United States, France, and Japan. Journal of Law, Medicine & Ethics 2011(Winter):2-10.

5. Sismondo S. Ghost management. PLoS Medicine 2007;4:1429-33.

6. Sismondo S, Doucet M. Publication ethics and the ghost management of medical publication. Bioethics 2010;24:273-83.

7. Schondelmeyer S, Purvis L. Rx Price Watch Report. Washington DC: American Association of Retired Persons 2012.

8. Kozauer N, Katz R. Regulatory innovation and drug development for early-stage Alzheimer's disease. New England Journal of Medicine 2013 (Mar 13);DOI: 10.1056/NEJMp1302513

9. Young JH. The Toadstool Millionaires: a social history of patent medicines in America before federal regulation. Princeton, NJ: Princeton University Press; 1961.

10. Schiff G, Galanter W, Duhig J, et al. Principles of conservative prescribing. Archives of Internal Medicine 2011;171:1433-30.

http://www.ethics.harvard.edu/lab/blog/312-risky-drugs

A Few Predictions on the Sunshine Act

Genevieve Pham-Kanter

As the implementation of the Physician Payment Sunshine Act draws near, a reasonable question to ask is, just how sunny is this Act really going to be?

The Sunshine Act–for those of you who did not meticulously read all 11,000 sections of Bill HR 3590–is that part of last year's health care reform law that requires pharmaceutical and medical device manufacturers to report payments that they make to doctors for consulting services, speaking, meals, research grants, and other gifts of monetary value.

These payments have long been cause for concern because of their potential to influence the prescribing and research practices of payment recipients (for background, see this Institute of Medicine report). Surely requiring the disclosure of these potentially distorting payments would be a good thing; what more needs to be said?

It turns out that more than a few Edmond J. Safra Center Lab Fellows have something to say about these payments and about the public disclosure of these payments. And what they have to say warrants a rather less sunny disposition towards the federal disclosure law. In particular:

- Lab Fellow Michelle Mello (Faculty, Harvard School of Public Health) and her co-author examined the Sunshine Act in relation to reporting regulations in other contexts like finance and health care quality. Past experience in these environments shows that consumers have difficulty with specialized and complex information so that disclosure without expert assistance in interpreting these disclosures will have little effect on consumer behavior. (New England Journal of Medicine 2013)
- Lab Fellow Genevieve Pham-Kanter (Faculty, University of Colorado Anschutz Medical Campus) and co-authors looked at the effect of state-level sunshine laws, precursors to the federal Sunshine Act. Their analysis of prescription claims showed that these sunshine laws had no effect on the prescribing practices of doctors or on prescription drug expenditures even though, in one of the states, payments information could be requested by and made available to the public. (Archives of Internal Medicine/JAMA Internal Medicine 2012)
- Lab Fellow Sunita Sah (Faculty, Georgetown University McDonough School of Business) and her co-authors found in their lab experiments that when individuals were presented with financial conflicts of interest that induced bias in the individuals' advice-giving, the knowledge that this conflict would be disclosed increased the bias of the advice individuals gave. Advice recipients who were informed of the conflict of interest adjusted somewhat for the bias of the advice giver but did not fully account for the degree of bias in the advice. (Journal of the American Medical Association 2012)
- On the other hand, Lab Fellow Aaron Kesselheim (Faculty, Harvard Medical School) and his co-authors found, in experiments in which internists were presented with research abstracts of hypothetical studies that varied in quality and funding source, that doctors judged abstracts more harshly and were less willing to prescribe the

> hypothetical drugs under study when there was disclosure that the research had been funded by industry (vs. no disclosure or disclosure of NIH funding). This harsher judgment was rendered regardless of the quality of the study, suggesting a negative bias associated with industry-related research payments. (New England Journal of Medicine 2013)

In short, analyses of sunshine regulations as they operate in the field predict little effect of the Sunshine Act on consumers or doctors. Lab experiments suggest perverse effects of disclosure but in somewhat conflicting directions: subjects who were informed of payments received by a party authorized to convey (ideally unbiased) information could either under-compensate or over-compensate in response to the disclosure of the payment. (The exact conditions for under- vs. over-compensation remain to be elucidated and are an intriguing direction for research.)

The evidence accumulated by Edmond J. Safra Center Lab Fellows so far suggests the Act is not quite sunshine; it's more like a dim flickering lamp post that occasionally lights up a street corner. We can intently scrutinize the part of the street that the lamp sometimes illuminates, but will that give us an accurate reading of our environment or just shift sketchy activity from one place to another?

Let's be clear that these results do not entail that obfuscation is preferred to transparency. A better lesson is that critical thinking and careful research, even if the findings are politically inconvenient and militate against our prior beliefs, are paramount because they can help legislators and agency rule makers make better policy. Disclosure is not the enemy; simple-minded slogans are.

And let's also distinguish simple-mindedness from cynicism or fatalism. The Lab and its Fellows (and other scholars elsewhere) are continuing to study the Physician Payment Sunshine Act and disclosure in medicine, and looking for ways to make disclosure work–for patients, doctors, researchers, the government, and firms.

A non-cynical and more productive view of this strand of literature from the Lab is that it tells us we may need a higher wattage light bulb, more or different kinds of lamp posts, more foot patrols, as well as the testing of these different initiatives. Systematic experiments, in the field and in the lab–rather than wishful thinking–are required to test and observe, infer and learn, about what works with payments data collection and what does not. In concrete terms, this may mean that an important part of refining the Sunshine Act, in addition to research like the Lab studies discussed above, is the incorporation of on-going evaluation and feedback processes into the payments reporting system itself. (And as part of this refinement and review, we can find out whether there had been in fact not very much dubious activity going on or that there was much, much more than we initially thought.)

summary, the Lab predicts somewhat dim illumination from the Sunshine Act. But this simply means that our next task will be to find ways to improve the Act and prove our predictions wrong. I suspect many of us would, in this case, be pleased to ultimately be proven wrong.

Not all of the Lab's work on the Physician Payment Sunshine Act and disclosure in medicine could be highlighted in this post. For further reading, see:

Gorlach, Igor, and Genevieve Pham-Kanter. 2012. Brightening Up: The Effect of the Physician Payment Sunshine Act on Existing Regulation of Pharmaceutical Marketing. Journal of Law, Medicine, and Ethics 41:315-322.

Hwong, Alison, and Lisa Lehmann. June 13, 2012. Putting the Patient at the Center of the Physician Payment Sunshine Act." Health Affairs Blog.

Kesselheim, Aaron, et al. 2012. A Randomized Study of How Physicians Interpret Research Funding Disclosures. New England Journal of Medicine 367:1119-1127.

Kesselheim, Aaron, et al. 2013. Distribution of Industry Payments to Massachusetts Physicians. New England Journal of Medicine 368:2049-2052.

Loewenstein, George, Sunita Sah, and Daylian Cain. 2012. The Unintended Consequences of Conflict of Interest Disclosure. Journal of the American Medical Association 307:669-670.

Mello, Michelle, and Meredith Rosenthal. 2013. Sunlight as Disinfectant--New Rules on Disclosure of Industry Payments to Physicians. New England Journal of Medicine 368:2052-2054.

Pham-Kanter, Genevieve, G. Caleb Alexander, and Kavita Nair. 2012. Effect of Physician Payment Disclosure Laws on Prescribing. Archives of Internal Medicine/JAMA Internal Medicine 17:819-821.

Rodwin, Marc. 1989. Physicians' Conflicts of Interest: The Limitations of Disclosure. New England Journal of Medicine 32:1405.

Sah, Sunita. 2012. Conflicts of Interest and Your Physician: Psychological Processes That Cause Unexpected Changes in Behavior. Journal of Law, Medicine, and Ethics (Symposium: Conflicts of Interest in the Practice of Medicine) 40:482-487.

Sah, Sunita, George Loewenstein, and Daylian Cain. 2013. Insinuation Anxiety: Increased Pressure to Follow Less Trusted Advice after Disclosure of a Conflict of Interest. Working Paper.

Sismondo, Sergio. 2013. Key Opinion Leaders and the Corruption of Medical Knowledge: What the Sunshine Act Will and Won't Cast Light On. Working Paper, forthcoming in Journal of Law, Medicine, and Ethics.

Sismondo, Sergio. Forthcoming. Key Opinion Leaders: Valuing Independence and Conflict of Interest in the Medical Sciences. In C.-F. Helgesson, Isa Dussauge, and Francis Lee (eds.) Value Practices in the Life Sciences. Oxford University Press.

Thacker, Paul D. The Slow Pace of Success in a 'Do Something Congress'. Edmond J. Safra Institutional Corruption Lab Blog.

http://www.ethics.harvard.edu/lab/blog/322-a-few-predictions-on-the-sunshine-act

Simply Fab: Institutional Corruption and the Trial of Fabrice Tourre

Gregg Fields

The Beatles may have been the Fab Four, but at Goldman Sachs a few years back, Fabrice Tourre was the Fab One. The trader had a clear gift for enticing sophisticated investors into less than fabulous vehicles like subprime mortgage securities.

The question that remains: can he prove as persuasive to the New York jurors who hold his fate in its hands? Tourre is facing civil charges brought by the Securities and Exchange Commission for his actions at Goldman Sachs.[1] Pundits have portrayed this trial as the beleaguered SEC's last chance to prove it can win big cases against Wall Streeters involved in the 2008 financial collapse. However, no matter what the jury decides, the clear verdict of this trial is that institutional corruption is a common characteristic along the Wall Street-Washington axis.

It's understandable if you've never heard of Fabrice Tourre. Goldman Sachs may be a titan on Wall Street, but Tourre was more of a rank-and-file foot soldier. When it filed its suit against him in 2010, the SEC's first reference to Tourre calls him an "employee." Officially, he was "a vice president on the structured correlation trading desk." He wasn't yet 30.

Despite his youth, Tourre was the central player in what would become a legendary episode in the mortgage meltdown. In 2006, a hedge fund named Paulson & Co., run by a man named John Paulson, began to suspect the subprime mortgage market was set to collapse.

Paulson saw a once-in-a-lifetime opportunity: make huge and complicated bets against securities backed by home loans likely to go bad. (This process of making money off an investment that goes south is known as selling short.) For help, he turned to Goldman Sachs and was led to Tourre.

Tourre, in turn, agreed to put together a security named ABACUS 2007-AC1. The reference to the ancient Chinese counting machine is ironic, because the mortgage-backed securities that went into it were picked largely because they didn't add up. Tourre, with heavy influence from Paulson, assembled a portfolio whose weakness was its greatest appeal, according to the SEC.

But Goldman's marketing materials to investors represented the portfolio as having been selected by a third company name ACA Management. Paulson's role wasn't mentioned at all. And "Tourre also misled ACA into believing that Paulson invested approximately $200 million in the equity of ABACUS 2007-AC1," when in fact Paulson was betting big that large losses loomed, according to the SEC complaint.

Paulson paid Goldman Sachs $15 million for putting the deal together. It closed on April 26, 2007. By October, a whopping 83 percent of the securities in ABACUS had been downgraded and the other 17 percent were on negative watch. Three months later, 99 percent of the portfolio had been downgraded. Investors were out $1 billion, which was the approximate profit for Paulson.

The Influence of Influences

In a recent paper, Lawrence Lessig, who heads the Edmond J. Safra Center for Ethics, offered this working definition of institutional corruption: "Institutional corruption is manifest when there is a systemic and strategic influence which is legal, or even currently ethical, that undermines the institution's effectiveness by diverting it from its purpose or weakening its ability to achieve its purpose, including, to the extent relevant to its purpose, weakening either the public's trust in that institution or the institution's inherent trustworthiness."

