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Diversity and Ethics: Toward an Objective Business Compliance Function

*Steven A. Ramirez**

This Article builds upon prior works which articulate an objective standard for corporate ethics and compliance that furthers shareholder wealth maximization: A firm should only engage in conduct that acclimates itself as optimally as possible to the full range of its constituencies, including investors, workers, consumers, and regulators. Further, because of the deep racial and social divisions within the United States today (and present in most business environments), a firm can achieve optimal acclimation only if it includes the full range of cultural diversity within its constituencies, as those diverse voices influence the behavior of the firm. This allows the firm to import the conscience of those constituencies due to differences in ethical sensitivities among discrete segments of the population. This Article argues in favor of an SEC disclosure guidance release requiring the disclosure of ethical and compliance governance structures and practices. Such a disclosure mandate should include: disclosure of governance structures at the board level and below; the role of cultural diversity in the ethics and compliance function; the degree to which the ethics and compliance function is independent of senior management; and how reports of potential misconduct are encouraged. These facts would be material to a reasonable investor given the history of shareholder losses (particularly in recent history) suffered at the hands of unethical and non-compliant management. This disclosure mandate could trigger a competitive race-to-the-top as firms search for those ethical and compliance practices that lead to the highest gains in sustainable financial performance. In short, competitive capitalism can lead to a race-to-the-top, in terms of ethicality and compliance practices, as well as a firm's embrace of cultural diversity. The Article concludes that financial market competition can thereby foster superior financial performance, superior management of ethical and compliance risk, and superior embrace of cultural diversity

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all at once. This would further secure investment within the American economy.

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INTRODUCTION

Once again,[1] large publicly traded firms, particularly large bank holding companies, face regulatory sanctions for tolerating criminality and blatant unethical misconduct within their business.[2] In the fall of 2016, regulators announced that Wells Fargo incentivized its workers to systematically create fake accounts for bonuses and levied large fines against the megabank.[3] Wells Fargo shareholders ultimately paid hundreds of millions of dollars to meet claims arising from management's wrongdoing.[4] Further, in the weeks following the announcement of the scandal and the settlement with regulators, shareholders lost $25 billion

1. Steven A. Ramirez, *Diversity, Compliance, Ethics & In-House Counsel*, 48 U. TOL. L. REV. 465, 465–67 (2017) (recounting the silence of the lawyers during massive crises in corporate ethics and compliance during the savings and loan crisis, the Enron frauds, and the subprime debacle, and proposing a means for achieving greater diligence of counsel in reporting material legal risks to senior management and beyond).

2. Consumer Financial Protection Bureau, *Consumer Financial Protection Bureau Fines Wells Fargo $100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts*, (Sept. 8, 2016), https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/.

3. *Id.* Later, Wells Fargo revealed it created a total of 3.5 million accounts in order to enhance its fee income. Matt Egan, *Wells Fargo Uncovers up to 1.4 Million More Fake Accounts*, CNNMONEY (Aug. 31, 2017, 12:34 PM), http://money.cnn.com/2017/08/31/investing/wells-fargo-fake-accounts/index.html.

4. *See* James Rufus Koren, *Wells Fargo's $142-million Sham Accounts Settlement: What you Need to Know*, L.A. TIMES (July 11, 2017, 2:44 PM), http://www.latimes.com/business/la-fi-wells-fargo-settlement-20170710-htmlstory.html (addressing the practical ramifications of both the $142 million in shareholder wealth paid to the Consumer Financial Protection Bureau ("CFPB") and management's squandering of more corporate resources to settle claims brought against the firm by aggrieved customers); *see also* Patrick Rucker & Dan Freed, *Wells Fargo will Pay $190 mln to Settle Customer Fraud Case*, REUTERS (Sept. 8, 2016), https://www.reuters.com/article/wells-fargo-settlement/wells-fargo-will-pay-190-mln-to-settle-customer-fraud-case-idUSL1N1BK1E8 (detailing the May 2015 allegations against Wells Fargo bank and the subsequent settlement in which Wells Fargo paid $185 million in penalties and $5 million to customers allegedly pushed into fee-generating accounts absent a request).

in market capitalization.[5] The Chief Executive Officer ("CEO") of Wells Fargo, on the other hand, garnered a total of $192 million during his tenure as CEO.[6] The recent ethical and compliance stumbles at Wells Fargo illustrate a key point regarding business leadership and corporate governance in the United States.[7]

Too often the behavior of business leaders in America renders the term "business ethics" an oxymoron that seems inconsistent with financial success.[8] Classes in business ethics similarly encourage students to think about ways to maximize short-term windfalls, ethics be damned.[9] The

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5. Narottam Medhora, *Wells Fargo Hit with Class Action Lawsuit over Sales Practices*, REUTERS (Sept. 27, 2016), https://www.reuters.com/article/wells-fargo-accounts-lawsuit/wells-fargo-hit-with-class-action-lawsuit-over-sales-practices-idUSL2N1C30JS ("[S]hares of the company have fallen more than 10 percent since Sept. 8 when it reached a settlement with regulators, wiping off more than $25 billion of market capitalization."). Ultimately, the Federal Reserve Board imposed further sanctions (including a major board shakeup), triggering a further 6 percent decline in share value. Evelyn Chang, *Wells Fargo Shares Dive after Fed Restricts Bank's Growth, Citing 'Consumer Abuses,'* CNBC (Feb. 2, 2018), https://www.cnbc.com/2018/02/02/federal-reserve-orders-wells-fargo-to-replace-four-board-members-restricts-growth-because-consumer-abuses.html.

6. Martha C. White, *$41 Million is Chicken Scratch Compared to What Stumpf Earned at Wells Fargo*, NBC NEWS (Sept. 29, 2016, 2:31 PM), https://www.nbcnews.com/business/business-news/41-million-chicken-scratch-compared-what-stumpf-earned-wells-fargo-n656901.

7. Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. REG. 257, 276 (2010) (finding that the top executives of two firms where shareholders suffered devastating losses achieved "decidedly positive" net payoffs from their leadership of the firms during 2000–2008).

8. A young MBA student surveyed about what she learned about business ethics in America from a business ethics class said it made her "wonder if there is not on [*sic*] single ethical person left in corporate America." Walter Pavlo, *An MBA's View Of The State Of Business Ethics In America*, FORBES (Jan. 14, 2014, 7:31 AM), https://www.forbes.com/sites/walterpavlo/2014/01/14/an-mbas-view-of-the-state-of-business-ethics-in-america/#3cf130bf3d48 ("I am concerned that MBAs, like myself, will find new ways to embezzle, insider trade, and commit crimes to further our own careers. Sadly, applications like Snapchat, which deletes text messages once they are read, would be an excellent tool for insider trading.").

9. We all want to be successful; I am not exempt from the idea of making as much money as possible in a shortest amount of time. However, I am more interested in finding solutions to ethical dilemmas rather than crossing an ethical line to better any corporation. At the end of the day, my perception of the state of ethics in American business is that it is trucking along in the same fashion as it has for decades and we MBAs are eager to slip into it. While reducing crimes associated with unethical behavior is a worthwhile goal, I'm not sure that I will see it reached in my time. Get ready white-collar defense attorneys, you're bound to have your hands full. *Id.*

Such attitudes among students should invite educators to remind their classes that while accountability for corporate elites faced much dilution under law in the past few years, many corporate executives nevertheless suffered incarceration and ignominy for such wrongdoing, including Aaron Beam, the founder and former CEO of Health-South (and Special Presenter at the 2017 Institute for Investor Protection conference). *See* Quentin Fottrell, *Aaron Beam: 'I think my dog still loves me,'* MARKETWATCH (2014), https://www.marketwatch.com/story/aaron-beam-he-fueled-the-scandal-at-healthsouth-2014-07-29 (analyzing the motivations and repercussions of

systematic breakdowns in ethical and compliance standards drove all aspects[10] of the Great Financial Crisis of 2008[11] and cost society trillions in lost output, highlighting the dismal state of business ethics in America today.[12] The lack of accountability following the crisis, which improbably permitted every CEO at every major Wall Street bank to escape criminal or financial liability, hardly suggests that ethical concerns are isolated; rather, the pervasive lack of ethical conduct presents a major threat to the American economy.[13]

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employing questionable ethics in business).

10. According to the Financial Crisis Inquiry Commission:

> We conclude there was a systemic breakdown in accountability and ethics. The integrity of our financial markets and the public's trust in those markets are essential to the economic well-being of our nation. The soundness and the sustained prosperity of the financial system and our economy rely on the notions of fair dealing, responsibility, and transparency. In our economy, we expect businesses and individuals to pursue profits, at the same time that they produce products and services of quality and conduct themselves well. Unfortunately—as has been the case in past speculative booms and busts—we witnessed an erosion of standards of responsibility and ethics that exacerbated the financial crisis.

FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxii (2011). Perhaps most disturbing, a manifest attitude of making quick money infected Wall Street in the lead-up to the crisis:

> On Wall Street, where many of these loans were packaged into securities and sold to investors around the globe, a new term was coined: IBGYBG, "I'll be gone, you'll be gone." It referred to deals that brought in big fees up front while risking much larger losses in the future. And, for a long time, IBGYBG worked at every level.

Id. at 8.

11. Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 LOY. U. CHI. L.J. 669, 707 n.251 (2014) [hereinafter Ramirez, *Virtues of Private Securities Litigation*] (explaining that "the term 'Great Financial Crisis of 2008' [denotes] the massive global financial market disruption that commenced with the failure of Lehman Brothers on September 15, 2008 and ending in the spring of 2009 when the U.S. stock market hit a low of below 7000 in the Dow Jones Industrial Average" in accordance with the recognition of two former Federal Reserve chiefs that this crisis inflicted "unprecedented virulence" on the American financial system).

