Ethical Role Modeling in Leadership

Case Study: John Gutfreund at Salomon Brother

Group Project

Gretchen Blake
Phillip Brandley
Kimberly Hyde

A paper presented in partial fulfillment of the requirements of: LEAD 505: Organizational Leadership and Ethics. Submitted June 2012
ABSTRACT (G. Blake Contribution)

The purpose of this paper is to conduct an in-depth case study of Salomon Brothers, Inc. and the government securities violations committed August 1991 and the lack of ethical leadership under CEO John Gutfreund. There were consequences to these actions, as we will examine. We will discuss how the top management team of Warren Buffett and Deryck Maugham reacted and lead the company through the crisis and investigate what impact their ethical and moral beliefs, values and expectations had on that recovery.
INTRODUCTION

In the most recent past, national news outlets have publicized scandals involving power house companies such as Enron, MCI, WorldCom, Arthur Anderson, Martha Stewart, Tyco and Salomon Brothers; a New York based international securities firm. On the surface in each case, it is obvious ethics were violated and illegal activities occurred. Digging deeper will identify key points in time where people made conscience decisions to deviate from acceptable practices. The more frequent this occurs, the more difficult the behavior is to differentiate between illegal, unethical and organizational culture. Despite the fact leaders continue to be caught acting or condoning illegal and unethical behavior, however unsettling, the behavior continues. The Salomon Brothers case study illustrates wrongdoing and the actions taken by leadership to salvage the organization and rebuild its reputation. This paper will identify crucial members of leadership and the actions taken to minimize the negative impact on the company by making adjustments to day-to-day activities and promoting transparency to rebuild the trust that has been lost due to the scandal.

DEFINING ETHICAL BEHAVIOR (G. Blake Contribution)

Many believe ethical behavior in leadership is simply a matter of having good character – someone who has the “right values” or one who has “strong integrity”; in reality, the stakes are higher than ever for organizations and ethical leadership is far more complex, in fact, ethical beliefs are the fundamental core of any business and establish behaviors that define the way an organization operates. At the heart of this culture is a leader who not only drives and molds core values, but more importantly
contexts, continuously reinforces these beliefs so they become hardwired in the fabric of the organization.

In the midst of the recent series of corrupt business scandals, leaders cannot ignore the importance of the moral impact of their leadership presence and behaviors and how rarely these actions will have a neutral net effect. Terry Thomas et al, writes in the article *Strategic Leadership of Ethical Behavior in Business* “In the leadership capacity, executives have great power to shift the ethics mindfulness of organizational members in positive as well as negative direction”. Rather than being left to chance, Thomas explains how this power to serve as ethics leaders must be used to establish a social context in which the company operates; “One which positive self-regulation of ethical behavior becomes a clear and compelling organizational norm in which people act ethically as a matter of routine.” Thomas goes on discuss how this behavior pulls on the ethical center of gravity resulting in either a positive or negative shift in practice. (Exhibit A: Organization Ethics Center of Gravity).

For Salomon Brothers under the leadership of CEO John Gutfreund; the operational definition of ethical behavior was severely flawed leading to the scandal that erupted in 1991 which was traced directly to the organizational culture. During his time as CEO, Gutfreund concentrated solely on short-term business goals with a heavy handed directive to employees to produce profits immediately. This type of ‘on the fly’ quarterly-goal culture created an environment which unethical behavior prevailed as a means to the immediate needs that were met at any cost. Perhaps Gutfreund’s background as a stock trader fostered this mentality as a CEO; because quick decision-making as a trader is imperative, this was the only behavior Gutfreund practiced; in fact,
during the investigation there was no evidence long-term strategic planning had ever occurred while he was at the helm which only further cemented the ethical failure that ensued. Joanne Ciulla writes in the book *Ethics, the Heart of Leadership* “when an ethical failure of leadership is exposed, we are inclined to look for an explanation of the leader’s behavior, not an analysis of the moral status of what was done” (Ciulla, 2004; p. 129). Certainly in the case of Salomon Brothers, the series of leadership missteps set up the perfect storm for a predictable crisis which played out like a movie script.

**THE PERFECT STORM: A CRISIS BREWING (G. Blake Contribution)**

In light of the multiple insider trading scandals that occurred during the 1980’s, the government securities trading market was erroneously considered the “safe haven” as investors believed this monster market of treasury bonds was too large and supervised to be laden with corruption, however, with recent federal de-regulation complimented by Salomon Brothers greed and operational practices; thus, the perfect storm began to amass. As an investment bank in the 1980’s, Gutfreund transformed Salomon Brothers from a private company to a publicly traded corporation which started a trend with other companies on Wall Street. Gutfreund became an iconic figure of the times and was even coined “The King of Wall Street” in the mid 80’s. This impressive rise to one of Wall Street’s most powerful investment houses quickly fell apart as insatiability took hold nearly collapsing after irregularities in bond trading were discovered during the 1991 scandal that involved a $10 billion exploitation of the US Treasury note and bond markets.