In that context, the Tourre case is a veritable textbook example of such influences, and of lost trust. Furthermore, the case has another trait common in cases of institutional corruption: no one has been accused of a crime. Goldman was a co-defendant in the SEC's case against Tourre, but all the charges are civil.

Paulson and his company have never been implicated by the SEC at all. Indeed, the SEC complaint includes a Paulson & Co. memo that suggests the company was simply taking advantage of an opportunity created by the mutual benefits Wall Street's major players reaped from churning out zombie securities despite the dangers.

"In my opinion this situation is due to the fact that rating agencies, (collateralized debt obligation) managers and underwriters have all the incentives to keep the game going, while 'real money' investors have neither the analytical tools nor the institutional framework to take action before the losses . . . are actually realized," the unnamed Paulson employee wrote. It is a situation that sounds a great deal like the phenomenon known as dependence corruption—where mutual interests skew institutional behavior in ways that don't serve the public interest.

According to an email obtained by the SEC, Tourre himself wrote an acquaintance: "The whole building is about to collapse anytime now. . . Only potential survivor, the fabulous Fab." Keep in mind that this was several months before the ABACUS deal closed.

The ABC's of the SEC

Another institutional actor in this case is, of course, the SEC. The agency managed to quickly get a $550 million settlement with Goldman just months after filing its complaint. It was the largest penalty ever assessed by the enforcement agency.

"This settlement is a stark lesson to Wall Street firms that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing," Robert Khuzami, the agency's director of enforcement at the time, said. While $550 million is unquestionably a lot of money, it's worth noting that in its most recent fiscal quarter Goldman's net earnings were $1.93 billion.

Furthermore, Goldman settled the case without admitting or denying the allegations against it. Settling cases without requiring the defendants to acknowledge guilt is a common SEC practice, but has drawn criticism that it reflects an abdication of institutional responsibilities, particularly in regard to investigating and determining what happened. In 2011, U.S. District Judge Jed Rakoff rejected a $285 million SEC settlement with Citigroup in a mortgage-related case. The SEC "has a duty, inherent in its statutory missions, to see that the truth emerges; and if it fails to do so, this court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances," Rakoff wrote. In

something of a rare convergence, both the plaintiff SEC and defendant Citigroup have appealed his decision.

Finally, it's worth pondering why Tourre, who now is working on a doctorate at the University of Chicago, is the only Goldman employee who was pursued by the SEC. The SEC complaint makes clear that Tourre was in regular contact with other Goldman officials. The transaction was approved by Goldman's mortgage capital committee, "which included senior-level management."

In going after a virtual unknown, the SEC pattern is similar to one it followed in the Citigroup case referenced above. That, too, involved the marketing of risky mortgage-backed investments, but the only person brought to trial was a midlevel executive named Brian Stoker. A jury would later clear Stoker, and one juror later told The New York Times he was a bit baffled why the SEC cast such a small legal net. "I wanted to know why the bank's CEO wasn't on trial," Beau Brendler, jury foreman, told the Times.

1. Much of the details and quotes in this article are drawn from the 2010 SEC complaint filed against Tourre and Goldman Sachs.

P.S. Aug. 2, 2013. Fabrice Tourre's trial lasted 11 days. On Thursday, Aug. 1, 2013, a Manhattan federal jury found Tourre liable for six of the seven civil fraud counts he faced. His punishment will be determined at future proceedings and may include fines and a possible ban from working in the financial industry.

http://www.ethics.harvard.edu/lab/blog/323-simply-fab

Systematic Evidence of Less-Than-Truthful Commercial Free Speech That Harms Citizens

Donald W. Light

In U.S. vs. Alfred Caronia, the U.S. Court of Appeals for the Second Circuit concluded that criminalizing the promotion of off-label uses of pharmaceuticals—that is, for purposes not approved by the Food and Drug Administration—amounted to an unconstitutional restriction on free speech. The court did not comment on evidence that Caronia had been untruthful in promoting a narcolepsy drug for the treatment of fibromyalgia and for patients under the age of 16.

The pharmaceutical trade association, which shapes much of the "news" on drugs through its huge news network, also overlooked the less-than-truthful use of free speech when it commented, "PhRMA believes that truthful and nonmisleading communication between biopharmaceutical companies and health care professionals is good for patients, because it facilitates the exchange of up-to-date and scientifically accurate information about new treatments."

But what about untruthful or non-truthful communication that fails to mention risks of harm and facilitates exchanges with missing or inaccurate information? One documented case can be found in Congressman Henry Waxman's report of the repeated distortions and omissions Merck used to promote Vioxx, the drug that killed or seriously harmed more patients than any other in history.

The Vioxx disaster led to extensive changes in law and practice to emphasize safety. Are drug companies behaving differently now? We now have the first systematic, prospective, comparative, randomized survey in which primary care physicians in three countries (and cultures) report on the truthfulness of the drug reps who talk with them. A leading group of researchers used precise definitions of truthful speech, and found that drug reps provided "minimally adequate safety information" about the risks of harm described in the label only 1.7% of the times they spoke to doctors. ("Safety" is the modern euphemism for risks of harm.) Pharmaceutical companies claim their mission is to help people get and stay healthier. Why, then, do they allow their sales reps to understate risks of harm and overstate benefits so that physicians are misled and mislead their patients in turn?

Despite reporting the frequency with which drug reps make untruthful omissions of harmful side effects, 54 percent of these same board-certified physicians rated the quality of scientific information provided by the reps to be good or excellent! And 64 percent said they were ready to prescribe the drug being promoted. A friendly, lucid sales pitch that falls well short of the trade association's standard of truthful communication wins the day. As a classic article on selling drugs described, reps don't sell drugs—they sell friendship, and by the way, here is new drug your patients will like and a whole carton-full of free samples you can give to your patients.

This is how misleading commercial free speech is used 98 percent of the time in the pharmaceutical industry across all companies represented in this three-nation randomized study. Patients, trusting their personal physicians to serve their best interests alone, become defenseless victims.

Here we have the key elements of institutional corruption: the corruptors, the nature of the corruption, and the corrupted, all protected by law and built into the economy of interests as well as into institutional practices. The study also provides evidence supporting the experiments in social psychology sponsored by the Edmond J. Safra Center for Ethics, which document how people take in and interpret partial and misleading information as suits their interests and emotional relationships.

Implicitly, the study emphasizes the importance of the current huge campaigns for greater transparency, by companies, with regard to trial data and payments to doctors, because they can counter other less-than-truthful commercial free speech. Such campaigns may even reduce the epidemic of serious harmful side effects from drugs that patients take but which have few or no offsetting advantages for them. In a letter responding to the study, published this week, I emphasize the risks of harm that result from corrupted free speech. In their reply, the authors add two examples, of a statin and antidepressant, which have greater risks of serious harm than alternatives and yet are widely promoted and prescribed.

Although the FDA prosecuted Caronia, it is failing in its mission to protect patients from harmful drugs. After an exhaustive review for approval, it allocates only a small percent of its budget to ensuring that physicians and patients are fully informed of the risks in the label, leaving it to companies to craft journal articles and have their sales reps overstate benefits and understate harms. The FDA regards clarifying the truth beyond the label as interfering with the practice of medicine. Or rather, as interfering with the less-than-truthful promotion of drugs that fails to warn about risks of harm.

Restricting or prohibiting contact with sales reps and the provision of free samples gets at the root of these widespread practices that distort both medical knowledge and medical practice. Quite a few places are already doing just that.

Acknowledgements: Much appreciation to Gregg Fields for his critical read and suggestions.

http://www.ethics.harvard.edu/lab/blog/326-less-than-truthful

On The Edge: The SAC Capital Indictment Draws a New Line on Institutional Corruption

Gregg Fields

It's relatively easy to spot common characteristics of institutional corruption. Things like conflicts of interest, way-too-cozy relationships between industry and government, and a general lack of transparency are often indicators that institutional actions are being driven by influences that don't serve the public interest.

Typically, institutional corruption has another common feature: It isn't a crime. Election financing may be dominated by mega-donors, and regulations often seem to ultimately favor those who spend the most on lobbying. But campaign contributions and aggressive lobbying are hardly criminal conduct.

A recent indictment in New York suggests that the legal sands of institutional corruption may be shifting, however. The case is United States of America v. S.A.C. Capital Advisors and several related corporate entities. SAC is a hedge fund run by financier Steven A. Cohen, who hasn't been charged himself, although he does face civil procedures from the Securities and Exchange Commission for how he ran his firm.

"As described below, this indictment charges the corporate entities responsible for the management of a major hedge fund with criminal responsibility for insider trading offenses committed by numerous employees and made possible by institutional practices that encouraged the the widespread solicitation and use of illegal inside information," the indictment, unsealed on July 25 by Preet Bharara, U.S. Attorney in Manhattan, begins.

The indictment then takes aim at an alleged corporate culture brimming with institutional corruption. "Unlawful conduct by individual employees and an institutional indifference to that unlawful conduct resulted in insider trading that was substantial, pervasive and on a scale without known precedent in the hedge fund industry," the indictment charges. The alleged actions took place between 1999 and 2010.

The allegations are similar to those the SEC has made in a number of civil complaints against the SAC organization and associated individuals. (The SEC doesn't have authority to bring criminal actions.)

The criminal indictment's language is striking for a couple of reasons. One, it makes clear this is not some mere civil inconvenience to be settled with a wrist-slap fine and a consent decree where the company neither admits nor denies guilt.

Secondly, it places the blame for the actions on an institution. Although some SAC employees have been charged separately—and some have already pleaded guilty—this indictment is notable in that it, in effect, criminalizes corrupt corporate cultures. In the fight against institutional corruption on Wall Street, it would seem, the stakes have been raised.

And no doubt many would argue that it's about time, considering the dearth of prosecutions related to the financial collapse of 2008.

Trimming Hedges

A useful place to start the SAC story would be the definition of "hedge fund." What, exactly, is that? Despite being shrouded in secrecy, hedge funds are essentially private mutual funds for very rich people. They are largely unregulated. The word "hedge" refers to their historical role in using various trading strategies to hedge risks—particularly with an eye toward trimming potential losses—for well-heeled investors. However, modern hedge funds are most noted for aggressively seeking sky-high returns through the use of sophisticated financial instruments like derivatives contracts and highly leveraged transactions.

It's incredibly lucrative for some. SAC, for instance, typically charged its investors three percent of their assets annually, plus it got to pocket up to 50 percent of all investment returns, according to the indictment. Cohen's personal fortune has been estimated at north of $9 billion, although clearly it could be set for a large fall if SAC's investors flee. (He also stepped up to the plate and became a minority owner of the New York Mets. The Mets owners were in a financial pinch at the time over investments made with Bernie Madoff.)

SAC, according to the indictment, flourished by encouraging its portfolio managers and analysts to gain an "edge" on the competition. And this edge, says the indictment, primarily consisted of ferreting out inside information on companies, then making or selling investments based on this knowledge before it was publicly disclosed. SAC theoretically had internal compliance systems, but the indictment portrays them as so limited as to be no match for traders who stood to earn millions of dollars by shirking the rules.

"The predictable and foreseeable result, as charged herein, was systematic insider trading by the SAC entity defendants resulting in hundreds of millions of dollars of illegal profits and avoided losses at the expense of members of the investing public," the indictment says. They gained the inside information simply by currying favor from employees in the know at the companies whose shares they owned.

Drug Deal

Here's an example. In 2008, the SAC hedge fund's largest investment was $700 million in two drug companies, Elan and Wyeth. On July 18 of 2008, Mathew Martoma, a portfolio manager specializing in health care, obtained negative inside information on a drug trial Elan and Wyeth were conducting. The information came from a doctor involved in the trial, and Martoma went to Michigan to meet with the man in person. According to SEC documents, the man is Dr. Sidney Gilman, a former professor at the University of Michigan Medical School, who was overseeing the trial's safety monitoring committee. According to the SEC, Dr. Gilman settled and agreed to cooperate with the SEC. He also received a non-prosecution agreement with prosecutors.