12. U.S. GOV'T ACCOUNTABILITY OFF., GAO–13–180, FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT 17 (Jan. 2013) (detailing the utility of studies that estimate output losses to show the rough magnitude of the overall costs associated with the 2007–2009 financial crisis, which cumulatively could exceed $13 trillion). By any reckoning, the Great Financial Crisis of 2008–2009 was a multi-trillion-dollar catastrophe. *See* Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007–09 Financial Crisis*, 20 FED. RES. BANK OF DALL.: STAFF PAPERS 1–2, 19 (2013), https://dallasfed.org/assets/documents/research/staff/staff1301.pdf (estimating the total cost of the crisis in the United States alone at up to $14 trillion and suggesting that the trajectory of potential GDP may be permanently lower).

13. MARY KREINER RAMIREZ & STEVEN A. RAMIREZ, THE CASE FOR THE CORPORATE DEATH PENALTY 1–27 (2016) (reviewing evidence of fraud and the many laws designed to punish fraud and concluding that "a new and unprecedented lawlessness emerged at the apex of American capitalism").

Shareholders do not benefit from the ethical and compliance lapses at their firms.[14] On the contrary, shareholders foot the bill at the most egregiously miscreant firms, to the exclusion of the managers actually orchestrating unethical and non-compliant misconduct.[15] In case after case, managers walked off with windfall options compensation,[16] generous retirement payments,[17] and golden parachute payments (if, in rare circumstances, fired).[18] Yet shareholders, particularly at the firms at the center of the Great Financial Crisis, suffered share price losses and the burden of paying off regulators for the misconduct of managers.[19] This reality holds true even today, ten years after the financial crisis.[20]

In 2017, I argued for an ethics screening body within firms that mirrored the ethical sensitivities of the firm's key constituencies through

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14. *Id.* at 2–3 (noting the payment of $16.65 billion paid to settle fraud allegations against Bank of America, $13 billion paid to settle such allegations against JP Morgan, and $7 billion paid to settle claims against Citigroup).

15. *Id.* at 7 (stating that while the government fined the megabanks for the sale of billions of toxic mortgages without full disclosure to the investors, "the government simply accepted fines that essentially punished innocent shareholders instead of senior leaders at the megabanks").

16. *Id.* at 122–23 ("[O]verall the senior officers garnered $1 billion in total compensation between 2000 and 2008. The structure of options compensation meant that Lehman's senior managers faced constant incentives to push short-term stock prices as high as possible as their options vested over time."). The shareholders that Lehman's officers duped into thinking the firm enjoyed high liquidity and financial stability suffered a total loss of their investment when the firm filed for bankruptcy. *Id.* at 109–11, 132.

17. Thus, Stanley O'Neal, the former CEO of Merrill Lynch, stepped down and took a $161.5 million retirement package with him. O'Neal left behind a doomed company after the firm reported a $7.9 billion loss due to aggressive bets in mortgage-backed securities. Tomoeh Murakami Tse, *Merrill CEO Steps Down, Leaves Firm In Crisis,* WASH. POST (Oct. 31, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2007/10/30/AR2007103000565.html.

18. *See, e.g.*, Claire Suddath, *Biggest Golden Parachutes*, TIME (2016), http://content.time.com/time/specials/packages/article/0,28804,1848501_1848500_1848461,00.html (citing to a 2007 emergency board meeting, in which Citigroup Inc.'s Charles Prince announced his resignation by saying, "Given the size and nature of the recent losses in our mortgage-backed securities business, the only honorable course for me to take as chief executive officer is to step down." He walked away with $99 million in vested stock holdings and a pension, on top of the $53.1 million salary and bonuses he racked up during his four-year tenure.).

19. Citigroup's shareholders lost 88 percent of their investment over the past ten years. *Citigroup's Decade of Agony is Almost Over*, ECONOMIST (Mar. 18, 2017), https://www.economist.com/news/business/21718924-recipient-americas-biggest-bank-bail-out-has-overhauled-its-capital-base-and-its-profits.

20. JPMorgan alone has paid a total of $36 billion in settlements and fines since 2008. Some of the highlights: selling securities constructed from "toxic" mortgages, according to the U.S. Department of Justice ($13 billion); failing to report questionable activity by Ponzi schemer Bernard Madoff ($1.7 billion); and, most recently, colluding to rig foreign-exchange rates ($1.9 billion to a host of regulators).

Anthony Effinger, *The Rise of the Compliance Guru—and Banker Ire*, BLOOMBERG (June 25, 2015, 5:00 AM), https://www.bloomberg.com/news/features/2015-06-25/compliance-is-now-calling-the-shots-and-bankers-are-bristling.

the importation of the full range of cultural diversity[21] within these constituencies.[22] I advocated that this would effectively import an ethicality into the firm that would require more than mere legal compliance to maximize shareholder wealth.[23] Diversity also imports rigor into the firm in that the firm's conduct must pass muster with all culturally diverse perspectives on compliance or ethical issues if diverse voices hold sway.[24] I focused on the role of in-house counsel in fostering this function.[25] I further suggested that in-house counsel could implement such a screening function to provide additional insulation to counsel seeking to further the ethical and compliance efforts of the firm

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21. Orlando C. Richard et al., *The Impact of Racial Diversity on Intermediate and Long-term Performance: The Moderating Role of Environmental Context*, 28 STRATEGIC MGMT. J. 1213, 1229 (2007) ("Cultural diversity exists when people with distinct and different group affiliations of cultural significance are found within a larger group or organization."). This implies no compromise in terms of financial performance. *Id.* at 1229 ("The delightful discovery is that beyond moderate levels of diversity we find a positive effect of racial diversity on both our short-term and long-term measures of performance."). Of course, diversity must be well-managed and tokenism must be avoided or diverse perspectives will be squelched. *See, e.g.*, Kimberly M. Ellis & Phyllis Y. Keys, *Workforce Diversity and Shareholder Value: A Multi-Level Perspective*, 44 REV. QUANTITATIVE FIN. & ACCT. 191, 209–10 (2015) (finding enhanced firm value for diverse workforces in firms that garner Fortune "Diversity Elite" recognition). When properly implemented, enhanced cultural diversity can enhance creativity. *See, e.g.*, Adam D. Galinsky et al., *Maximizing the Gains and Minimizing the Pains of Diversity*, 10 PERSP. ON PSYCHOL. SCI. 742, 745 (2015) ("The practices of inclusive multiculturalism and perspective taking also help catalyze the innovation and decision-making benefits of diversity. For example, organizational climates that value diversity increase information processing and exchange and thus produce better decisions. Similarly, when team members consider one another's perspectives, diverse teams are more creative.").

22. Ramirez, *supra* note 1, at 466 ("This essay posits that cultural diversity can help in-house counsel achieve superior ethical, compliance, and reputation risk management outcomes for their firms, and therefore in-house counsel should seek to maximize cultural diversity within the corps of corporate counsel representing firms, and throughout the firm.").

23. [E]nhanced cultural diversity embedded in a screening function within the firm, that is armed with the tools for a heterogeneous assessment of the most dubious firm practices, provides the firm with an objective and rigorous basis for determining the ethicality and costs of a given practice or course of conduct.

Id. at 483.

24. Basing the acclimation of the firm to cultural diversity should also operate to provide the firm with a standard of ethicality more rigorous than the definition of ethicality that has too often prevailed in the past." Cultural diversity would subject a proposed course of conduct to additional ethics screens based upon "the ethics sensitivities of women and different ethnic groups.

Id. at 479.

25. *Id.* at 481 (using a robust and culturally diverse group to vet the "ethicality or compliance repercussions of a given business practice would . . . shield an in-house attorney from much more patent risks and career threats in being forced to blow the whistle alone, without the support of other culturally diverse voices"). Possible termination for whistleblowing may account in part for the silence of the lawyers with respect to the fraud and unethical behavior underlying corporate scandals such as the subprime debacle. *Id.* at 465.

notwithstanding possible managerial resistance.[26] Earlier, in 2010, I posited that optimal legal risk management should not be siloed in the CEO, and that an independent committee of the board with legal expertise and an anonymous reporting function would prove superior to the proven flaws of CEO autonomy regarding legal, compliance, and reputational (i.e., ethical) risk management.[27] This Article extends these proposals and concepts into the realm of investor protection under the federal securities laws.[28]

More specifically, this Article argues that investors deserve to know the contours of a firm's compliance and ethical governance when making investment decisions.[29] While courts traditionally deem management integrity not material under the federal securities laws, and therefore not subject to mandatory disclosure, telling the truth about ethical governance systems is not the same as telling the truth about managerial corruption or ethicality.[30] Thus, for example, Congress required disclosure of the

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26. *Id.* at 465–67 ("This essay suggests that in-house counsel interested in protecting shareholders from the costs of misconduct within their firms, however, can take proactive steps to protect shareholders from the kind of skullduggery that drove all aspects of the subprime crisis, as well as the Enron series of frauds."). The use of a culturally diverse screening function could operate to short-circuit dubious conduct prior to the need of counsel to consider reporting the misconduct under the Model Rules of Professional Conduct. MODEL RULES OF PROF'L CONDUCT r. 1.6, 1.13 (AM. BAR ASS'N 2016).

27. Steven A. Ramirez, *Legal Risk Post-SOX and the Subprime Fiasco: Back to the Drawing Board*, *in* ENTERPRISE RISK MANAGEMENT 351–67 (John Fraser & Betty J. Simkins eds., 2010) [hereinafter Ramirez, *Back to the Drawing Board*].

28. This Article will focus upon the mandatory disclosure regime under the Securities Act of 1933 and the Securities Exchange Act of 1934. Securities Act of 1933, Pub. L. No. 73–22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2012)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2012)).

29. The existence of an ethics code, or an explanation why a firm lacks one, is already disclosed as a material fact:

> Pursuant to [the Sarbanes-Oxley Act of 2002] section 406(a), the Securities and Exchange Commission (SEC) issued regulations requiring each public company to disclose whether it has a code of ethics, and if a company has not adopted such a code, to explain why it has chosen not to do so. SEC rules also require each company that has a code to disclose any waiver of the code, as applied to corporate officers that the SEC rules identify, in a timely manner under Item 5.05 of Form 8-K.

Madoka Mori, *A Proposal to Revise the SEC Instructions for Reporting Waivers of Corporate Codes of Ethics for Conflicts of Interest*, 24 YALE J. REG. 293, 293 (2007).

30. In 1976, the United States Supreme Court defined a "material" fact as one that would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Despite the definition, there were no pressures from investors for corporate disclosure of unadjudicated violations of law or antisocial conduct, or for ethical or moral behavior at the corporate level.

John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard,* 48 CATH. U. L. REV. 41, 42 (1998) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). *See* MICHAEL J. KAUFMAN & JOHN M. WUNDERLICH, RULE 10B-5 PRIVATE SECURITIES FRAUD LITIGATION 869–80 (2015) (citing to numerous cases holding that management

existence of codes of ethics in the Sarbanes-Oxley Act after the massive securities frauds of 2001 and 2003, including the collapse of Enron and WorldCom.[31] Disclosure of ethical and compliance governance systems, including the role of cultural diversity within those systems, would encourage firms to compete for capital on the basis of their governance of compliance and ethics risks.[32]

Businesses that use cultural diversity to screen their business conduct within the framework of a well-ordered scheme of shareholder wealth maximization will better acclimate themselves to all key constituencies, leading to superior financial performance.[33] Given the increased diversity of consumer, labor, and investor pools, this approach to encouraging extra-legal standards of conduct draws upon differences in ethical sensitivities to drive more rigorous ethical and compliance screening of business conduct.[34] Further, to the extent the business enterprise enhances its financial performance through a more diverse screening

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integrity and ethicality cannot form the basis for a private securities fraud action under Rule 10b-5 because such facts are not material).

31. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 406, 116 Stat. 745 (2002) (codified at 15 U.S.C. § 7264) (requiring the SEC to issue rules requiring publicly traded firms to "disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions").

32. Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 287–94 (2005) (suggesting that firms could "compete on the basis of ethical commitments" when investors can weigh differing approaches to ethics). The SEC took a similar approach when it used its power under the Sarbanes-Oxley Act to create the Qualified Legal Compliance Committee ("QLCC"). Ramirez, *Back to the Drawing Board*, *supra* note 27, at 351 (stating that while the QLCC innovation encouraged firms to centralize legal compliance in the hands of an independent board committee, few public firms took advantage of this innovation).

33. Maretno Harjoto et al., *Board Diversity and Corporate Social Responsibility*, 132 J. BUS. ETHICS 641, 642 (2015) ("Firms could suffer both monetary and reputational losses from failing to align management's interests with those of their stakeholders. Effective stakeholder management is a critical requirement for firm success."). *See also id.* (indicating that group dynamics and decisionmaking vary depending on the background of the individuals serving on corporate boards, and thus, a diverse group of directors brings different knowledge bases, sets of experiences, and perspectives on society to group decisionmaking; as a result, diversity increases the board's ability to recognize the needs and interests of different groups of stakeholders as reflected in CSR performance).

34. Social scientists theorize that women and ethnic minorities approach ethics and risk differently based upon cultural socialization. *See* Leslie Dawson, *Ethical Differences Between Men and Women in the Sales Profession*, 16 J. BUS. ETHICS 1143, 1143–44 (1997) ("This theory holds that general and nearly universal differences that characterize masculine and feminine personalities are formed in childhood and are incontrovertible; these in turn differentially shape the work-related interests, concerns, and values of the sexes."); Melissa L. Finucane et al., *Gender, Race, and Perceived Risk: The "White Male" Effect*, 2 HEALTH, RISK & SOC'Y 159, 169 (2000) (reporting that survey data did not support any biological explanation for diverse risk perceptions because differences between men and women in risk perception differed across races); *id.* at 170 (concluding that the differences were likely driven by socialization effects).

mechanism, it should lead to quantifiable gains over those firms that do not feature such an innovation. Ultimately, the optimal structure for corporate ethical screening should emerge to give shareholders enhanced value as the firm achieves greater acclimation among constituencies. Competitive pressure can thereby enhance firm ethicality and investors can thereby objectively measure firm ethicality. The U.S. Securities and Exchange Commission ("SEC") should facilitate this process of market discovery of optimal ethical and compliance structures within the firm through the issuance of disclosure guidance of ethical and compliance structures within public firms.[35] Such structures will prove material to investors.

Part I will review recent ethical and compliance lapses and will demonstrate the materiality of such lapses to shareholders who typically suffer significant investment losses in the wake of disclosure of ethical and compliance lapses. Part II will suggest keys to achieving superior ethical and compliance outcomes through the firm-wide embrace of cultural diversity, and the degree to which that diversity plays a role in ethical and compliance risk management. Part III will argue that internal governance mechanisms and structures relating to ethics and compliance are material, and that the SEC should facilitate market movement toward more optimal internal firm structures through appropriate disclosure guidance beyond current ethics-related disclosures. The Article will conclude that embedding cultural diversity within a well-structured system of governance will yield objectively measurable positive outcomes in financial performance. As such, firms will be able to demonstrate an ethics and compliance advantage, and ultimately compete to perfect that advantage.

I. THE MATERIALITY OF ETHICS AND COMPLIANCE

In the current political environment, ethics and compliance systems within public firms likely will take on increased significance. The Trump administration posits that deregulation will lead to greater economic growth.[36] Nevertheless, the administration's approach relies upon

35. As such, this proposed reform is a pro-market reform, simply requiring disclosure of facts that otherwise may not easily be known to market participants but that are nevertheless material. Simply put, it should enhance market efficiency while at the same time encouraging managers to attend to ethics and compliance more aggressively than in the past. *See* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 125 (2007) ("[T]here are again strong theoretical reasons, backed by an impressive body of empirical evidence, that mandatory disclosure can have the socially desirable effect of increasing competition between firms for capital and competition in the product market.").

36. *An Assessment of the White House's Progress on Deregulation*, ECONOMIST (Oct. 17, 2017) https://www.economist.com/news/business/21730170-donald-trump-has-blocked-new-

irrational and arbitrary factors not conducive to rational regulation, but instead focused on empowering the corporate class.[37] The administration directed the government to forsake any semblance of rational cost-benefit analysis in favor of a regulatory approach that completely ignores any regulatory benefits and focuses only upon costs to business to foreclose regulation.[38] Worse, any rule passing the first irrational requirement can only become effective upon the irrational requirement that two other regulations face repeal.[39] The government must now disregard massive economic benefits of rational regulation in vital areas such as environmental protection, transportation, and energy.[40] These requirements essentially slowed regulatory rulemaking to a crawl not seen since 2007, immediately preceding the Great Financial Crisis.[41]

Further, more deregulation appears likely. The U.S. House of Representatives already voted to partially repeal the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[42] and the Trump administration released its own plan to repeal parts of the Dodd-Frank Act in October 2017.[43] The Dodd-Frank Act encapsulates

regulations-ease-repealing-old-ones-will-be-harder ("Deregulation, along with tax cuts and trade reform, is one of the three pillars of President Donald Trump's economic agenda. Republicans promise that, freed of red tape, American firms will invest more and unleash faster economic growth.").

37. Mr. Trump has slowed rulemaking in two main ways. First, on coming to office, he ordered government agencies not to impose any net new regulatory costs on companies, regardless of the benefits of doing so, and said that in order to write any new rules they would have to repeal two old ones. Because it takes time to unearth and discard dud rules, the practical effect of this has been to put a brake on new issuance. *Id.*

38. Exec. Order No. 13771, 82 Fed. Reg. 9339 (Jan. 30, 2017) ("[T]he heads of all agencies are directed that the total incremental cost of all new regulations . . . to be finalized this year shall be no greater than zero, unless otherwise required by law or consistent with advice provided in writing by the Director of the Office of Management and Budget.").

39. *Id.* ("Unless prohibited by law, whenever an executive department or agency (agency) publicly proposes for notice and comment or otherwise promulgates a new regulation, it shall identify at least two existing regulations to be repealed.").

40. ECONOMIST, *supra* note 36, at fig. 2.

41. *How to Judge Whether Deregulation is Going Too Far*, ECONOMIST (Oct. 12, 2017), https://www.economist.com/news/leaders/21730148-donald-trumps-regulatory-policy-strange-mix-thoughtful-and-dangerous-how-judge-whether ("Even diehard libertarians should worry when the administration weakens rules governing the leaching of coal ash into groundwater, or permits the use of pesticides that may impair children's brain development.").

42. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5581).

43. U.S. DEPARTMENT OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS: REPORT TO PRESIDENT DONALD J. TRUMP 205–20 (Oct. 2017) https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf ("Treasury recommends that Section 1502 (conflict minerals), Section 1503 (mine safety), Section 1504 (resource extraction), and Section 953(b) (pay ratio) of Dodd-Frank be repealed and any rules issued pursuant to such provisions be withdrawn.").

the primary regulatory response of the U.S. government to the massive wealth destruction investors faced after the Great Financial Crisis of 2008.[44] It reaches a range of troublesome and complex regulatory topics, from derivatives[45] to executive compensation,[46] and from too-big-to-fail banks[47] to diversity in the financial sector.[48] While the Dodd-Frank Act certainly inspired criticism from across the political spectrum,[49] it has undisputedly prevented a recurrence of the Great Financial Crisis.[50]

Economic history suggests that sustainable economic growth requires a sound legal and regulatory infrastructure that lowers the cost of capital or raises the returns to capital, including the stabilization of the economy through appropriate regulation, particularly in the financial sector.[51] Even the staunch conservative scholar and jurist Richard Posner admitted in

44. Steven A. Ramirez, *Dodd-Frank as Maginot Line*, 15 CHAP. L. REV. 109, 110 (2011) (assessing the Dodd-Frank Act as the primary government response to the Great Financial Crisis and concluding that "while Dodd-Frank may prevent another subprime crisis, it will prove unable to prevent a future, more serious debt crisis").

45. Timothy E. Lynch, *Coming Up Short: The United States' Second-Best Strategies for Corralling Purely Speculative Derivatives,* 36 CARDOZO L. REV. 545, 549 (2014) (arguing that purely speculative derivative trades are still permitted under Dodd-Frank despite their negative externalities and the fact that they constitute negative sum transactions and serve no rational purpose).