On Monday, July 21, 2008, after receiving the negative information, SAC began selling its entire $700 million position in the companies, then shorted $260 million of the stock. (Shorting is a form of investing where you profit if a stock falls in price.)

The drug at issue was bapineuzumab, an experimental Alzheimer's experiment. According to a *Wall Street Journal* article on July 30, 2008, the trial results had been issued at the

International Conference on Alzheimer's Disease and "remain inconclusive and may underwhelm many scientific experts and investors."

Noted Marketwatch.com: "Shares of Elan Corp and Wyeth were battered Wednesday, the day after the companies released more clinical data on their hotly anticipated Alzheimer's therapy bapineuzumab."

By selling early, "The SAC Hedge Fund's profits and avoided losses from this illegal insider trading amounted to approximately $276 million," the indictment alleges. Martoma, who reportedly fainted the first time FBI agents approached him at his South Florida home last year, has been indicted for insider trading but has maintained he is innocent. He earned a $9.8 million bonus in 2008, according to SEC documents, but never was able to duplicate his performance that year and was fired by SAC in 2010.

Earlier this year, CR Intrinsic Investors, the SAC affiliate that handled the trading in the drug companies, agreed to pay the SEC more than $600 million to settle charges that it participated in insider trading.

A similar situation occurred the month after the Elan-Wyeth episode. An analyst named Jon Horvath learned on Aug. 18 from a contact that Dell, the computer maker, would soon be reporting disappointing earnings. On Aug. 26, SAC unloaded its $12.5 million in Dell holdings. Two days later, on Aug. 28, Dell indeed reported disappointing earnings. According to a CNNMoney.com clip at the time, net income fell 17 percent compared to the same quarter a year earlier. "Shares of Dell plunged after-hours on the news," CNNMoney.com reported. By selling early, SAC avoided losses of $1.7 million, the indictment says. (Horvath pleaded guilty to insider trading last year.)

What's Wrong

Although the institutional corruption concerns regarding the SAC allegations are pretty self-evident, they nevertheless bear a proper analysis.

Consider the simple issue of transparency. If one buys the premise that robust financial markets are good for society, then it only follows that the public must have trust in the integrity of those markets. Transparency can go a long way toward establishing such trust. But SAC, according to the civil and criminal cases, chose to invest based on secret information it gained illegally.

Another common indicator of institutional corruption is what is known as dependence corruption—where two parties are united by motivations that don't serve the public interest. A common example is the dependence of Congress on mega-donors, who depend on Congress for legislation that may not necessarily serve the public but, rather, the economic interests of the donors.

The SAC case provides a new facet to the dangers posed by dependence corruption. To wit, companies depend on large investors to support their stock price. Large investors depend on corporate performance to help their portfolios grow. If insider trading is allowed to flourish, a corporation would only naturally be motivated to tell large investors ahead of time if, say, a news event was going to impact the stock. It's only logical to presume that smaller investors would get material news later—they're simply less important in the scheme of things. As an example of what dependence corruption can do the public trust, think of the reputations of

credit rating agencies and their banking clients following the implosion of highly-rated mortgage securities that preceded the housing collapse.

Another issue often linked to institutional corruption is the revolving door syndrome. It typically refers to public servants leaving for lucrative private sector jobs. But in the SAC case, the government alleges employees were hired primarily because they could provide the "edge" of inside information. In such a context, it's certainly plausible that insiders at a company could share information with the hope of joining the hedge fund later. (A world where, as we have seen, Martoma's annual bonus was $9.8 million.)

To be sure, there are unanswered questions in the SAC case. Among the most noteworthy: Why wasn't Cohen indicted? In July, the SEC instituted administrative proceedings against him, based primarily on transactions that are detailed in the indictment against his companies. Yet, the current indictment refers repeatedly to "the SAC owner," and never mentions Cohen by name.

Game On?

The answer may be that, simply, the case isn't over. On July 30, for instance, Bharara, the U.S. Attorney in New York, brought charges against a research analyst formerly based in San Francisco. It's alleged the analyst fed information to Richard Lee, an SAC portfolio manager, about Microsoft and Yahoo. Lee pleaded guilty on July 23 to one count of conspiracy and one count of securities fraud.

Charles Gasparino, author of the newly published *Circle of Friends*, a book about the government's more recent investigations of insider trading, wrote in *Time* magazine last week that pundits who think Cohen has beat the rap are probably wrong. "In other words, don't be surprised if you see an indictment of Cohen in the coming weeks as well," he wrote.

For his part, Bharara hasn't publicly tipped his hand as to plans for Cohen. However, when he unsealed the indictments on July 25, he described the SAC organization in terms that made clear that the antidote to institutional corruption is institutional integrity—which sometimes requires the heavy weight of criminal prosecution. "Companies, like individuals, need to be held to account and need to be deterred from becoming dens of corruption," Bharara said in a prepared statement. "To all those who run companies and value their enterprises, but pay attention only to the money their employees make and not how they make it, today's indictment hopefully gets your attention."

http://www.ethics.harvard.edu/lab/blog/327-on-the-edge

If You Could Ask 100,000 People Around the World One Thing to Better Understand or Tackle Institutional Corruption, What Would it Be?

Dieter Zinnbauer

A couple of weeks ago the NGO I am working for, Transparency International, published its bi-annual Global Corruption Barometer—this time covering a record 107 countries with representative household surveys. This is the largest public survey exercise that seeks to elicit a detailed account of the perception of, and experience with, corruption around the world. Covering 114,000 households and more than 8 million data-points, this is a treasure trove for research and policy analysis on corruption.

Our own analysis can only tease out some of the many interesting findings that the data may hold, and we warmly invite everyone to get the data from us and run their own analysis. But the picture that emerges is clear.

Here is the three-message speed-read:

1. the scale and scope of corruption that people in many countries around the world are faced with in their daily lives is pretty astounding. More than 1 in 4 people reported to have paid a bribe in the last 12 months when dealing with key public institutions and services
2. the public view of the degree of integrity of all kinds of really important public institutions is pretty damning, but still:
3. the reported readiness to take action and do something about it is surprisingly high.

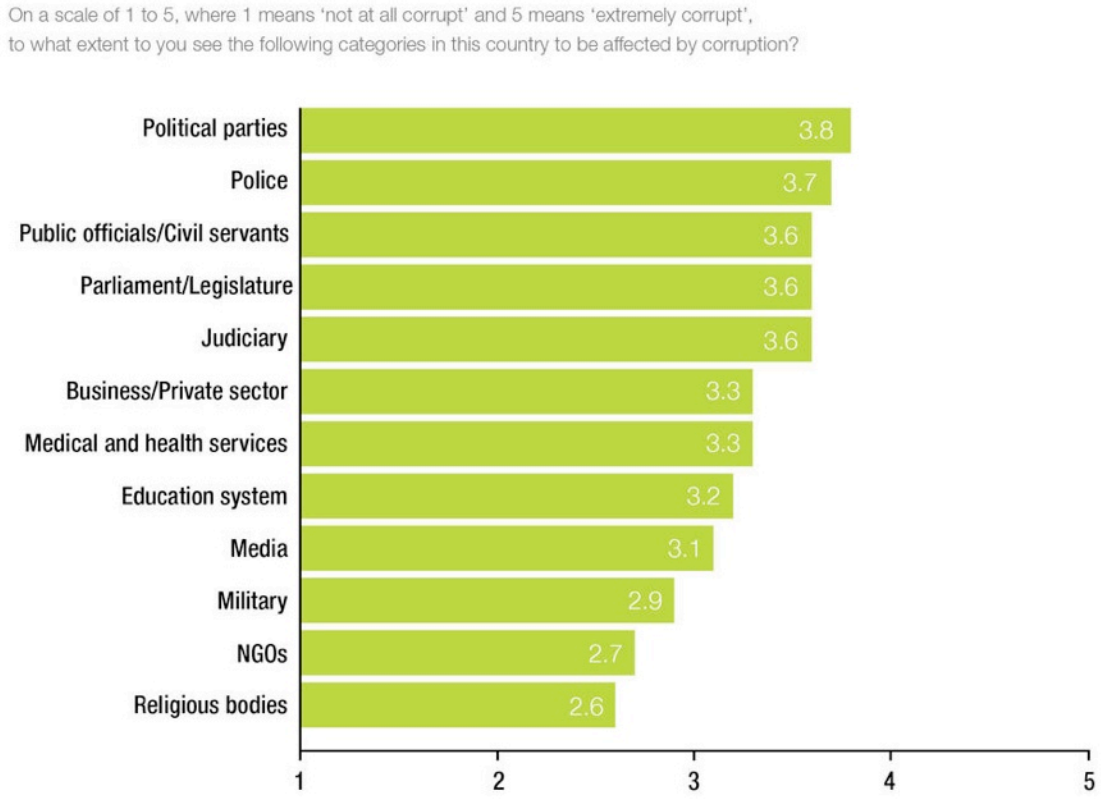
The Barometer gives us a good empirical picture of all kinds of street-level types of corruption, from bribes to the importance of personal connections for getting things done.

Yet it is much more difficult to come up with questions that would allow us to *capture policy capture* - measure, trace, compare and ultimately focus public pressure and advocacy on the more subtle types of upstream corruption. And it is at least equally tricky to include questions that would help us get a better handle on what the community of experts gathered around the Edmond J. Safra Center might call the scale and scope of institutional corruption.

One might argue that a general household survey is the wrong approach for this in the first place. Still, there are several questions included in the Barometer that already yield some interesting leads in relation to policy capture and/or institutional corruption:

- We ask people about their overall perception of corruption in a number of institutions (political parties, media) and services (health, education, police) that are

often considered particularly vulnerable to institutional corruption. Here is the global picture:



- We also want to know the extent to which people think that their country is run by special interests. Here are the relevant results for some OECD countries:

To what extent is this country's government run by a few big interests looking out for themselves? Percentage of respondents that answered 'large extent' or 'entirely'.

% respondents that think the government is run by a few big interests			
Norway	5	Canada	54
Switzerland	19	Germany	55
Denmark	24	France	57
Finland	28	Slovakia	60
Korea (South)	28	United Kingdom	60
Luxembourg	39	Mexico	62
Japan	44	Chile	63
New Zealand	44	Slovenia	63
Estonia	46	United States	64
Czech Republic	49	Spain	66
Turkey	49	Belgium	70
Australia	52	Italy	70
Hungary	52	Israel	73
Portugal	53	Greece	83

- And we invite them to assess whether overall corruption has gotten better or worse in the last couple of years.

All three figures from Transparency International (2013): Global Corruption Barometer 2013 Report, http://www.transparency.org/gcb2013/report

So how is this linked to institutional corruption? At the very least, these responses in themselves indicate that it is critical to explore institutional corruption as one possible factor behind what are truly alarming numbers. In addition, by gauging and tracking the public trust in certain services and institutions, the Global Corruption Barometer provides an important contextual backdrop for identifying and designing remedies for institutional corruption in these areas. And quite likely, the collective sentiments expressed in answers to these questions could at least partially also reflect institutional corruption:

- either directly, when high-profile corruption scandals that people have learnt about through the media influence their perception of a specific institution or sector
- or indirectly, since other factors that may drive these views, such as a sense of being left behind, or unfair treatment, could themselves be the negative consequences of, and thus a red flag for, institutional corruption at work and its adverse impact on social mobility, income inequality, etc.

So the Barometer 2013 results may provide some interesting empirical leads and context for the study of institutional corruption. But could more be done?

After the survey is before the survey.

And it is never too early to start thinking about the questions that could be brought on board in the next iteration, in order to help us better understand, trace, and tackle issues of policy capture or institutional corruption. This is a great opportunity to compare notes on how to approach the measurement of institutional corruption. What empirical tools do you find most suitable to measure and track policy capture and institutional corruption? What could help us tease out some relevant information, specifically in those tricky situations where institutional corruption may not even be perceived by the public as such, and leave no clear traces in the public (dis)trust of affected institutions? What kind of questions could we ask more than 100,000 people around the world in 2015 to help make progress on understanding, tracking and fixing institutional corruption?

I would love to hear from you: dzinnbauer@transparency.org

http://www.ethics.harvard.edu/lab/blog/328-if-you-could-ask-100000-people

The AIG Bailout Revisited: Calculated Corruption or Miscalculated Risk Management?

Malcolm S. Salter

How we tell stories matters. If we tell the AIG bailout story as an example of calculated corruption, we wring our hands about how best to reverse the declining legitimacy of 21st-century capitalism. And we write more rules and regulations, offer stiffer punishments for violations, and beg for more ethical leadership.

If, however, we tell the AIG bailout story as an example of miscalculated risk management, then our attention shifts to the sources of these miscalculations, such as existential fear of a total credit market collapse, and the ways in which we can better cope with such fears and uncertainties when trying to de-risk and restructure an entire industry.

The implications of the first telling are largely legal. The implications of the second telling are largely technical, managerial, and psychological.

Five years after considerable financial assistance was provided to the American International Group by the New York Fed and the U.S. Treasury, the AIG bailout story remains highly controversial. But what is the "true" story? And why is this story still so controversial?

Controversy over the bailout was present from its earliest days, starting in September 2008 when many members of Congress and allied non-interventionists raised their voices against the plan being put in place by the U.S. Treasury and the Federal Reserve Bank. These critics saw the bailout as an inexcusable breach of market discipline. Early complaints about the appropriateness of an AIG bailout were subsequently reinforced by the relentless public criticisms of Fed and Treasury officials by Neil Barofsky, who served as Inspector General of the $700 billion TARP program from December 2008 through March 2011 (*Bailout: An Inside Account of How Washington Abandoned Main Street While Rescuing Wall Street*). Following Barofsky's public criticisms was Simon Johnson, a former Chief Economist of the International Monetary Fund, who voiced his criticisms in a 2010 book (with James Kwak) documenting the power of Wall Street in the economic governance of nations (*13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*). More recently, David Stockman, well known as the Director of the Office of Management and Budget under President Ronald Reagan, has attacked the bailout in his 2013 book bewailing the corruption of American capitalism (*The Great Deformation: The Corruption of American Capitalism*).

Simon Johnson's and David Stockman's criticisms of the AIG bailout mark a turning point in the conversation.. Both argue that American capitalism—and financial institutions in particular—hold the global economy hostage to private interests, as in the prelude and aftermath of the 2008 financial crisis, and that this control is in large part perpetuated through so-called "cronyism." They also agree that the AIG bailout is a prime example of "crony capitalism" at work in America today—a calculated corruption of the political

process whereby the success or survival of a business is dependent on the favoritism it is shown by the ruling government instead of being determined by a free market.

Today, bailout critics typically point to two problems: first, that warding off an AIG bankruptcy was totally unnecessary in the first instance as a bulwark against serial collapses of other financial institutions (so-called "contagion"), which could lead to a total shut-down of credit markets in the U.S. and abroad; and, second, that the bailout as eventually structured was a not-so-subtle cover for public subsidies to banks holding large amounts of depreciating securities (such as collateralized debt obligations) linked to the collapsing housing market, which were effectively insured through the purchase of billions of dollars of credit default swaps (CDS) from AIG. For these critics, the AIG bailout story is just about as pure an example as there is of how cronyism and lack of transparency have corrupted American capitalism.

While the tumultuous context of the AIG bailout makes a definitive assessment of these claims difficult, contemporary critics do spotlight two pivotal questions that have not as yet been answered to many parties' satisfaction:

- *Was federal assistance to AIG truly essential for financial system security?*
- *Was the ultimate form of this assistance—most particularly, the government-sponsored repurchase of credit default swap contracts held by AIG's customers at their par value—a misuse of public monies that served private interests at the expense of the public interest?*

If the answers to these two questions are positive, then AIG should indeed be branded as a paradigmatic case of crony capitalism and the dishonor that goes with this label.

This may well be the case, but it is worth testing whether or not such a telling of the AIG bailout story is accurate. There is a big difference between (a) calculated corruption in the form of generous financial transactions put in place by the U.S. Treasury and the New York Fed for the benefit of large domestic and foreign banks deemed vulnerable to an AIG collapse and (b) unintended miscalculations by Treasury and Fed officials working in a state of existential fear to manage the risks of a global financial meltdown.

I am currently exploring the latter possibility—that both the initial bailout decision and the subsequent structure of the bailout was a much more complicated phenomenon than characterizations of corruption, collusion, and crony capitalism suggest. I am attempting to argue that the lingering controversies over the bailout are not a result of the corrupt behavior of public officials but rather the result of impromptu and highly improvised risk management by officials who had never before experienced or tried to manage such a risk to the global financial system and who were conditioned by their professional training, deeply embedded world view, and current responsibilities to focus on the worst-case scenarios following a fast-approaching AIG collapse. Public officials no doubt made miscalculations and missteps; but where miscalculations were made, they should not be confused with corruption.

My initial reading of the unfolding crisis in 2007-2008 suggests that federal assistance to AIG was indeed essential to preserve financial system security, as argued at the time by Fed and Treasury officials. I also see that there is little reason to believe the bailout was purposively designed as a cover for the subsidization of AIG's counterparties (mainly large banks) with which principal decision makers for the government had long-standing personal

relationships and, in the case of Treasury Secretary Henry Paulson, a prior financial relationship that created significant personal wealth.

However, the eventual **form** of the federal assistance, which unfolded in four separate transactions from September 2008 to March 2009 in response to changing conditions at the company and in the capital markets, appears more problematic because AIG's counterparties in the credit insurance business—mainly large domestic and foreign banks—received what now looks to be very generous treatment from the government during the bailout. This treatment has been seized upon by bailout critics who passionately argue that government officials with long histories and deep connections in the finance industry promoted this generous treatment, and that such treatment is a perfect example of corrupt "crony capitalism" at work. Critics also point to a lack of transparency in SEC filings about the identity of AIG's counterparties, payments made to them by AIG, and the compensation of AIG officials. (N.B., Davis Polk, the New York Fed 's lawyers, reviewed and approved all draft SEC filings.)

Fair enough, but the crony capitalism claim deserves careful examination. A plausible counter-argument is that claims of blatant cronyism in the AIG transaction are overblown and, indeed, inaccurate. Rather than a planned campaign by Treasury and Federal Reserve officials to use public monies and credit facilities to protect and obfuscate the private interests of banks with which these officials had nurtured long-standing relationships, the form of the bailout strategy can more accurately be seen as reflecting a set of assumptions about the nature of systemic risk to the global financial system and the menu of possible remedies, both of which had become deeply ingrained in the world view of Fed and Treasury officials during decades of work with the finance industry. These assumptions (and related fears) were reinforced by many months of mounting evidence and accompanying anxiety over the vulnerability of the financial system to a major "readjustment." They inevitably shaped officials' understanding of what was "the right thing to do" while trying to manage rapidly emergent and shifting risks. In hindsight, mistakes may have been made. But rather than a classic case of cronyism, collusion, and corruption, I see the AIG bailout as a case of impromptu and highly improvised risk management under conditions of extreme anxiety over possible outcomes.

I say this fully realizing how tempting it is to assume the worst about crony capitalism in the AIG bailout when Timothy Geithner, president of the New York Federal Reserve Bank, and Henry Paulson, Treasury Secretary under President Bush, were in the saddle. After all, Paulson was the former chairman and CEO of Goldman Sachs, a major recipient of significant government aid in the course of the AIG bailout, from 1999 to 2006; his staff at the Treasury included many former Goldman Sachs veterans—for example, Robert Steel, Steve Shafran, Neel Kashkari, Dan Jester, and Ken Wilson; Geithner's chief of staff was an ex-Goldman partner; and Geithner's board of directors include many of Wall Street's most influential players. In addition, the cronyism charge is bolstered by the fact that in the heat of AIG' worst troubles, the New York Fed hired Morgan Stanley, later itself a recipient of public monies, to advise on the AIG bailout. Finally, certain details of the bailout program related, most specifically, to the government-financed buyback of credit default swaps from AIG's counterparties at par value (when the counterparties' insured mortgage-backed securities were falling in value) have raised a firestorm of complaints. But these outwardly incriminating facts do not seem to fit with the career paths, public service aspirations, conflict of interest controls, and risks of public humiliation for high-ranking Treasury and Federal Reserve Bank officials.

Telling the AIG bailout story fully and clearly requires a detailed description of the multi-step transaction that unfolded over many months in a largely incremental fashion. Strangely enough, not all the facts of this highly technical transaction are clear or understood five years later. Similarly, few folks realize that by the end of 2012, four years after the bailout was initiated, the Treasury reported an overall positive return of $22.6 billion on the $182.3 billion committed by the government to stabilize AIG during the financial crisis.

Once the basic facts of the bailout transaction and subsequent implementation are laid out, the two questions noted above need to be carefully addressed. Was the bailout truly necessary in the first instance? Would an AIG bankruptcy actually lead to "deadly contagion" in the form of cataclysmic financial failures of large, systemically important banks? For this first set of questions to be answered satisfactorily, we need to look into the specific situations of one or two leading banks: What would have been the likely impact on a bank like Goldman Sachs or Merrill Lynch of the loss of protection (via CDS contracts) on bonds, mortgage backed securities, and other assets insured by AIG and held on its balance sheet? What would be the financial impact of losses of 20 or 30 percent on any AIG paper or other loans held on a bank's balance sheet? What proportion of a bank's existing capital base would such potential losses represent? How much impairment of the capital base of a large bank like Goldman Sachs does it take to cause an immediate shutdown of access to overnight repurchase agreements for all trading banks, which is one definition of a total financial collapse?

Next, the claim of cronyism surrounding the government-sponsored repurchase of credit default swap contracts held by AIG's customers at their par value needs to be investigated. Of particular interest was why Treasury Secretary Timothy Geithner, who was still head of FBNYC in September 2008, allowed AIG to pay clients the full value (par) of AIG-issued CDS contracts when (a) the bonds and other insured securities like CDOs had fallen so significantly in value, (b) other mortgage-bond insurers had been able to strike deals on similar contracts at reduced prices, and (c) when, prior to the bailout, AIG had been negotiating in an attempt to get its counterparties (bank customers) to accept as little as 60 cents on the dollar. To some observers, AIG's payments—funded by government-extended credit—were no less than a bailout of Wall Street, and Goldman Sachs in particular. Indeed, a report prepared by the House Committee on Oversight and Government Reform refers to these payments as a "backdoor bailout of AIG counterparties." (Paulson was still Treasury Secretary.) In this sense, the committee report echoed the finding of Neil Barofsky, the special inspector general for TARP, that the Fed "refused to use its considerable leverage" to negotiate better terms. Barofsky's finding was later roundly criticized by the New York Fed.

At hearings held by the aforementioned House Committee in January 2010, an important report commissioned by the New York Fed and prepared by the BlackRock asset management firm in 2008 came to light. The BlackRock report fueled House Committee interest by demonstrating on the basis of its modeling of AIG counterparty derivative positions and related investment strategies that without harried pressure from the New York Fed, AIG would probably have been able to strike a better settlement with its most important counterparties and save a lot of public money. In particular, the BlackRock study suggested that Goldman Sachs was, prior to the bailout, willing to take a haircut on its AIG CDS payouts (i.e., taking something less than the par value of the relevant credit default swaps).