46. *Securities Regulation – Dodd-Frank Wall Street Reform and Consumer Protection Act,* 129 HARV. L. REV. 1144, 1145–46 (2016) (assessing possible attack on SEC rule mandating disclosure of executive pay ratio which took effect on January 1, 2017, in the following regulation: 80 Fed. Reg. 50, 104 (Aug. 18, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249)).

47. H. Rodgin Cohen, *Preventing the Fire Next Time: Too Big to Fail*, 90 TEX. L. REV. 1717, 1722 (2012) ("TBTF [Too Big to Fail] is an unacceptable policy that must be ended by legislative reform. This policy creates moral hazard; it produces marketplace distortions; it is inequitable; and, of most importance, it represents a potential call option on the taxpayer.").

48. *See* Kristin Johnson et al., *Diversifying to Mitigate Risk: Can Dodd-Frank Section 342 Help Stabilize the Financial Sector?*, 73 WASH. & LEE L. REV. 1795, 1867 (2016) (concluding that Congress acted appropriately in seeking to diversify the financial sector).

49. *See* Ben Portiss, *Is Dodd-Frank Overdue or Overkill? 2 Dueling Views*, N.Y. TIMES (Aug. 3, 2011, 4:20 PM), https://dealbook.nytimes.com/2011/08/03/is-dodd-frank-overdue-or-overkill-2-dueling-views/ (quoting Nobel laureate Joseph Stiglitz for the proposition that Dodd-Frank "went nowhere far enough" and quoting former Comptroller of the Currency Edward Ludwig for the proposition that the Act is "a deleterious drag on capital formation and meaningful job opportunities for our people").

50. *See* Ben McLannahan, *Did Dodd-Frank Really Hurt the US Economy?*, FIN. TIMES (Feb. 13, 2017) https://www.ft.com/content/dd4a6698-efe7-11e6-930f-061b01e23655 (showing that bank lending expanded, and banks increased capital and profits, since the enactment of Dodd-Frank); John W. Schoen, *Despite Critics' Claims, Dodd-Frank Hasn't Slowed Lending to Business or Consumers*, CNBC (Feb. 6, 2017, 2:13 PM), https://www.cnbc.com/2017/02/06/despite-critics-claims-dodd-frank-hasnt-slowed-lending-to-business-or-consumers.html (showing that bank lending increased after the enactment of Dodd-Frank).

51. Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 546 (2003) (showing that the Great Depression necessitated new financial regulations such as the federal securities laws and inaugurated a search "to endow our economy with . . . an optimized regulatory infrastructure").

2009 that,

> the depression [following the Great Financial Crisis] has shown that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism.[52]

The pre-Dodd-Frank regulatory environment hardly offered adequate investor protection to shareholders and other securities investors.[53] Worldwide, equity markets got hammered when all of the losses underlying the subprime debacle came to light.[54] All of this suggests that further deregulation enhances the risks of another calamity like the Great Financial Crisis stemming from unethical and unlawful misconduct.

The staggering shareholder losses associated with egregious failures in ethics and compliance risk management also manifest themselves at the firm level. The shareholders of Wells Fargo certainly can attest to the devastating consequences of systematically sanctioned ethical and compliance breaches.[55] Indeed, the entire megabank sector worldwide, which suffers from a pervasive lack of accountability and the most promiscuous government subsidies,[56] spends billions in shareholder

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52. Robert M. Solow, *How to Understand the Disaster*, N.Y. REV. BOOKS (May 14, 2009) http://www.nybooks.com/articles/2009/05/14/how-to-understand-the-disaster/ (book review of RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 75 (2009)) (stating that Posner is an independent thinker but "his independent thoughts have usually led him to a position well to the right of the political economy spectrum" and "his thought exhibits an affinity to Chicago school economics: libertarian, monetarist, sensitive to even small matters of economic efficiency, dismissive of large matters of equity, and therefore protective of property rights even at the expense of larger and softer 'human' rights").

53. Ramirez, *Virtues of Private Securities Litigation*, *supra* note 11, at 735 (demonstrating that the Great Financial Crisis arose from massive securities fraud against investors in mortgage-backed securities and firms exposed to such securities). Due to sustained attacks on the rights of investors to privately enforce the federal securities laws, the law failed to adequately deter securities fraud. *Id.* at 736–37.

54. Söhnke M. Bartram & Gordon M. Bodnar, *No Place to Hide: The Global Crisis in Equity Markets in 2008/2009*, 28 J. INT'L MONEY & FIN. 1246, 1246 (2009) ("[L]ooking at return performance across an array of regions, countries, and sectors, broad [equity] market averages are down approximately 40% on their end of 2006 levels.").

55. *See supra* notes 2–5.

56. Arthur E. Wilmarth Jr., *There's No Such Thing as a 'Good' Megabank*, AM. BANKER (Nov. 22, 2016, 8:30 AM), https://www.americanbanker.com/opinion/theres-no-such-thing-as-a-good-megabank ("Giant financial conglomerates were at the epicenter of the global financial crisis. The U.S., United Kingdom and European Union provided more than $10 trillion of capital infusions, guarantees and emergency loans to stabilize their financial systems and rescue failing megabanks. . . ."). Professor Wilmarth suggests that the huge subsidies behind the megabanks fuel an inherent moral hazard that arises when risky conduct enjoys government funding: "megabanks . . . finance their speculative activities in the capital markets by exploiting explicit and implicit federal safety net subsidies. To expect managers and regulators to produce 'good' megabanks is to ignore the lessons of history and fundamental laws of human nature." *Id.*

wealth to pay regulatory fines in a way that simply reflects that systematic unethical and unlawful conduct remains a part of the megabank business model.[57] Even beyond the megabanks, however, public firms regularly destroy massive amounts of shareholder wealth from ethically dubious conduct.

Consider the recent data breach uncovered at Equifax that affected up to 143 million Americans.[58] Hackers gained access to consumer information, including names, addresses, dates of birth, and Social Security numbers.[59] After Equifax announced the breach, on September 7, 2017, its stock plunged 30 percent, wiping out $6 billion in shareholder wealth in just ten days.[60] Management first heard hints of trouble on March 8, 2017, and definitely knew they faced serious problems on August 22, 2017.[61] Yet, the company allowed the security problems to fester, and, as always, shareholders were the last to learn of management's recklessness.[62] The CEO of Equifax resigned after the breach with a reported total payout of over $90 million.[63]

Or, consider the so-called "Dieselgate" scandal that rocked shareholders of Volkswagen across the world in 2015.[64] In fact, investors are calling for the firm's break-up to unlock the value that is currently mired in scandal.[65] The company installed software on its diesel engines that could sense an emissions test and reduce emissions to pass the test even while spewing unlawful pollution otherwise.[66] The company expended over $26 billion to meet liabilities arising from the scam.[67]

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57. Gavin Finch, *World's Biggest Banks Fined $321 Billion Since Financial Crisis*, BLOOMBERG (Mar. 1, 2017, 11:01 PM), https://www.bloomberg.com/news/articles/2017-03-02/world-s-biggest-banks-fined-321-billion-since-financial-crisis ("Banks globally have paid $321 billion in fines since 2008 for an abundance of regulatory failings from money laundering to market manipulation and terrorist financing, according to data from Boston Consulting Group."). In 2015, the entire megabank sector worldwide consisting of over 300 large banks posted an economic profit of $167 billion. *Id.* During the entire period of 2009–2015 the sector posted negative economic profit. *Id.*

58. AnnaMaria Andriotis et al., *'We've Been Breached': Inside the Equifax Hack*, WALL STREET J. (Sept. 18, 2017, 8:04 AM), https://www.wsj.com/articles/weve-been-breached-inside-the-equifax-hack-1505693318?mg=prod/accounts-wsj.

59. *Id.*

60. *Id.*

61. *Id.*

62. *See id.*

63. Jen Wieczner, *Equifax CEO Richard Smith Who Oversaw Breach to Collect $90 Million*, FORTUNE (Sept. 26, 2017), http://fortune.com/2017/09/26/equifax-ceo-richard-smith-net-worth/.

64. Andrew Bary, *Volkswagen's Road to Recovery*, BARRON'S (Aug. 12, 2017, 1:08 AM), https://www.barrons.com/articles/volkswagens-road-to-recovery-1502513470 (noting that Volkswagen shares trade in the U.S. and Germany).

65. *Id.*

66. *Id.*

67. *Id.*

Shareholders suffered deep losses as a result of the scandal and shares still trade at a deep discount to their value prior to the disclosure of the scandal.[68]

The next great wave of corporate scandals may well dwarf the above scandals and even the subprime debacle. ExxonMobil and other carbon producers appear to have undertaken a concerted effort to hide the truth about climate change in the name of short-term profits from underpriced carbon.[69] The pharmaceutical industry may well face legal and regulatory sanctions from their role in hyper-peddling addictive opioids.[70] Eventually, shareholders face the costs of these undisclosed risks even if the short-term profits may initially fatten shareholder wallets.[71] By

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68. Gilbert Kreijger, *How VW Rose So High and Fell So Low*, HANDELSBLATT GLOBAL (June 23, 2017, 2:59 PM), https://global.handelsblatt.com/companies-markets/how-vw-rose-so-high-and-fell-so-low-volkswagen-history-dieselgate-emissions-fraud-porsche-hitler-784792 ("'Dieselgate' is now the biggest case of fraud in automotive history. It has cost VW €21.6 billion so far, triggered hundreds of lawsuits and wiped out a fifth of VW's preference stock value.").

69. For example, scholars studied ExxonMobile's scientific knowledge of the dangers of climate change cannot square with their public pronouncements:

> We conclude that ExxonMobil contributed to advancing climate science—by way of its scientists' academic publications—but promoted doubt about it in advertorials. Given this discrepancy, we conclude that ExxonMobil misled the public. Our content analysis also examines ExxonMobil's discussion of the risks of stranded fossil fuel assets. We find the topic discussed and sometimes quantified in 24 documents of various types, but absent from advertorials.

Geoffrey Supran & Naomi Oreskes, *Assessing ExxonMobil's Climate Change Communications (1977–2014)*, 12 ENVTL. RES. LETTERS 1 (2017).

70. According to *60 Minutes*:

> In the midst of the worst drug epidemic in American history, the U.S. Drug Enforcement Administration's ability to keep addictive opioids off U.S. streets was derailed—that according to Joe Rannazzisi, one of the most important whistleblowers ever interviewed by 60 Minutes. Rannazzisi ran the DEA's Office of Diversion Control, the division that regulates and investigates the pharmaceutical industry. Now in a joint investigation by 60 Minutes and The Washington Post, Rannazzisi tells the inside story of how, he says, the opioid crisis was allowed to spread—aided by Congress, lobbyists, and a drug distribution industry that shipped, almost unchecked, hundreds of millions of pills to rogue pharmacies and pain clinics providing the rocket fuel for a crisis that, over the last two decades, has claimed 200,000 lives.

Bill Whitaker, *Ex-DEA Agent: Opioid Crisis Fueled by Drug Industry and Congress,* CBS NEWS (Oct. 17, 2017, 10:12 AM), https://www.cbsnews.com/news/ex-dea-agent-opioid-crisis-fueled-by-drug-industry-and-congress/.

71. Disclosure of the systems in place to assure ethical and compliant conduct would address a fundamental information asymmetry with respect to misconduct: management will always know about such misconduct before shareholders. *See supra* notes 62 and 68. Economists Michael Spence, Joseph Stiglitz, and George Akerlof won the Nobel Prize in 2001 for showing that under conditions of asymmetric information markets cannot reach efficient outcomes. Press Release, Nobel Prize, The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2001 (Oct. 10, 2001), https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/press.html. Here the reality of asymmetric information means shareholders randomly partake in involuntary profits from often reprehensible behavior and randomly face losses they cannot avoid.

definition, shareholders suffer from inherently asymmetric information regarding managerial misconduct at their firms, as management alone knows of their own misconduct and trades accordingly.

Disclosure of ethics and compliance risk-management systems in and of itself is not likely to end corporate scandals.[72] Much costly, irrational, and socially pernicious corporate misconduct appears inherent to the corporate form, at least as currently structured.[73] Nevertheless, full disclosure will at least bring future costs, sanctions, and liabilities forward into the present value of firms, and thereby cause firms to reckon with their ethical and compliance transparency from a cost of capital point of view.[74] The next Section will explore the possibility that a fully diversified ethics and compliance function may actually curtail such wrongdoing.

II. DIVERSITY AND ETHICS

Scholars and other thought leaders have long strived to create objective and normative notions of ethicality.[75] At the same time, while some level of universality pertains to behavioral norms, scholars also generally recognize that ethicality carries with it some level of culture-bound notion

72. Unlawful securities fraud seemed under control from a macroeconomic perspective under the legal and regulatory infrastructure that existed prior to the enactment of the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act in the 1990s, as well as prior to judicial hostility to private securities litigation. Ramirez, *Virtues of Private Securities Litigation*, *supra* note 11, at 677–710 (exploring the effects of modern capitalism, in view of market efficiency theory, in which a superior informational foundation to drive investment gives rise to a fertile ground for panics leading to major financial panic and collapse).

73. For example, the effective abolition of liability for damages for breaches of the duty of care for directors does not encourage boards that care much about shareholders. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (enabling a corporation to amend its articles of incorporation to include "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as director . . ."); *see also* Steven A. Ramirez, *The Chaos of* Smith, 45 WASHBURN L.J. 343, 362 (2006) ("It is difficult to justify the obliteration of the duty of care or a CEO-primacy model of corporate governance on economic grounds; no empirical evidence suggests that permitting directors to be infinitely negligent is economically sound.").

74. Appropriate disclosure would force firms to compete for capital through superior ethics and compliance systems.

75. PETER SINGER, ETHICS 3 (1994) (surveying answers offered by great thinkers regarding the search for objective norms and concluding that the "ancient quest" if fulfilled would be more valuable than any "sacred relic"). Insofar as business ethics is concerned, this Article is premised on the notion that firms should strive to optimize their acclimation to all important constituents, and that cultural diversity with the firm affords the firm the ability to maximize shareholder through such acclimation. *See* Ramirez, *supra* note 1, at 479–80 (articulating an approach based upon the firm's manifest need to acclimate itself as positively as possible to the varying perspectives of its key constituencies as a means for enabling in-house counsel to guide their firms to superior ethical and compliance outcomes).

of appropriate conduct.[76] In a globalizing economy, business leaders must navigate different cultural visions of morality itself.[77] This Section will argue that, in a paradigm of true shareholder primacy, managers should seek to implement and abide by a *process* that includes and empowers the same cultural diversity present in the business' key constituencies (labor, investors, consumers, and regulators) to acclimate the firm as optimally as possible to those constituencies for the purpose of maximizing shareholder wealth.[78]

In the U.S., for example, scholars have shown that different acculturation experiences (based, for example, upon gender or ethnic differences) lead to different ethical sensitivities.[79] In one study, the authors found statistically significant differences between men and women as well as between the four major ethnic groups present in the U.S. regarding responses to a number of ethics-related survey questions.[80] No group held a monopoly on virtue; instead, different groups scored higher on the ethics survey depending on the nature of the

76. Mohamed S. Msoroka & Diana Amundsen, *One Size Fits not Quite All: Universal Research Ethics with Diversity*, RES. ETHICS (forthcoming 2018) (manuscript at 2) (stating that extreme cultural relativism would hold that culture is the sole source of a moral right or rule and that extreme universalism would hold that culture is irrelevant to morality, but opting for a mediating approach between those two radical approaches). Msoroka and Amundsen advocate a fusion of universality combined with cultural diversity in the specific context of research involving human subjects: "Universality with diversity requires making room within a universal one-size-fits-all ethics approach for a deeper consideration of how cultural values and beliefs bear influence on the process of ethical deliberation." *Id.* at 14.

77. Domènec Melé & Carlos Sánchez-Runde, *Cultural Diversity and Universal Ethics in a Global World*, 116 J. BUS. ETHICS 681, 682 (2013) ("[T]he statement 'Polygamy is morally wrong,' . . . may be true relative to one society, but false relative to another. Similar examples could include cutting off a hand when someone is caught stealing, the mutilation of female genitals, or in a business context, tolerating bribery and harming the environment.").

78. *Id.* ("Moral diversity among cultures is not a novelty. Among the ancient Greek philosophers, moral diversity was widely acknowledged, as it was with Medieval thinkers, like Thomas Aquinas. Modern cultural anthropologists have also empirically shown that moral diversity is a matter of fact.") (citations omitted).

79. *See, e.g.*, Costas Hadjicharalambous & Lynn Walsh, *Ethnicity/Race and Gender Effects on Ethical Sensitivity in Four Sub-Cultures*, 15 J. LEGAL ETHICAL & REG. ISSUES 119, 128 (2012) (offering an empirical analysis of ethical variations across different racial/ethnic and gender groups).

80. *Id.* at 128 ("While gender differences were found in 26 of the 30 scenarios, ethnicity/race differences, significant at $p < 0.05$, are observed in only 10 of the 30 scenarios."). The authors of the study noted that the most pronounced differences between African Americans and Caucasians were in the area of caring for others, consistent with prior research. *Id.* (citing Linda A. Jackson et al., *Gender, Race and Morality in the Virtual World and its Relationship to Morality in the Real World*, 60 SEX ROLES 859 (2009)). The authors also noted that the finding of statistically significant differences between Asian Americans and Caucasians was also consistent with prior research. *Id.* (citing Louis P. White & Melanie J. Rhodeback, *Ethical Dilemmas in Organization Development: A Cross-Cultural Analysis,* 11 J. BUS. ETHICS 663 (1992)).

ethics inquiry or scenario.[81]

Moreover, in considering the differences in ethical sensitivities, the differences in risk perceptions across gender and ethnicity play an equally important role for business ethics and compliance risk management.[82] Both women and ethnic minorities perceive risk differently from white males.[83] In fact, social scientists have long studied the "white male effect" of risk insensitivity.[84] This socially constructed effect appears to turn on cultural privilege.[85] In the U.S. that translates into higher risk aversion in women, ethnic minorities, and more vulnerable white males.[86] Thus, including women in leadership positions appears to give firms an edge in terms of managing financial risks.[87] Firms with both

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81. *See* Hadjicharalambous & Walsh, *supra* note 79, at 127, tbl.6 (illustrating that while no single demographic dominated the ethics survey, disparate ethical sensitivities arose between different gender and/or ethnic groups). This too is consistent with prior research. *See* John Tsalikis & Osita Nwachukuru, *Cross-Cultural Business Ethics: Ethical Beliefs Differences Between Blacks and Whites*, 7 J. BUS. ETHICS 745, 746, 751, 753 (1988) (investigating the differences in ethical beliefs between blacks and whites in the United States in a study involving 234 white students and 255 black students who exhibited similar ethical beliefs despite reaching different "probability of making the same decision" in two ethical scenarios).

82. *See* Dan M. Kahan et al., *Culture and Identity-Protective Cognition: Explaining the White-Male Effect in Risk Perception*, 4 J. EMPIRICAL LEGAL STUD. 465, 465–66 (2007) ("Numerous studies show that risk perceptions are skewed across gender and race: women worry more than men, and minorities more than whites, about myriad dangers—from environmental pollution to hand guns, from blood transfusions to red meat."); Irwin P. Levin et al., *The Interaction of Experiential and Situational Factors and Gender in a Simulated Risky Decision-Making Task*, 122 J. PSYCHOL. 173, 180 (1988) (finding that women students were more risk averse than male students in an experimental setting).

83. James Farrell, *Demographic and Socioeconomic Factors of Investors*, *in* INVESTOR BEHAVIOR: THE PSYCHOLOGY OF FINANCIAL PLANNING AND INVESTING 117 (H. Kent Baker & Victor Ricciardi eds., 2014) (compiling and reviewing empirical studies focusing on the differences in investment behavior across race and gender groups).

84. *E.g.*, James Flynn et al., *Gender, Race, and Perception of Environmental Health Risks*, 14 RISK ANALYSIS 1101, 1107 (1994) ("There are two new and important results in these data. First, nonwhite males and females are much more similar in their perceptions of risk than are white males and females. Second, white males stand out from everyone else in their perceptions and attitudes regarding risk.").