Apparently, this was a possibility for Goldman (but not for the other top counterparties) because Goldman had sold off its entire CDS-insured CDO book of business—thereby

leaving very little CDO risk on its balance sheet. In this way, Goldman was essentially "an AIG conduit."

Whatever leverage Goldman had in bargaining with the Fed over the repurchase of AIG-issued CDS, it was successfully mobilized. Like Goldman, neither Merrill Lynch nor Société Générale budged on price. (Deutsche Bank's position remains unclear.} The open question, of course, is how each of these counterparty banks were able to gain such remarkable leverage over the New York Fed in structuring the terms of the AIG stabilization program.

Secretary Geithner responded to the BlackRock report and similar analyses that revealed counterparties' capacity to accept less than par value on their AIG-issued insurance contracts by testifying to the Congressional Committee, "If we had tried to force counterparties to take less than they were entitled, AIG would have collapsed. There were no better alternatives." But is this correct? We can only know by discovering and analyzing other alternatives that the Fed considered and rejected.

Much work remains, if only to "set the record straight." But more than this, if we as a nation, influenced by inaccurate story telling, end up mistaking abundant of caution and existential fear for corruption and crony capitalism (and all the venality that this label connotes), then the chances of attracting and retaining truly knowledgeable and honest men and women from the private sector and academia to high-stakes and inevitably controversial positions in the public sector will diminish considerably—to our collective disadvantage. Henry Paulson, who refused multiple invitations from President Bush to become his Treasury Secretary, along with his bailout partners at the Washington and New York Fed, may not have been the best possible person from business and academia to contain the unfolding financial crisis. But it is difficult to imagine many more than a dozen or so other qualified, deeply committed individuals for that job at that time.

http://www.ethics.harvard.edu/lab/blog/333-the-aig-bailout-revisited

The Tail Wagging the Dog: Institutional Corruption and the Federal Sentencing Guidelines for Organizations (FSGO)

Carla Miller

In his article "On the Edge,"[1] Gregg Fields wrote about the recent criminal case filed against SAC Capitol Advisors and noted a shift in that the indictment "criminalizes corrupt corporate cultures." Interestingly, after the indictment, SAC bragged about its "strong culture of compliance" in a New York Times article. SAC even went so far as to say their compliance program was "cutting edge," and cost tens of millions of dollars with 38 staff, including top-notch lawyers and consultants. Reporter James Stewart asked "Which sets up the question: What were they doing?"[2] Indeed, what were they doing?

As a former federal prosecutor, I have closely followed the history of a unique aspect of prosecuting corporations—the Federal Sentencing Guidelines for Organizations (FSGO). The FSGO are used to set the penalty for a corporation's criminal acts. Credits have been created for corporations that have established an effective ethics program; these credits can generate very valuable reductions in fines and penalties. How will SAC's "cutting edge" compliance program, as stated above, impact the end result in this prosecution? What is the value of having spent tens of millions of dollars? Could it get any worse without the program? The ethics community will be closely watching the outcome of the case to see if the FSGO is used, and how, in setting any criminal penalties.

There is a broader question as it relates to the concepts of institutional corruption and the work of the Lab at the Edmond J. Safra Center for Ethics. Over the last decade, the FSGO has begun to have a life of its own outside of the criminal justice system and it drives the creation of thousands of ethics programs, including some in my area of interest, municipal governments.

Can something that has its genesis in the criminal justice system effectively outline the components of a comprehensive structure that not only prevents crime, but addresses the non-criminal aspects of institutional corruption? Do we define the structure and content of ethics programs from the bottom up (fear of punishment) or from the top down (prevention of institutional corruption)?

The Basics (FSGO in a Nutshell)

- In 1987, Guidelines were formulated by the U.S. Sentencing Commission to promote fairness in sentencing individuals convicted of a crime.
- Organizations can also be held liable for the criminal acts of their employees (vicarious liability) and can be charged with crimes. If convicted, the entity can pay large fines, be placed on probation and be monitored by outside parties.

- In November, 1991, the standards were released for sentencing organizations; these are the Federal Sentencing Guidelines for Organizations (FSGO)
- These guidelines apply to all corporations, labor unions, pension funds, non-profits and governmental entities.[3] They come into play after the entity is charged with a crime, gets convicted, and is at the sentencing stage.
- The most significant section is Part B2.1—"Effective Compliance and Ethics Program" which is the section that lays out the criteria that is used to evaluate whether an ethics program is effective or just a facade. If it is effective, credits are applied and money is saved.
- The FSGO guidelines focus on the prevention of crimes, and define an effective ethics program as one that "prevents and detects criminal conduct."
- Within a few years after these standards were created, most major corporations had ethics programs in place. Either the threat of more severe punishment or the incentive of perhaps even avoiding a prosecution altogether served as a "nudge" (maybe a kick) to create these ethics programs.
- Since 1991, there has been a huge growth in corporate ethics programs, which includes outside consultants, certifications and organizations (e.g. the ECOA). Conferences dissect the guidelines and share best practices on creating programs that fit the FSGO criteria. It has been estimated that business ethics consulting and related spin-offs have created a billion dollar industry.
- The FSGO was the catalyst for hundreds of thousands of hours of work and hundreds of millions of dollars in investment to create strong structures and materials for ethics programs. Many of these programs are exemplary, and the ethics professionals working in them are dedicated and diligent within the parameters of their company's policies.
- Government ethics consulting at the local level is sporadic and not well funded, but FSGO standards have spilled over into municipal governments as the framework for creating local ethics programs (e.g. Austin ethics audit; Denver ethics audit).
- The FSGO standards, even though created in the context of sentencing in criminal cases, have become the de facto blueprint on how to implement ethics programs in the U.S.

The Report of the Ethics Resource Center

In 2012, the Ethics Resource Center (ERC) released an excellent study summarizing 20 years of FSGO practices. The report acknowledged many positive results, but also listed several challenges to the program.

Statistically, over the last 20 years, only five corporations out of 3,433 sentenced have received the "credit" for having a good ethics program. The challenge is that the large companies seem to be able to get their cases dropped or settled prior to a trial, and the statistics are murkier at this stage. Larger corporations have more money and more lawyers to fight the prosecution in the early stages. The real goal is not to get credit for an ethics program at sentencing, but for the criminal indictment to never see the light of day in the first place.

The ERC also noted confusion, and inconsistencies across numerous federal agencies, in applying ethics standards and in making them transparent. This increase in complexity only invites "experts" to offer costly solutions. In fact, there is an ethics revolving-door phenomena. Those government employees intimately familiar with the complex ethics regulations are highly sought after in the private sector, the "ethics industry."

In 2010, there were active lobbying efforts to lighten the requirements of the FSGO; these efforts were successful. As the guidelines become more technical, the complexity of the subject matter provides the opportunity for a monopoly or capture by the few attorneys who understand how to adroitly utilize them to fend off prosecutions for their clients.

Another challenge noted in the ERC report was that it is difficult for some people to comply because of the general nature of the guidelines; people like to check the box as to compliance and they need clear directions in plain English. If some people have difficulty in applying the 7 steps of the FSGO, they would have even more of a problem with an analysis for institutional corruption.

The Seven Guidelines

The FSGO guidelines for an effective ethics program focus on the prevention and detection of crimes. There are seven components that need to be in place. Here is my simplified version.

1. Have standards and procedures in place to prevent crimes.

What about standards and procedures that will prevent the legal and systemic corrupt influences and dependencies in the organization? Are there such standards that could be applied in concise guidelines? Do they exist? If not, why not? It is not likely that people will work with the concepts of institutional corruption unless they are condensed into practical nuggets for practitioners.

2. The Governing Board shall have oversight over the ethics program; there will be a high level "point person" for the program with direct access to the Board.

It is easier to do risk assessments and reports to a Board on what is being done to prevent actual crimes. It conceivably would be much harder for an employee to report to the Board on issues that involve the more abstract concepts of legally corrupt activities in the culture of the group, of which the Board itself could be an inextricable part; this has been a recipe for disaster in the past. Ultimately, the reporting ethics personnel have their economic future tied to what the Board thinks of them; they can be "blinded" to significant issues regarding legally corrupt activities. This is especially true if they are not lawyers and bow to the more "sophisticated" analysis of their attorneys.

3. Don't give discretionary authority to people in the organization who have a criminal history.

How about identifying the positive characteristics for those in authority: courage in reporting offenses; going against the group culture; and identifying more than just the crimes of the organization? How do we identify, encourage, train and cultivate those few people in the group who can take on institutional corruption?

4. You need to train people on your standards.

This usually involves classroom settings or online courses that people certify they have completed. Sometimes values training is added to the legal rules. The vision for training would be to introduce the group to ideas of institutional corruption and how it relates to the fragility of our democratic institutions. See William English's paper[4] on "Institutional

Corruption and the Crisis of Liberal Democracy." If they have an emotional connection to the bigger picture, one that conceivably could threaten their future, the more specific rules and values might stick.

5. There must be monitoring and auditing to detect crimes and to evaluate the program. There **may** be anonymous ways to report crimes without fear of retaliation.

May be anonymous reporting? Should be. Most people will prefer to keep quiet rather than risk losing their jobs; and that's for reporting crimes. What about people coming forward with early warning signs of corruption? The focus on actual crimes is essential, but it is only the first step in correcting corrupt cultures that push the envelope on technical compliance with the law.

6. Create incentives and disciplinary measures for your ethics program.

(See number 1, above. The focus is too narrow if only on criminal violations and not broader organizational corruption.)

7. After a crime occurs, don't let it happen again.

It's always good to learn from mistakes; hopefully this isn't used in a more devious fashion in which the activity is continued, but done in a "technically legal" manner.

Gaming the System

Enron had an ethics code and a sophisticated ethics program, most likely in conformance with the FSGO standards which had been in effect for almost a decade when Enron's code was released in July, 2000. In December 2001, Enron was bankrupt, and the breakdown will be the source of lessons on fraud and institutional corruption for decades.

Malcolm Salter of the Safra Center stated in his paper[5] ("Short-Termism at Its Worst") that Enron pursued one of the "greatest gaming strategies of all times" and that "much of this behavior was not clearly unlawful." "Many of Enron's complex transactions . . . lived instead in the penumbra between the clear light of wrongdoing and the clear light of rightdoing." Gaming can be spotted when there are ambiguities in laws, unclear language and confusion; the ERC has already noted these challenges with the Federal Sentencing Guidelines. The programs that were put in place for "ethics" can themselves be subject to capture by the forces of institutional corruption.

Gaming the system is at the heart of institutional corruption. If the FSGO program maintains its focus on criminal conduct alone, then it can be used as a joystick for a very large game. If a company or a government heralds its "ethics program" it should mean something to the public; it should be something they can trust is not a charade.

Institutional corruption should be seen as the overarching construct that can be utilized to repair institutions, including local governments. By narrowing the scope of "ethics" programs to the prevention of crimes and legalistic regulations, we have the "tail wagging the dog."

References

1. Gregg Fields, "On the Edge," Research in Action Blog, The Lab @ Edmond J. Safra Center for Ethics, August 1, 2013, http://www.ethics.harvard.edu/lab/blog/327-on-the-edge.

2. James B. Stewart, "At SAC, Rules Compliance With an 'Edge,'" *New York Times*, July 26, 2013, http://www.nytimes.com/2013/07/27/business/at-sac-rules-compliance-with-an-edge.html?pagewanted=all.

3. <§ 8A1.1. " 'Organization' means 'a person other than an individual.' 18 U.S.C. § 18. The term includes corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations."