85. Anna Olofsson & Saman Rashid, *The White (Male) Effect and Risk Perception: Can Equality Make a Difference?*, 31 RISK ANALYSIS 1016, 1029 (2011) (finding that in Sweden (which scores high on gender equality) "there is no pure 'white *male* effect' . . . it is just a 'white effect,' since the white majority shows low risk perception regardless of gender") (emphasis in original); Shahar Sansani, *Ethnicity and Risk: A Field Test of the White-Male Effect*, 25 ECON. LETTERS 74, 74 (2018) (finding that dominant social group in Israel took more risk than outgroups consistent with the "White-Male Effect," the notion that white males in the U.S. perceive lower risks than females and non-whites).

86. Terre A. Satterfield et al., *Discrimination, Vulnerability, and Justice in the Face of Risk,* 24 RISK ANALYSIS 114, 127 (2004) ("[S]trong (affirmative) feelings of discrimination and vulnerability and evaluative judgments of justice, as well as strong support for environmental injustice claims, are closely linked to high perceptions of environmental health risks.").

87. *See* Thorsten Beck et al., *Gender and Banking: Are Women Better Loan Officers?*, 17 REV. FIN. 1279, 1317 (2013) (finding female loan officers have fewer problematic loans); Maureen I.

women and minorities on board also score higher ratings in corporate transparency.[88] Higher risk aversion and transparency naturally translate into greater compliance and ethicality.

The predatory lending that underlaid the Great Financial Crisis created a natural experiment to test these principles. For example, Professors Muller-Kahle and Lewellyn found that financial firms with more female representation at the board level engaged in less subprime lending.[89] Utilizing a database of subprime lenders from the U.S. Department of Housing and Urban Development, they matched subprime lenders with non-subprime lenders by size and industry and found that board configuration in the two sets of firms differed in statistically significant ways.[90] Specifically, the non-subprime lenders had boards with more gender diversity, longer board tenure, and were less busy with other board seats at other firms.[91] Furthermore, "[t]he greater the percentage of women on the board, the less likely a firm was to specialize in subprime lending."[92] In short, the exploitative mortgage lending underlying the subprime debacle may have been preventable had there been greater diversity on financial institution boards.[93]

Another study found that gender-diverse boards navigated the risks of the financial crisis better. In a study of U.S. bank holding company

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Muller-Kahle & Krista B. Lewellyn, *Did Board Configuration Matter? The Case of US Subprime Lenders*, 19 CORP. GOVERNANCE: AN INT'L REV. 405, 405 (2011) (finding that firms with diverse leadership did not engage in as much subprime lending as firms with homogeneous leadership); Ajay Palvia et al., *Are Female CEOs and Chairwomen More Conservative and Risk Averse? Evidence from the Banking Industry During the Financial Crisis*, 131 J. BUS. ETHICS 577, 592 (2015) (finding that banks with female CEOs posed lower risk of bank failure).

88. *See, e.g.*, Arun Upadhyay & Hongchao Zeng, *Gender and Ethnic Diversity on Boards and Corporate Information Environment*, 67 J. BUS. RES. 2456, 2460 (2014) (finding that board diversity is negatively associated with corporate opacity).

89. Muller-Kahle & Lewellyn, *supra* note 87, at 405.

90. The design of the study effectively addresses the problem of the direction of causation, as subprime lending a year in the future cannot explain board configuration in the prior year. The authors explain:

> [R]everse causality is less plausible, given our research design. In our empirical tests, all of our independent variables are collected in the year preceding the firm identified on the subprime list. Thus, measures for our explanatory [variables] in the earlier period could not have resulted from being identified as a subprime specialist in the subsequent period.

Id. at 409.

91. *Id.* at 412–13 (using the group decisionmaking perspective in the context of subprime lending to examine board of directors configuration and its influence on decisionmaking processes around the issue of risky subprime lending); *see also id.* at 409 (defining busyness as the number of outside board seats held by each outside director divided by the number of outside directors).

92. *Id.* at 413.

93. *Id.* at 405. While the study focused on U.S. lenders, another study involving European banks found that boards with more women incurred lower risks too. *See generally* Ruth Mateos de Cabo et al., *Gender Diversity on European Banks' Boards of Directors*, 109 J. BUS. ETHICS 145 (2012).

performance during the financial crisis, a group of scholars at the U.S. Office of the Comptroller of the Currency (the primary federal regulator of national banks) found that when bank holding companies reached a "critical mass" of three female directors,[94] they enjoyed superior financial performance during the crisis.[95] Notably, during less stressful times the performance advantage dissipated.[96] This suggests that gender-diverse firms manage risk better than homogeneous firms.[97] Other studies reach similar conclusions.[98]

Importing heterogeneous perspectives into the firm allows businesses access to richer and more elaborate information which can be operationalized as a break on "groupthink."[99] That can thwart behavior, such as unethical or non-compliant behavior, that tacitly enjoys cultural approval based upon affinity bias.[100] With respect to ethnic diversity, this dynamic manifestly disrupted the "groupthink" behind bubbles in

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94. Laura St. Claire et al., *Braving the Financial Crisis: An Empirical Analysis of the Effect of Female Board Directors on Bank Holding Company Performance* 1 (Office of the Comptroller of the Currency, Economics Working Paper No. 2016-1, June 2016), https://www.occ.gov/publications/publications-by-type/occ-working-papers/2016-2013/wp2016-1.pdf. By focusing on performance of those firms that include a critical mass of diversity, the authors effectively controlled for firms that pursue tokenism rather than empower diverse perspectives. *Id.* at 22 ("The magic number 3 is the tipping point at which women are taken seriously as board members, while a fewer number of female directors is not sufficient to overcome tokenism."). To address the possibility of reverse causation, the authors lagged performance measurement one year after the critical mass level was reached. *Id.* at 16 ("This partially addresses reverse causality because future [performance] cannot retroactively affect the past number of women.").

95. *Id.* at 1 ("We conclude that during the financial crisis, controlling for financial and board governance characteristics, BHCs with at least three female directors braved the crisis better, significantly outperforming BHCs with fewer female directors, as measured by Tobin's Q.").

96. *Id.* at 6.

97. *Id.* at 24.

98. *See* Hisham Farag & Chris Mallin, *Board Diversity and Financial Fragility: Evidence from European Banks*, 49 INT'L REV. FIN. ANALYSIS 98 (2017) (finding that European banks with a critical mass of female directors displayed less financial vulnerability during the financial crisis).

99. Diversity has been shown to enhance cognitive functioning of groups and to disrupt groupthink, a dynamic characterized by mindless adherence to group norms and assumptions. *See* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 494–97 (1999) (stating that heterogeneous boards benefit from cognitive conflict that results in a more thorough consideration of problems and solutions); Marlene A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1306 (2003) (stating that "social homogeneity on corporate boards harms critical deliberation" and that "the best way to avoid groupthink is to prevent enclaves of like-minded people from making group decisions"; therefore, "reform proposals should discourage groupthink by promoting more diversity on boards in terms of gender, race, class, ethnicity, age, national origin, sexual orientation, and socioeconomic background, as well as expertise and temperament").

100. *See* Sheen S. Levine et al., *Ethnic Diversity Deflates Price Bubbles*, 111 PROC. NAT'L ACAD. SCI. 18524, 18524 (2014) ("Our results suggest that bubbles are affected by a property of the collectivity of market traders—ethnic homogeneity.").

experimental markets.[101] According to the authors:

> We find that price bubbles are fueled by the ethnic homogeneity of traders. Homogeneity, we suggest, imbues people with false confidence in the judgment of coethnics, discouraging them from scrutinizing behavior. In contrast, traders in diverse markets reliably price assets closer to true values. They are less likely to accept inflated offers and more likely to accept offers that are closer to true value, thereby thwarting bubbles. This pattern is similar in Southeast Asia and North America, even if the two sites differ greatly in culture and ethnic composition, in what is implied by "ethnic diversity" and how it is operationalized.[102]

This is the central element in the diversity advantage: it disrupts the "groupthink" dynamic that drives all systemic unethical and non-compliant behavior.[103] This disruption of "groupthink" supplements the efforts of the firm to acclimate to diverse key constituencies.[104]

In the end, business is not so concerned about always reaching the objectively right answer in terms of some universally accepted truth.[105] Instead, business seeks merely to maximize shareholder wealth through

101. *Id.* at 18527 ("[T]raders in diverse markets reliably price assets closer to true values. They are less likely to accept inflated offers and more likely to accept offers closer to true value, thereby thwarting bubbles.").

102. *Id.* The results are based upon 2,022 transactions by 180 traders in thirty different markets—fourteen diverse and sixteen homogeneous. *Id.* The market with the lowest accuracy was the homogeneous market in North America—i.e., the market with all white traders. *Id.*

103. *E.g.*, *supra* notes 3, 13 and 20.

104. *E.g.*, *supra* notes 79–88.

105. From a business perspective, the deep uncertainty regarding objectively verifiable ethical norms must give way to the putative mission of the business corporation to maximize shareholder wealth. Corporate law only rarely, at best, enforces the norm that the business corporation be operated for the purpose of shareholder wealth maximization. *See* LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 10 (2012) (demonstrating that the law fails to back up shareholder primacy). Instead, as discussed above, the law has taken decisively anti-shareholder and pro-management turns. *See supra* notes 30 and 53. Restoration of shareholder primacy, in terms of public corporations where legal protections are needed to assure shareholder prerogatives are preserved notwithstanding diffused ownership, would fully vindicate the federal purpose for regulation of public firms. *See* 15 U.S.C. § 78(b) (2014). More specifically, Congress enacted the federal securities laws because trading in shares could create "[n]ational emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare." *Id.* Such emergencies are "precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit." *Id.* This amounts to a federal mandate to protect investors, not speculators who are ancillary to the primary purpose of the federal securities laws. In short, shareholder primacy may be assumed for private firms and assumed as part of the investor protection mandate under the federal securities laws for public firms. State corporate law, particularly in Delaware, and the war against private securities litigation is the genesis of CEO primacy and all the problems that entails.

optimal acclimation to all important constituents.[106] Observing ethical standards beyond law that achieves such acclimation depends upon principles of sound risk management.[107] Risk management entails mechanisms and systems within the firm to assure that all risks are identified and assessed across the enterprise, rather than allowing risks to fester in any risk silo.[108] Once a firm achieves that goal, the firm can rationalize its risks in accordance with its risk policy and its disclosures to shareholders.[109] This approach to risk management paid off during the subprime debacle.[110]

These same principles support the concept that there should be no ethics or compliance silo. Thus, a culturally diverse ethical and compliance screening function or team can either conceptualize ethics and compliance outcomes better than a homogeneous team or assess the varying risks associated with such conceptualization in a superior way to achieve an advantage over a homogeneous screening mechanism. Culturally diverse teams both conceptualize ethics better and manage risk better. The combined effect of these two elements yields positive outcomes with respect to ethical and compliance outcomes.[111]

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106. *See* Amy J. Hillman & Gerald D. Keim, *Shareholder Value, Stakeholder Management, and Social Issues: What's the Bottom Line?*, 22 STRATEGIC MGMT. J. 125, 125 (2001) (suggesting that "[b]uilding better relations with primary stakeholders like employees, customers, suppliers, and communities could lead to increased shareholder wealth by helping firms develop intangible, valuable assets which can be sources of competitive advantage" and testing this proposition with data from the performance of S&P 500 firms and concluding that "stakeholder management leads to improved shareholder value, while [mere] social issue participation is negatively associated with shareholder value").

107. *See* Betty Simkins & Steven A. Ramirez, *American Corporate Governance and Enterprise Risk Management*, 39 LOY. U. CHI. L.J. 571, 572 (2008) (concluding that "enterprise-wide risk management [ERM] can enhance the functioning of the corporation as well as the ability of capital markets to respond to risk, but that the current legal framework fails to facilitate this process" and suggesting that "disclosure requirements with respect to risk management would encourage superior transparency and management within the public corporation").

108. *Id.* at 581 ("Currently, many organizations still continue to address risk in 'silos,' with the management of . . . risks each conducted as narrowly focused and fragmented activities," but enterprise-wide risk management views "all risk areas . . . as parts of an integrated, strategic, and enterprise-wide system. While risk management is coordinated with senior-level oversight, employees at all levels of the organization using ERM are encouraged to view risk management as an integral and ongoing part of their jobs.").

109. *Id.* at 581–82 (quoting COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, ENTERPRISE RISK MANAGEMENT–INTEGRATED FRAMEWORK 2 (2004), http://www.coso.org/Publications/ERM/COSOERMExecutiveSummary.pdf).

110. Vincent Aebi et al., *Risk Management, Corporate Governance, and Bank Performance in the Financial Crisis*, 36 J. BANKING & FIN. 3213 (2012) (finding that banks with a more independent risk management function outperformed other banks during the financial crisis).

111. For example, scholars found that firms with female leadership suffered fewer allegations of fraud and more conservative accounting. *See generally* Lawrence J. Abbott et al., *Female Board Presence and the Likelihood of Financial Restatement*, 26 ACCT. HORIZONS 607, 626 (2012) ("Using a matched-pair sample of restatement and control firms, we conducted conditional logistic

III. DISCLOSING THE GOVERNANCE OF ETHICALITY AND COMPLIANCE

In the past, I urged public firms that took ethics and compliance seriously to form independent committees of the board with legal expertise to manage compliance and legal and reputational risk.[112] More specifically, I proposed an independent committee of the board composed entirely of lawyers that would function to receive reports of wrongdoing within the firm (including anonymous reports) and to conduct an annual legal compliance audit.[113] Much of my proposal found its roots in the SEC's innovation of the Qualified Legal Compliance Committee ("QLCC"). The SEC created the concept of the QLCC based upon the directions of Congress to promulgate regulations implementing new rules governing the professional responsibility of counsel appearing before the Commission in the Sarbanes-Oxley Act of 2002 ("SOX").[114] SOX itself embodied Congress' response to the failure of Enron, WorldCom, and a series of similar corporate governance and accounting failures in 2001–2002, and the legislative determination that ethics mattered.[115]

The whole point of the SEC in creating the QLCC (and Congress in passing the Sarbanes-Oxley Act) was that ethics and compliance mattered to the investing public.[116] In addition, Congress mandated that publicly traded firms adopt an ethics code or explain to their investors why they declined to impose ethical mandates upon their firm's business conduct.[117] This constituted a clear indication that both Congress and the SEC found ethics and compliance material subject to mandatory

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regressions comparing the characteristics of restatement and control firms. Briefly, we find a significant reduction in the likelihood of financial restatement and the presence of at least one female board director."); Douglas Cumming et al., *Gender Diversity and Securities Fraud*, 58 ACAD. MGMT. J. 1572, 1573 (2015) ("Our evidence shows that gender diversity reduces the likelihood of being in our fraud sample and reduces the severity of the fraud."); Simon S.M. Ho et al., *CEO Gender, Ethical Leadership, and Accounting Conservatism*, 127 J. BUS. ETHICS 351, 366 (2015) ("[R]egardless of the measure of . . . conservatism, we find consistent evidence that companies led by female CEOs report earnings more conservatively."); Mary Jane Lenard et al., *Female Business Leaders and the Incidence of Fraud Litigation*, 43 MANAGERIAL FIN. 59 (2017).

112. Ramirez, *Back to the Drawing Board*, *supra* note 27, at 351–67.

113. *Id.* at 362–63.

114. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (codified as amended at scattered provisions of 15 U.S.C. (2012)). The Sarbanes-Oxley Act of 2002 is often referred to as "SOX."

115. *The Good, the Bad and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2126–27 (2003) ("Arguably the most far-reaching corporate reform legislation since the [federal securities laws of 1933 and 1934], [SOX] was designed to increase the transparency, integrity, and accountability of public companies and, in turn, to combat the kind of corporate deceit that had given rise to the scandals and financial breakdowns.").

116. *See supra* notes 29, 31 and 32.

117. *See supra* notes 29 and 31.

disclosure under the federal securities laws after the Enron series of corporate scandals.

The SEC exemplified the kind of disclosure guidance needed with the guidance it furnished with respect to the costs of climate change.[118] It essentially requires every publicly traded firm to disclose material facts regarding the impact of climate change (including potential governmental action) upon its business.[119] The SEC noted that some industries, such as the insurance industry, already seek to adjust to climate change and the financial exposures it may entail.[120] By encouraging firms to disclose such matters, the SEC uses financial markets to force publicly traded firms to reckon with, and rationalize their approach to, all future costs and benefits[121] that firms may face from this source of risk.[122] Simply stated, market competition for a lower cost of capital (an item which affects CEO compensation through options compensation)[123] will cause

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118. Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Feb. 8, 2010) (to be codified at 17 C.F.R. pts. 211, 231, and 241) ("This release outlines our views with respect to our existing disclosure requirements as they apply to climate change matters. This guidance is intended to assist companies in satisfying their disclosure obligations under the federal securities laws and regulations.").

119. *Id.*

120. As the SEC stated:

> The insurance industry is already adjusting to these developments. A 2008 study listed climate change as the number one risk facing the insurance industry. Reflecting this assessment, the National Association of Insurance Commissioners recently promulgated a uniform standard for mandatory disclosure by insurance companies to state regulators of financial risks due to climate change and actions taken to mitigate them. We understand that insurance companies are developing new actuarial models and designing new products to reshape coverage for green buildings, renewable energy, carbon risk management and directors' and officers' liability, among other actions.

Id. at 6291.

121. Overall, climate change entails risk, but like all risks some may intelligently manage it for profit:

> New trading markets for emission credits related to ''cap and trade'' programs that might be established under pending legislation, if adopted, could present new opportunities for investment. These markets also could allow companies that have more allowances than they need, or that can earn offset credits through their businesses, to raise revenue through selling these instruments into those markets. Some companies might suffer financially if these or similar bills are enacted by the Congress while others could benefit by taking advantage of new business opportunities.

Id.

122. *See generally* Steven A. Ramirez, *The Law and the Economics of a Carbon Tax* (forthcoming 2018) (showing that climate change will prove to be the most dramatic economic disruption in human history).

123. In considering sound corporate governance proposals, scholars must consider the impact of any proposal upon CEOs first and foremost since corporate governance grants CEOs a very high level of autonomy to further their own interests at the expense of shareholders. *See* Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top,* 24 YALE J. REG. 314 (2007).

firms to reduce climate-change costs and maximize climate-change opportunities.[124]

Another instance of the SEC clarifying disclosure obligations under the federal securities laws came in the immediate aftermath of the Great Financial Crisis.[125] The SEC acted because shareholders demanded more information about the leadership of public firms, and the SEC's action seemed tailored to emerging management lapses from the subprime debacle.[126] Significantly, the SEC imposed disclosure obligations relating to the governance of risk management for every public firm and the degree to which the risk management function operated independently of the CEO and other managerial officers.[127] Similarly, the SEC imposed disclosure obligations upon publicly traded firms to inform shareholders of the role diversity plays in the selection of directors, whether the firm applies any policy to the issue of diversity in the boardroom, and to describe any such policy.[128] The SEC thus already

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124. *See supra* notes 118–122.

125. Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334 (Dec. 23, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, and 274) (requiring registrants to disclose, *inter alia*: "compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; [and] the board's role in risk oversight").

126. *Id.* ("[I]nvestors have increasingly focused on corporate accountability and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions."). By late 2009, manifest managerial lapses played a leading role in understanding all phases of the subprime debacle and scholars set out to prove that corporate governance law and regulation failed to adequately reign in CEO autonomy in particular. *See* Steven A. Ramirez, *Lessons from the Subprime Debacle: Stress Testing CEO Autonomy*, 54 ST. LOUIS U. L.J. 1, 53–54 (2009) ("CEOs are the new potentates, with power to crash global capitalism and rake in millions for the favor. The rule of law must reassert itself. CEO power to . . . manipulate risk, to stack the board with their own clones, and to skirt legal compliance must be diminished.").