4. William English, "Institutional Corruption and the Crisis of Liberal Democracy," Edmond J. Safra Research Lab Working Papers, No. 15 (2013), SSRN: http://ssrn.com/abstract=2281305 or http://dx.doi.org/10.2139/ssrn.2281305.

5. Malcolm S. Salter, "Short-Termism at Its Worst: How Short-Termism Invites Corruption . . . and What to Do About It," Edmond J. Safra Research Lab Working Papers, No. 5 (2013), SSRN: http://ssrn.com/abstract=2247545 or http://dx.doi.org/10.2139/ssrn.2247545.

http://www.ethics.harvard.edu/lab/blog/334-the-tail-wagging-the-dog

Is Financial Reform Being Gamed? What Implementation of the Volcker Rule will Reveal about the Gaming of Financial Reform

Malcolm S. Salter

With both the President and members of Congress now calling for a swifter implementation of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, it seems to be a good moment to reflect upon some of the large issues involved in the implementation of financial reform. One such issue involves the extent to which large banks may be gaming financial reform in ways that subvert the public purpose of the Act rather than working in a more straightforward mode with regulatory agencies to define and comply with rules in ways that reflect legislative intent.

Three features of the Dodd-Frank Act —a massively long statute running over 2,200 pages long —would seem to invite various forms of gaming. First, the financial stakes and competitive implications for the domestic banking industry are undeniably huge. Second, some important features of this act are considered ill-advised and unwarranted by many bankers and members of Congress. (Only 3 Republican senators voted for the House Version of the bill.) Third, Congress chose to subcontract to federal regulatory agencies the actual writing of hundreds of new rules pertaining to key provisions of the Act. This legislative strategy predictably opened the pathway to full-throated lobbying by the banking industry as the regulatory rule-making process geared up.

The current rule-making process has already extended way beyond the two years originally envisioned for conforming to the Dodd-Frank Act —a result of the complexity of the issues involved, extensive comment periods of proposed regulations, aggressive industry lobbying, and the inability of regulatory agencies to agree on final regulatory language. According to Davis Polk & Wardwell, which closely follows the implementation of the Act, just 158 of the 398 required rule makings (or 40 percent) have been finalized nearly three years after Dodd-Frank was passed. During this delay the banking industry has naturally sought to win arguments at the regulatory level that were never addressed or resolved during the legislative phase. Bank officials and their representatives have not only tried to gain as much clarity and as many exclusions as possible in the new rules, but also to preserve maximum flexibility in regulatory compliance going forward. Congressional sponsors of the Act have also been working hard to ensure that the language of the new rules does not water down or otherwise subvert the intent of the legislation. Suspicions of gaming naturally led to snail-like negotiations and word-crafting.

On many of the Act's provisions, bankers, financial economists, Congressional sponsors, and federal regulators have widely diverging views of what rules are called for and can be effectively implemented. One of the most highly contested rules is known as the "Volcker Rule", championed by former Federal Reserve Chairman Paul Volcker.

The Volcker Rule: Key Provisions and Regulatory Context

Known formally as Section 619 of the Dodd-Frank Act, the Volcker Rule is one of the law's iconic provisions. It is also one of the act's most complex provisions. Although Dodd-Frank devotes only 5,000 words to the Volcker Rule, Congress left plenty of leeway for regulators to design (bend?) how the final rule will look —as with so much within the bill.

The intent of the Volcker Rule is to prohibit banks from engaging in both commercial banking and investment banking, as the 1933 Glass-Steagall Act once did. Since a large part of investment banks' business is now proprietary trading, which involves the purchase and near term sale of high-risk investments for banks' own account, the intent of the Volcker Rule is to prohibit large, integrated banks from putting their federally insured deposits at risk by making risky investments for their own trading account. The rule also seeks to eliminate potential conflicts of interest between large banks and their customers.

In addition to prohibiting federally insured, deposit-taking banks from engaging in proprietary trading, the Volcker Rule also limits the amount of money (no more than 3 percent of a bank's capital) that banks can invest in or use to sponsor hedge funds and private equity funds. The idea behind these investment restrictions is to eliminate the temptation of banking entities to bail out investors in troubled hedge funds and private equity funds, which are typically highly leveraged and can significantly expand a banking entity's losses during a financial crisis.

In contrast to these *prohibited* activities, the Volcker Rule also expressly includes exemptions from these prohibitions for certain *permitted* trading activities, including "making a market" for the benefit of customers, risk-mitigating hedging activities, underwriting, and trading in U.S. treasuries, U.S. municipals, U.S. government agencies, and the paper of Fannie Mae and Freddie Mac.

These exemptions may seem simple enough, but the Volcker Rule as crafted by Congress does not precisely define important permissible activities. For example, market-making is permitted by section 619 to the extent that it is "designed to not exceed the reasonably expected near term demands of customers, or counterparties," but this provision neither defines "market-making" as a banking activity nor offers a clear meaning of the phrases "reasonably expected" or "near term." The lack of clarity between prohibited proprietary trading and permitted market-making has alarmed the banking industry. Many bankers argue that under normal trading conditions, there is often overlap between customer-oriented market-making and proprietary trading, especially in relatively illiquid credit markets where a simple matching of buyers and sellers is not possible. In such situations, maintaining a functioning market for bank customers in credit instruments and derivatives, along with equities, for bank customers frequently requires market makers to obtain positions in these securities *in anticipation of* customer flow. But under these circumstances, the market maker is necessarily exposed to changes in the value of the securities, and market-making begins to look very much like proprietary trading. Is this permissible under the Volcker Rule?

Authority for developing final definitions necessary to implement the intent of the Volcker Rule (and other rules under the Dodd-Frank Act) is shared by several regulatory agencies under the overall authority of the newly formed Financial Stability Oversight Council (FSOC), chaired by the Treasury Secretary. These agencies include the Office of the Comptroller of the Currency (Department of the Treasury), the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission, the Federal Reserve Board, and the Securities and Exchange Commission. Dodd-Frank required FSOC to study the

implementation of Section 619 and make recommendations to the five agencies responsible for Volcker Rule implementation within six months of the statute's enactment. FSOC's first action was a request, on October 1, 2010, for public input on the Volcker Rule. Approximately 8,000 comment letters were received, with roughly 6550 being identical letters arguing for strong implementation of the Volcker Rule. The remaining 1450 comments set forth individual perspectives from financial market participants, Congress, economists, and the public at large.

On October 11, 2011 FSOC released a highly complex, 298-page report, which proposed a variety of definitions and preliminary regulations and then posed more than 1,300 questions for comment by industry participants. FSOC asked that comment letters addressing the proposed rules and outstanding questions be submitted by January 13, 2012.

By the January 13 comment deadline, hundreds of banks, asset managers, business groups, American corporations, members of Congress, U.S. regulators, foreign regulators, and others submitted detailed letters addressing FSOC's proposed definitions, regulations, and questions. A review of comment letters submitted by leading Wall Street banks, the Securities Industry and Financial Markets Association, members of Congress, and former industry executives reveals many persistent disagreements and concerns about the Volcker Rule. While the banks tended to accept the risk-reduction premise of the rule (namely, that proprietary trading on Wall Street should be placed outside the taxpayer safety net), they argued that the rule, in its current form, is too complex, too burdensome, and inconsistent with preserving the functioning of global trading markets. In the words of JPMorgan Chase, the "extraordinary complexity and large number of laws" in the Volcker Rule makes implementation impossible without imposing "unacceptable costs on our economy and financial system."

Initial Debate over Regulatory Rule-Making

Underlying these broad criticisms are a broad array of more specific concerns. For example, in its 65-page comment letter JPMorgan Chase questioned, among many other matters, (1) the proposed definition of a "trading account," —a seemingly minor matter but one which is absolutely critical to one's understanding of what constitutes prohibited proprietary trading; (2) proposed criteria for defining and differentiating between proprietary trading and market-making; and (3) various proposed rules that inhibit effective asset-liability management, risk-mitigating hedges, and liquidity management —all argued by JPMorgan Chase to be central to safe and sound bank management. The bank also argued that FSOC's assumption that banking entities will camouflage prohibited trading and work to evade and subvert the intent of the Volcker Rule has contributed to unnecessary complexity.

The basic thrust of Goldman Sachs' 63-page comment letter was that FSOC's definitions of permitted and prohibited trading activities are so narrowly defined that they significantly limits banks' capacity to help clients raise capital, manage their risks, invest their wealth, and generate liquidity for their holdings. More fundamentally, Goldman criticized regulators and rule-makers for their "totally out-of-date" conception of how financial markets work, one based on an antiquated agency-based, exchange-traded equities paradigm. In the current world of finance, Goldman argued, new illiquid assets abound, thereby invalidating the applicability of the regulators' implicit, exchange-traded market model. In other words, being a market-maker in today's world requires warehousing an inventory of securities in order to actually make a market—since for many securities there is simply no counterparty currently available, and therefore no price. Goldman claimed that if FSOC stays with the old

conception of how financial markets work, the inevitably narrow and restrictive definitions of market-making would destroy market liquidity. (The Securities Industry and Financial Markets Association reiterated Goldman's dire warning about the devastating effects on corporate liquidity in its 175-page comment letter.) According to Goldman, the inevitable result will be massive mark-to-market losses on bank and corporate balance sheets and an escalation of cumulative financial transaction costs into the hundreds of billions of dollars. The most promising way forward, Goldman argued, is to invest in developing quantitative "metrics" that could be helpful for indicating the true character of a trading activity —be it proprietary trading or market-making —and to avoid inappropriately restrictive definitions. The design and implementation of such metrics, Goldman argued, will require "robust and on-going dialogue between banking entities and their regulators. It will also require expanding the conformance period beyond the July 2012 start date." Whether this suggestion will be perceived as foot-dragging or gaming the implementation of financial reform remains to be seen.

Chairman Volcker's comment letter argued that the market liquidity argument, put forth by Goldman and others, was way overdrawn: "There should not…be a presumption that evermore market liquidity brings a public benefit. At some point, great liquidity, or the perception of it, may itself encourage more speculative trading…" Volcker also rebutted claims that proprietary trading by commercial banks is not a serious risk factor, that the competitive position of U.S. based banking institutions will be adversely affected (as claimed by JPMorgan and Goldman), and that the proposed regulation is simply too complicated and costly. But Volcker did agree with Goldman's call for meaningful metrics to help discriminate between permitted market-making and prohibited (and "deliberatively concealed and recurring") proprietary trading. Volcker also recognized in his letter "the thorny issue of guidance" with respect to situations where market-making for customers takes on characteristics of prohibited proprietary trading. Since only a very few, large banks engage in continuous market-making on any significant scale, Volcker was nevertheless sanguine about the possibility of effective regulatory oversight.

Chairman Volcker's concise letter, while seemingly balanced and non-confrontational, was not seen as such by Jamie Dimon, the chairman and chief executive of JPMorgan Chase. Dimon told Fox Business in a February 13, 2012 interview, "Paul Volcker by his own admission has said he doesn't understand capital markets. He has proven that to me." Dimon added, "I understand the goal to make sure these companies don't take huge bets with their balance sheets. But market-making? Just like these stores down the street, when they buy a lot of polka dot dresses, they hope they're going to sell, they're making a judgment call. They may be wrong! So protecting the system I agree with, but starting to talk about the 'intent'… I tell you… for every trader, we're going to have to have a lawyer, compliance officer, a doctor to see what their testosterone levels are, and a shrink [asking them], "what's your intent?" No, we're going to make markets for our clients to give them the best products, the best services, the best research and the best prices. That's a good thing in spite of what Paul Volcker says."

One of the most remarkable comment letters came from John Reed, who held CEO titles at Citigroup and its predecessor from 1984 to 2000. Reed had helped engineer the merger between Citibank and Sanford Weill's Travelers Group (owner of the investment firm Salomon Smith Barney) after the repeal of the Glass-Steagall Act, which had separated traditional banks from those involved in capital markets. He has since said that the repeal of Glass-Steagall was a mistake. In his comment letter. Reed recommended that the proposed Volcker Rule be made stronger by requiring regulators to change how traders are paid to

prevent future abuse of the activities that the rule still permits, requiring quarterly CEO and top management signoffs on complying with the rule, and the imposition of "severe penalties" for non-compliance.

Eighteen months after all the requested comment letters were received by FSOC, it is still unclear how such disparate, strongly held views about the final rendering of the Volcker Rule will be reconciled. Hence the mounting impatience of the President and some members of Congress. Not only have various bank regulators been at loggerheads over such issues as distinguishing between permitted market-making activities and prohibited proprietary trading, but regulators have also been swamped with industry lobbyists seeking to water down the rule's various provisions. The delay in implementing the Volcker Rule is palpable. In the words of Paul Volcker, "We passed a law, like it or not, and three years later, we've got no rule."

Are New Rules Related to Proprietary Trading Being Gamed?

Gaming in the present context refers to deceptive (and often lawful) behavior that subverts the intent of socially mandated rules for private gain. Gaming contrasts with good faith negotiation of rules or good faith compliance with the spirit of established rules. When it comes to rule-making in the world of economic regulation, the distinction between deception and good faith negotiation lies in the motives of affected firms and their lobbyists. If companies and their lobbyists try to negotiate language and rules with regulators that leave open unintended possibilities for side-stepping the rule's intent in the future, then such behavior can said to be a deception and a form of gaming. If, however, the motive were to clarify the meaning or scope proposed rules without pushing for loopholes that permit unintended evasion of regulatory or legislative intent in the future, then that would be a case of good faith negotiation rather than a case of gaming.

Game players typically try to rig society's rules in their favor through largely invisible lobbying efforts. They also tend to follow the letter of the law but not necessarily its intent or spirit. They exploit —for personal or institutional gain —purposively grey areas of the law that are not easily understood or recognized as violations.

Gaming typically comes in two, trust-destroying forms: a rule-making game and a rule-following game.

The rule-making game is an *influence* game. It involves influencing the writing of society's rules by legislative or regulatory bodies, so that loopholes, exclusions, and ambiguous language provide future opportunities to "work around" or circumvent the rules' intent for personal or institutional gain. The rule-following game is a *compliance* game. It involves the exploitation of gaming opportunities created during rule-writing.

Since only 38 percent of the required rules under section 619 of Dodd-Frank have been written and agreed upon, it is difficult as of August 2013 to report any authoritative conclusions about the behavior of large banks with respect to gaming the implementation of Dodd-Frank in general and the Volcker Rule more specifically. For sure, during the legislative phase there was massive lobbying in Congress by financial institutions and their various associations in opposition to reform. While this lobbying did not prevent passage of the Dodd-Frank Act, it did succeed in significantly watering down the Volcker Rule as originally proposed. And during the continuing regulatory rule-making phase, the gray area between proprietary trading and market-making would seem to invite heavy influence peddling and

lobbying —particularly with respect to definitions of permitted and prohibited activities creating exclusions and loopholes that could be exploited for private benefit in the future.

That said, during *preliminary rule-making*, which includes draft rules and related questions issued by FSOC on October 11, 2011 and the subsequent comment period for industry participants (ending on January 13, 2012), I have not been able to detect—sitting outside the lobbying process—any truly defining cases of gaming behavior that fundamentally subverts the intent of the statute, as opposed to good faith (and persistent) efforts to achieve clarity and ease-of-implementation in the final regulations.

For example, all of dozens of comment letters that I reviewed from the largest banking institutions and industry associations to the FSOC in January 2012 addressed specific regulatory questions regarding prohibitions or exclusions related to trading, market-making, and hedge fund investing in a substantive, largely technical manner. While most of these respondents were not supporters of the Dodd-Frank Act (although not totally adverse to some sort of financial reform), opinions and recommendations were typically substantiated by systematic analysis of financial function and supporting processes. In my review of invited comment letters, I detected no gross misrepresentations of fact or mischaracterizations of banking processes, although there was certainly room for substantial differences of opinion over the costs, benefits, and challenges of prohibiting certain trading functions under the proprietary trading restriction.

Of course, in preparing public letters of this sort there are no conceivable gains to be had from overtly self-interested, unsubstantiated arguments on the part of banks targeted for re-regulation. For this reason, we should not rush to any judgments about this laudable straightforwardness. Beneath this surface of comity and technical debate, and outside my field of vision, it is possible —and even likely —that a battle royal is being fought over the crafting of regulations in ways that would enable banks to lawfully sidestep some of the prohibitions or even subvert the intent of the Volcker Rule in the future. Indeed, the large amount of money being spent on lobbying by banking interests has hardly declined as the Dodd-Frank Act has moved from the legislative phase to the current regulatory rule-making phase. And given the significant financial stakes involved for large banks, we know that there are many incentives for banks to figure out ways of side-stepping prohibitions against proprietary trading by claiming such trading to be part and parcel of such permitted trading activities as market-making, hedging, or other customer-initiated transactions.

This gaming potential was clearly acknowledged in the January 2011 report by FSOC on proprietary trading. This report minced few words in acknowledging and describing the various ways in which banks could mask prohibited proprietary trading as market-making or risk-mitigating activities, thereby gaming the essential purposes of the Volcker Rule. In the same vein, U.S. Senator Jeff Merkley, the Oregon Democrat who with Senator Carl Levin, a Michigan Democrat, put the Volcker Rule into Dodd-Frank complained to Bloomberg in response to industry claims that the new proprietary trading rule would choke off liquidity in the markets, "The banks are using every strategy they possibly can to 'confuse the issue'."

<u>What the Record Reveals</u>

As far as predicting future gaming and circumvention is concerned, many opportunities exist. First, many regulations (and prohibitions) have yet to be written, inviting the normal sparring over substantive restrictions and language. Second, great uncertainty exists about whether or not the intent of financial reform can actually be adequately protected by the

regulatory regime put in place by the legislative authors of the Dodd-Frank bill. This regime puts the onus of compliance on the banking entities themselves (a costly and complicated function requiring breakthrough methodologies). It also requires relevant government agencies to conduct robust oversight and enforcement (also costly and involving dispersed regulatory authority). The effectiveness of this regime will only be revealed in the coming months and years.

These disclaimers aside, what else can we say now about past and current industry efforts to shape and perhaps side-step the intent of the Volcker Rule?

As a start, we can say that lobbying and influence peddling remains robust as of the summer of 2013. All indications are that the energy and resources invested by industry associations and financial institutions in lobbying for favorable regulatory language have remained large and sustained. The industry has been heavily engaged in all aspects of the financial rule-writing through a wide variety of channels like the U.S. Chamber of Commerce, the Securities Industry and Financial Markets Association, the American Bankers Association, the Financial management Association International (for hedge funds), and the Financial Services Roundtable.

To complicate the problem, members of Congress have long received significant campaign contribution from the finance industry. According to the Center for Responsive Politics, a nonprofit organization that monitors political donations, the financial sector is one of the largest source of campaign contributions to federal candidates and parties. And according to Robert G. Kaiser's detailed legislative history of the Dodd-Frank Act (*Act of Congress: How America's Essential Institution Works, and How It Doesn't*. Knopf, 2013), the watchdog Public Campaign Action Fund has calculated that members of the House Financial Services Committee (chaired by Rep. Barney Frank during the writing of the Dodd-Frank Act) received a total of $62.9 million from the financial sector from the start of their Congressional careers through the spring of 2009—an average of $885,000 per member. Kaiser also reveals that Chairman Frank received considerably more finance sector donations, totaling $,1,041,298 in 2007-08 alone. Frank's co-author and collaborator, Chairman Chris Dodd of the Senate Banking, Housing, and Urban Affairs Committee, received $6,081,836 over the same period. We can safely assume that members of the Senate committee received comparable attention and care. Both Barney Frank and Chris Dodd have claimed that this campaign money did not influence their approach to regulatory reform, and that they have consistently supported reforms that large banks opposed. Still, as Kaiser observes, neither Dodd nor Frank ever proposed breaking apart the large banks or otherwise changing the fundamental structure of the banking sector.

With respect to lobbying, Marcus Stanley —legislative director of Americans for Financial Reform (a coalition of 250 national, state and local consumer, labor, investor, civil rights, community, and small business organizations) —claims that the financial industry spent $1.4 billion on lobbying to influence the legislative process in 2008-2010. In addition, according to *The Economist*, the financial services community deployed more than 3,000 lobbyists to influence the scope and content of the Dodd-Frank reform bill. That's about 30 lobbyists per U.S. Senator. During the legislative phase of Dodd-Frank and the Volcker Rule, the influence game was rigorously played and, if the act's mind-numbing complexity is any guide, responsive to many private interests.

After the passage of the Dodd-Frank bill, the financial sector maintained its level of spending on campaign contributions and lobbying. Lobbying-only numbers released by the

Center for Responsive Politics, show that finance firms and trade associations spent collectively $96.8 million during 2012, only a little less than the amount that was spent in 2010 and 2011 when Dodd-Frank activity on Capitol Hill was most intense.

Immediately after the bill was voted, the "ground war" conducted by industry lobbyists shifted from Congress to on federal agencies like the Federal Reserve and the Securities and Exchange Commission, to which the act left the tough work of writing the actual regulations. According to Gary Rivlin of *OpenSecrets.com*, the infantry on the ground in 2012 included 183 lobbyists working for the U.S. Chamber of Commerce, 91 for the American Bankers Association, 60 for JPMorgan Chase, 51 for Goldman Sachs, 49 for the Securities Industry and Financial Markets Association, 28 for the Financial Services Roundtable, just to mention a few. To give a sense of relative "fire power," the top five industry groups working to influence and bend Dodd-Frank to their interests fielded 406 lobbyists on Capitol Hill in 2012, versus 20 for the top five consumer protection groups defending Dodd-Frank —a 20 to 1 ratio. This ratio does not reflect the combined forces of regulatory lawyers, research staffs, PR people, friendly think tanks supporting the finance industry, and, of course, bankers themselves meeting face to face with federal agencies on dozens of occasions.

It should be no surprise that these motivated lobbyists are extremely well organized. According to detailed research of industry lobbying by Kim Krawiek, within hours of the bill's passage in July 2010, big banks and industry trade groups systematically divided their teams of lobbyists into 18 work groups, each focused on different elements of the new law. One of these work groups focused on the Volcker Rule. In the words of Krawiek, "battalions of lawyers burrowed deep in the federal government to foil reform." Whether that characterization is appropriate remains to be seen. But there is little doubt about the massive effort to influence regulatory language. Says Michael Barr, who was an assistant secretary at the Treasury Department during the writing of the Dodd-Frank bill, "You pick a page at random, and I'll tell you about all the issues on that page where the fighting was intense."

The "Big" Questions

How do we understand the full picture of how the Volcker Rule is being implemented and perhaps gamed? As the regulatory rule-making process grinds to its inevitable end, will the Act's essential purposes be protected or successfully subverted? How will the pubic interest and legislative intent be interpreted in matters of highly technical securities trading? What exclusions, loopholes, and gaming opportunities will survive final rule-making? How will Wall Street's largest banks choose to comply with the final provisions of Volcker Rule? How much trading with proprietary-type characteristics will actually be shut down?