127. The SEC suggested:

> [D]isclosure about the board's involvement in the oversight of the risk management process should provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company. This disclosure requirement gives companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee, for example. Where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals.

Proxy Disclosure Enhancements, 74 Fed. Reg. at 68,345. The foregoing discussion operates effectively as disclosure guidance, as the final rule only states: "disclose the extent of the board's role in the risk oversight of the registrant, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure." *Id.* at 38,635 (quoting 17 C.F.R. § 229.407(h) (2010)).

128. The Commission did not even attempt to define diversity, opting instead to allow firms and financial markets to sort it out:

holds experience and expertise with respect to mandating the disclosure of corporate governance structures and the role diversity plays in those structures.

This all applies to the governing structures of ethicality, reputational risk management, and compliance risk management within publicly traded firms. The degree to which the firm deploys cultural diversity to vet such issues should be disclosed to investors given the evidence in Part II of this Article regarding the important role diversity can play in compliance and ethical outcomes.[129] The independence from management that the firm uses to address such issues, the expertise the firm brings to a given issue, and the degree to which the firm enlists outside consultants or attorneys to advise it with respect to such issues may all play a material role in a reasonable investor's investment decision, particularly in light of the manifest costs of mismanaging such risks as recounted in Part I of this Article.[130] Similarly, whether the firm allows compliance issues to fester in risk silos or takes affirmative action to assure such risks come out of the shadows of the firm (by, for example, implementing anonymous hotlines or incentives for whistleblowing) can also play a role in investment decisions.[131] Finally, forcing firms to either

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> We recognize that companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments.

Id. at 68,344. The new rule provides only that firms describe the role of diversity: "Describe the nominating committee's process for identifying and evaluating nominees for director . . . and whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director." *Id.* at 68,364 (quoting 17 C.F.R.§ 229.407(c)(ii)(7) (2010)). The rule also requires disclosure of any policy governing this process. *Id.*

129. *Supra* Part II.

130. Professor Langevoort summarizes the learning on the basic contours of a sound compliance function, which can be extended to include an ethics function:

> The common structural framework includes (1) a commitment from senior leadership to the task, setting a right "tone at the top;" (2) delegation of authority to officials with distinct compliance responsibilities and the resources to do their task; (3) firm-wide education and training about both the substance and process of compliance; (4) informational mechanisms to alert as to suspicious activity (e.g., whistleblowing procedures); (5) audit and surveillance tactics to detect compliance failures or risks; and (6) internal investigation, response, discipline and remediation so as to learn and adjust when failures occur. By most accounts, the right mix of these is firm-specific, a customization that recognizes the great range of motives, opportunities and types of violations most likely to be a problem at a given firm.

Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 939–40 (2017).

131. *Id.*

adopt QLCCs or explain the lack of such a compliance function also can furnish material information to the investing public.[132] Those firms adept at managing ethicality, reputational, and compliance risk can and should enjoy a lower cost of capital because shareholders would be equipped to avert at least some of the most catastrophic losses.[133] Taking these steps could truly align the interests of management enjoying options compensation arrangements with equity investors, as Congress intended the federal securities laws to operate.

The scope of this Article does not include the precise contours of the disclosure guidance the SEC should issue. Instead, this Article focuses on establishing the materiality of ethicality and compliance governance structure and the critical and more rigorous role cultural diversity may play in a well-ordered system of ethics and compliance risk management.[134] Moreover, different firms in different sectors may find that different governing structures make sense given their operating environment and other institutional structures, such as compensation practices.[135] Indeed, encouraging experimentation with the most efficacious governing structures could well emerge as a major benefit of deeming ethics, compliance, and reputation risk management structures material.[136] Investors simply enjoy an entitlement to disclosure of manifestly material facts, such as how the firms govern and control (or do not control) the manifest risks of unethical and non-compliant behavior.

The SEC should keep in mind, moreover, that a failure to issue disclosure guidance (as argued above) will only operate to shift the issues to the courts. Such a process could create decades of uncertainty among public firms and impose large litigation costs as courts wrestle with issues relating to the precise contours of the disclosure obligations firms face.[137] While the possibility that the courts will address the issue in a decidedly pro-CEO way definitely looms, if the courts simply discount the importance of ethics and compliance, they will essentially assume complicity with CEOs in the continuing unethical and fraudulent

132. No such disclosure obligation currently exists. *See* 17 C.F.R. §§ 205.2(k) and 205.3(c) (2017).

133. *See supra* notes 5, 14 and 19.

134. *See supra* notes 27 and 32.

135. Langevoort, *supra* note 130, at 939–40.

136. *Id.*

137. *See* JOHN W. CIOFFI, PUBLIC LAW AND PRIVATE POWER: CORPORATE GOVERNANCE REFORM IN THE AGE OF FINANCE CAPITALISM 61 (2010) (discussing the complex topic of corporate officers' fiduciary duties to their shareholders and how the court historically struggled to evaluate these claims, leading to a significant waste of judicial resources).

practices that plague the U.S. business sector.[138] Furthermore, many courts may well comprehend the social benefits for all, and for all shareholders in particular, of a more ethical and compliant corporate sector. Very few judges benefited from the historic collapse of capitalism during the Great Financial Crisis and the trillions expended by the government to rescue the corrupt financial sector.[139] Even today, the emergence of a new precariat arising from the ashes of the Great Financial Crisis threatens core American values and seemingly tolerates even the most virulent degrees of corruption.[140] The unbridled conduct occurring within the corporate sector threatens the rule of law and social stability.

Private securities litigation could, in other words, impose accountability on the corporate sector as well as CEOs notwithstanding the recalcitrance of the SEC.[141] Private securities litigation constitutes a depoliticized form of law and regulation that typically cannot suffer corruption from high economic inequality and the campaign contributions, lobbying efforts, and job offers that invariably follow in its wake.[142] Moreover, private securities litigation makes no claim on taxpayer resources nor entails any new government bureaucracy.[143] Private enforcement for securities fraud squares with even the most austere notions of libertarian ideals for the role of government.[144] It also serves the interests of the investing public by forcing fraudfeasors to repay their victims.[145] For all the reasons above, in favor of the SEC deeming material and thus mandating disclosure of ethics, compliance, and reputational risk management structures within the firm, courts should also not hesitate to impose such disclosure requirements upon public firms in the absence of SEC guidance.[146] Indeed, by deeming ethics and compliance systems material, the courts would essentially vindicate all underlying legal and regulatory policies favoring a sound system of regulated capitalism.

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138. *See* Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court – The Tortuous Path from* Central Bank *to* Stoneridge Investment Partners, 6 BERKELEY BUS. L.J. 131 (2009) (stating "[t]his article asserts that Congress and the federal courts are complicit in the widespread corporate corruption that has come to light this past decade").

139. Steven A. Ramirez, *The Economic Threat of Economic and Racial Hierarchy* (forthcoming 2018).

140. GUY STANDING, THE PRECARIAT: THE NEW DANGEROUS CLASS 68–81 (2011).

141. Ramirez, *Virtues of Private Securities Litigation*, *supra* note 11, at 722–23.

142. *Id.* at 723–24.

143. *Id.* at 724.

144. *Id.* at 725–26.

145. *Id.* at 725.

146. *See supra* Part I.

Whether accomplished through the SEC or the judiciary, the disclosure of the precise contours of how a firm manages ethical and compliance risk plays a material factor not just in shareholder returns, but in macroeconomic performance too.[147] The essential purpose of the federal securities laws is to stabilize and secure credit markets and, by extension, investment, as demonstrated in Section 2 of the Securities Exchange Act of 1934.[148] It is axiomatic that plunging investment drove the Great

147. Joseph P. Kennedy attributed the Great Depression to pervasive unethical behavior. ARTHUR M. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 423 (1958) (implicating "practically all the important names in the financial community in practices which, to say the least, were highly unethical").

148. For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are effected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions: (1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit. (2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans. (3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System. (4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

Securities Exchange Act of 1934, ch. 404, tit. I, § 2, 48 Stat. 881; Pub. L. 94–29, § 2 (codified as amended 15 U.S.C. § 78(b)). *See also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180,

Depression as well as the recession of 2008.[149] In both instances, deep and fundamental lapses in basic ethics and legal compliance drove the economic contraction. Securing a stable credit and investment environment through enhanced disclosure of ethics and compliance is therefore consistent with the longstanding goals of the federal securities laws.

CONCLUSION

Enhanced ethics and compliance will serve shareholders well, particularly in an era of diminished regulation. Demanding that ethical and compliance governance systems be deemed material will create market pressure and accountability on firm managers for superior extra-legal outcomes and compliance outcomes. Businesses that use cultural diversity to screen their business conduct within the framework of shareholder primacy will better acclimate themselves to all key constituencies and achieve objective ethical and compliance results. Given the increased diversity of consumer, labor, and investor pools, this approach to encouraging extra-legal standards of conduct draws upon differences in ethical sensitivities to drive more rigorous ethical screening of business conduct. Further, to the extent that the business enterprise enhances its financial performance through a more diverse screening mechanism, it should lead to quantifiable gains over those firms that do not feature such an innovation. Firms will attract persons spanning the breadth of cultural diversity to do business with the firm, and pay less in fines. Ultimately, the optimal structure for corporate ethical and compliance screening should emerge to give shareholders enhanced value as the firm achieves greater acclimation among constituencies. Competitive pressure can thereby enhance firm ethicality and investors can thereby objectively measure firm ethicality. The SEC should facilitate this process of discovery of optimal ethical and compliance structures within the firm through the issuance of disclosure guidance of ethical and compliance structures within public firms. Such structures will prove material to investors, and the disclosure of such material facts vindicate the underlying macroeconomic purpose of the federal securities laws.

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186 (1963) ("A fundamental purpose [of the federal securities laws] was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.").

149. Ramirez, *Virtues of Private Securities Litigation*, *supra* note 11, at 678–80. Investment similarly plunged during the 2008 recession. *Federal Reserve Bank of St. Louis*, GROSS DOMESTIC INVESTMENT, https://fred.stlouisfed.org/series/GPDIA (last visited Mar. 7, 2018).