With respect to proprietary trading by large banks, what we know so far is that Goldman Sachs —just to stay with this example —reported in its annual 10-K filing with the U.S. Securities and Exchange Commission that it liquidated during 2010 "substantially all the positions" in the principal-strategies unit that operated within the firm's equity division. That was certainly a quick response to a first reading of the bill. In addition, the bank reported that in the first quarter of 2011 it "commenced the liquidation of the positions that had been held by the global macro proprietary-trading desk" within the fixed-income, currencies, and commodities ("FICC") division.

We also know that Morgan Stanley was planning to break off its largest pure-proprietary trading group, Process Driven Trading, as an independent advisory firm by the end of 2012.

Similarly, we know that executives from JP Morgan Chase, Citigroup, General Electric's GE Capital unit, and Credit Suisse have met with Federal Reserve or U.S. Treasury Department officials on multiple occasions to discuss implementation of the Volcker Rule.

All of these examples are indicators of trust-building adaptation to changed circumstance. Still, important questions remain. Goldman, for example, which has publicly supported financial reform, has not entirely eliminated some businesses that make bets with its own capital. While Goldman states in its SEC filing that it "will continue to assess our business, risk management, and compliance practices to conform with developments in the regulatory environment," we do not yet know whether or not it will lawfully transfer some of its remaining proprietary trading off-shore to its Global Macro Proprietary Trading Desk in London. Similarly, we do not know whether or not large banks will shift some of their traders to market-making or client-service desks—thereby enabling the bank to continue operating as before, albeit at diminished scale and visibility. Similarly, we do not yet know how large banks will respond to prohibitions on investments in hedge funds and private equity funds? Will they follow JP Morgan Chase in shedding its private equity operation? How will banks deal with new hedge fund restrictions? As noted in the first FSOC report, while a number of banking entities have shut down or plan to shut down dedicated ("bright line") proprietary trading operations and hedge fund businesses that were a source of losses during the financial crisis, impermissible proprietary trading may continue to occur within permitted activities that are not organized solely to conduct proprietary trading.

We can only imagine the full range of questions pertaining to the implementation of Volcker Rule that remain for bankers and their regulators to clear up. And we can only imagine how much energy and resources the banking community will invest during the final rule-making phase in trying to preserve opportunities for lawfully practicing various forms of trading that contribute so much to banks profits. For this reason, continuing to follow the implementation of the Volcker Rule will help us better understand where and to what extent the Volcker Rule has been gamed, where it has been responsibly adopted and complied with, and how the remnants of gaming can be best contained in the future. There is no better test case by which to assess regulatory and industry behavior in the implementation of financial reform.

http://www.ethics.harvard.edu/lab/blog/335-is-financial-reform-being-gamed

One Holy Mess: Pope Francis Fights Institutional Corruption at the Vatican Bank

Gregg Fields

They are scenes reminiscent of a Dan Brown novel: whispers of money laundering and connections to the mafia; a banker found hanging from the Blackfriars Bridge in London; and a powerful American consulting firm delving into the secrecy-shrouded financial arm of the Vatican.

But the drama surrounding the Institute for Religious Works, commonly known as the Vatican Bank, is not a sequel to the controversial bestseller *The Da Vinci Code*. The Vatican's banking unit is in the middle of a firestorm of controversies and acknowledged lapses in oversight. The cleanup started under Pope Benedict XVI but has been thrown into high gear by Pope Francis. There are signs already that greater transparency and increased regulatory oversight are in the pipeline.

In a broader context, the saga of the Vatican's bank is a telling example of how, given the right conditions, institutional corruption can infest organizations blessed by moral authority and endowed with a mission of public service. It shows how institutional corruption can insidiously erode the public's trust in respected organizations, reducing the effectiveness of their leadership. It classically illustrates the moral hazards that arise when relations between the regulator and the regulated grow too cozy—in this case, they were virtually the same entity.

"To the consternation of the public and to the continued embarrassment of Catholics worldwide, the Vatican bank remains a rich source of material for Italian journalists, conspiracy theorists and anyone else who wants to build a case for Vatican intrigue," wrote Francis J. Butler, former president of the Foundations and Donors Interested in Catholic Activities, in a recent commentary for the independent U.S. newspaper National Catholic Reporter. "The question before Pope Francis is whether the elimination of the Vatican bank entirely—which would mean giving up about $86 million euro in yearly profits—would be the only sure way to be free of further financial scandal."

An Eternal Issue

The Vatican, of course, is one of the highest profile organizations in the world. In that sense, the pontiff's banking reform efforts will naturally be widely watched around the globe, particularly the 1.2 billion Roman Catholics. Its bank, which most commonly goes by IOR, the Italian acronym for Istituto per le Opere di Religione (in English, the Institute for Religious Works) has been a lightning rod for controversy almost since its founding by Pope Pius XII in 1942, in the depths of the horrors of World War II.

If Pope Francis succeeds in saving the IOR and restoring its credibility, the results may prove to be a persuasive template for those addressing institutional corruption in other

powerful entities such as Congress or Wall Street. Yet, as with financial reform following the financial crisis, the effort to rehabilitate the IOR is now several years old, illustrating the intractable nature of institutional corruption.

"Since 2010 the IOR and its management have been working hard to bring structures and processes in line with international standards for anti-money laundering," Ernst von Freyberg, the IOR's president, said this summer in announcing a management restructuring that saw the IOR's director and deputy director resign. Von Freyberg, a German industrialist, was hired to clean up the bank earlier this year. "While we are grateful for what has been achieved, it is clear today that we need new leadership to increase the pace of this transformation process," he said.

Scandals linked to the IOR are hardly new. It has been accused, though never found liable, for colluding with Croatia's collaborationist government to steal assets from Hitler's victims during World War II. A suit filed in the U.S. by Holocaust survivors, Alperin v. Vatican Bank, was ultimately dismissed on grounds that IOR is protected by the Foreign Sovereign Immunity Act. (Collaboration controversies have also long dogged the Bank for International Settlements, based in Basel, most recently in the book *Tower of Basel* by Adam LeBor.)

In the 1960s, controversy flared when the IOR hired Italian financier Michele Sindona as a financial advisor. The problem: Sindona was a central player in a seemingly endless number of banking collapses and financial swindles in Italy. His major American holding, Franklin National Bank, collapsed in 1974—reportedly costing the Vatican tens of millions of dollars—and he eventually was given a 25-year sentence for fraud related to the debacle. He was later extradited to Italy to face other charges, and died in prison in 1986 of cyanide poisoning. Whether it was suicide or murder was never determined.

Perhaps the most notorious blemish on IOR's past, however, is the 1982 collapse of Italy's largest bank, Banco Ambrosiano, with which the Vatican, as a shareholder, had a strong working relationship. Banco Ambrosiano's chairman, Roberto Calvi, whose Vatican ties had earned him the nickname "God's banker" despite a conviction for illegal foreign exchange transactions, was later found hanging from London's Blackfriars Bridge. An initial finding of suicide was later discredited and it is now generally accepted that he was murdered. (A highly fictionalized character based on Calvi was a subplot in Godfather III.)

"Our biggest issue is our reputation," von Freyberg conceded in an interview with Vatican radio earlier this year.

Self-regulating

How could a city-state with a population of 800 become so enmeshed in international financial intrigue? In essence, the IOR operated much like an "offshore" banking haven like Grand Cayman or Bermuda. Like those small islands, the Vatican City-based IOR had sovereign status. Its regulator is the Financial Information Authority, an internal watchdog of the Vatican. In recent weeks, the Vatican has essentially conceded that this led to what students of institutional corruption might call regulatory capture. In early August, the pope issued a Motu Proprio—a decree at his own initiative—that increased the FIA's powers of supervision over the IOR.

Those who study institutional corruption often conclude that a lack of transparency is a contributing factor. It's a relevant point in this case, because the IOR was perhaps the least

transparent financial institution in the world. No branches, no shareholders and essentially no central banking authorities to whom it must answer.

It also has a structure that significantly limits the constituencies to whom it must answer. It doesn't make loans, for instance, or perform other traditional bank functions. Only people like Vatican employees, clerics, and entities like charities and dioceses affiliated with the Holy See (the authority and government functions of the papacy) are allowed to have accounts. In one example of how inscrutable its operations were, the bank only developed a website in summer 2013.

Certainly, religious organizations are often granted a great deal of leeway in terms of privacy regarding their operations. However not many institutions own their own bank—one that, according to its new website, www.ior.va, has more than $9.4 billion in assets.

Outside Influences

Despite the publicly announced cleanup efforts, scandals have continued. One example concerns the case of Monsignor Nunzio Scarano. He was arrested earlier this year over an alleged plot to bring 20 million euros in cash into Italy. According to press reports, he is also being investigated for money laundering in southern Italy. The Vatican's criminal court has frozen Scarano's accounts.

It is worth noting, meanwhile, that the Vatican financial reforms, which gained traction under Pope Benedict XVI and are clearly gaining momentum now, came only after years of bruising international pressures. In 1989, the G-7 countries including the United States, Italy and the United Kingdom banded together to form the Financial Action Task Force, to coordinate international money laundering efforts. One of the biggest concerns then, at least for the U.S., was drug smuggling proceeds.

In the 1990s, Moneyval, an organization comprising smaller states belonging to the Council of Europe, was formed to combat money laundering. Global anti-money laundering initiatives gained new urgency after the terrorist attacks in 2001, with a number of international agreements forcefully lifting the shrouds of secrecy that had been one of the leading competitive advantages that banking havens historically enjoyed.

The Vatican only joined Moneyval in 2011, which led to a Vatican-requested review of IOR released last year. The report found the Vatican had "come a long way in a very short time" but that "further important issues still need addressing in order to demonstrate that a fully effective regime has been instituted."

Besides bringing in von Freyberg, Promontory Financial Group, the prominent Washington consulting firm, has been hired to conduct a forensic review of the bank's finances. In May, it signed an information sharing agreement with the U.S. Financial Crimes Enforcement Network (FinCEN).

"The IOR is engaged in a process of comprehensive reform, to foster the most rigorous professional and compliance standards. These efforts are based on the legal framework set forth by the Vatican, in cooperation with international bodies," von Freyberg, the president, says in a letter posted on the IOR website. "This includes implementing strict anti-money laundering processes and improving our internal structures. We are conducting an extensive evaluation of all our clients' accounts, with the aim of closing down those relationships that do not conform to our strict standards."

Restoring Faith

In that regard, von Freyberg has hit upon what many observers have missed about the scandals surrounding the IOR. True, there appear to have been a number of unsavory characters with whom it associated. But what likely attracted them was a system that was easily subject to influence. A mutually dependent relationship—one might call it dependence corruption—seems to have developed between IOR and people that ultimately sullied the reputation of the institution. Long term, that undermined its moral authority.

As Lawrence Lessig, director of the Edmond J. Safra Center for Ethics, wrote recently: "Institutional corruption is manifest when there is a systemic and strategic influence which is legal, or even currently ethical, that undermines the institution's effectiveness by diverting it from its purpose or weakening its ability to achieve its purpose, including, to the extent relevant to its purpose, weakening either the public's trust in that institution or the institution's inherent trustworthiness."

That would suggest the IOR faces two challenges. One, it must create new systems that eliminate its vulnerability to the influences that lead to institutional corruption. Secondly, and perhaps more importantly, it must re-strengthen the credibility that lies at the heart of the public's trust.

The question in this case is whether it's too late. Pope Francis raised that possibility himself in a press conference earlier this summer. "Some say perhaps it would be better as a bank, others say it should be an aid fund, others say it should be shut down," he said, during the return flight from his papal visit to Brazil. "But the hallmarks of the IOR—whether it be a bank, an aid fund, or whatever else—have to be transparency and honesty, they have to be."

http://www.ethics.harvard.edu/lab/blog/336-one-holy-mess