In the case study of Salomon Brothers, Sims and Brinkmann write “We’re not talking about the failure to cross a ‘t’ or to dot an ‘i’ in this kind of case” more
importantly, it was about how Gutfreund’s leadership led to a culture prime for “greedy and power-hungry employees whose commitment to ethical behavior was suspect” (2002, p. 330). Even though the scandal took place due to the practices of Salomon Brothers related to the practices with Treasury bond trading, more specifically, it was Paul Mozer, a rogue trader who was submitting bids in excess of what was allowed by Treasury rules. Although Gutfreund was made aware of the situation, he and other top executives failed to respond by suspending practices. Unquestionably a series of events was forged during the time the storm was gathering force that was further complicated by complicated interrelationships among financial institutions, federal officials and Wall Street and the failure of corporate governance in the industry which breed greed and allowed fraud to prevail.

**THE IMPACT OF AUCTION IRREGULARITIES (G. Blake Contribution)**

After the US Treasury learned Mozer had been submitting false bids in a plot to purchase more Treasury bonds than allowed by a single buyer during the period of December 1990 and May of 1991, Salomon was fined $290 million in December of 1992 making this the largest penalty ever imposed on an investment bank. In addition, Salomon Brothers was required to set up an additional $100 million fund to be used to secure a repository for private damage claims. Salomon Brothers escaped criminal charges, but even so was devastated by the scandal both in terms of business and in reputation which led to the acquisition by Travelers Group. In terms of Gutfreund; he was removed as CEO in August 1991 and received a personal fine of $100,000 by the US Securities and Exchange Commission (SEC) and was barred from ever serving as a chief executive of a brokerage firm. Despite a wounded reputation and some pocket
change in terms of his net worth, Gutfreund skated through the debacle relatively unscathed.

**LEADING THROUGH THE CRISIS**

In order to change the direction in which Salomon Brothers was heading, a change in leadership was needed. Salomon Brothers named Warren Buffett as the new interim chairman because of his, “…personal reputation in the United States, though in London and Europe he was called the “mystery man from Omaha.” To most, this was like an immediate integrity jolt for Salomon Brothers, in fact, as one securities industry analyst observed, “he is such a highly credible personality, his taking over should reassure everyone the place is going to be well run”. (Paine, p. 110). “…Buffett severed all relations with Mozer and Murphy, terminating their employment and declining to pay their legal expenses. Ousting Mozer and Murphy sent a clear message to government investigators and the public their behavior that unethical acts would not be tolerated. “We are often inclined to say morally tainted leaders *knew* what they were doing was morally wrong, but; nevertheless, they were *motivated* to do it anyway” (Ciulla 2004; p.130).

Now that leadership at the top was in place, Buffett selected Deryck Maughan as the new chief operating officer. Maughan who was perceived as both a strong intellect and a highly competent, communicative manager was selected not only because of reputation, but also his job experience. Dubbed “Mr. Integrity” by the press, Maughan served 10 years in the Treasury Department of the United Kingdom as well as four years in the London office of Goldman Sachs making him a great choice to lead the makeover. Maughan (Paige, 1994; p. 113).
One of the most crucial steps Warren Buffett and Deryck Maughan took was to open Salomon’s doors to the government regulators and promised to waive the attorney-client privilege and turn over all reports and notes prepared by the firm’s lawyers investigating the government trading desks transgressions. The only way for Salomon to repair their reputation was to bring everything out on the table, no secrets or surprises with the adage of honesty as the best policy to follow from that point forward. A letter was sent to all the shareholders guaranteeing integrity and honesty; with the hopes of salvaging any and/or all clients. (Paige 1994. p. 114).

The New York Times once characterized Salomon Brothers, Inc. as a company who evaded rules and trampled anyone who stood in the way of profit. (Sims, p 66). Buffett and Maughan understood the need to change the ethical culture of Salomon which meant immediate changes. “Upper management at Salomon was committed to upholding ethical principles and purging those who had a past history of, or knowledge of unethical or illegal behavior” (Sims, p 67). Buffett made it clear to all employees any unethical practices were to be reported immediately and enforced a strong code of conduct including the expectation that upper management demonstrate through example, what they not only expected of themselves but everyone throughout the company.

With the spotlight on Salomon Brothers, Buffet and Maughan were under the scrutiny of not only their clients, but the financial world, government regulators, shareholders and his employees. In response to this scrutiny, both committed to answering all questions with open transparency and to the best of their ability. Buffett made it known that he was there to change the culture; “Lose money for the firm, I will
be very understanding; lose a shred of reputation for the firm, I will be ruthless.” (Paige, 1994). As Buffet and Maughan began cleaning up practice at Salomon Brothers, communication was the centerpiece of the transformation. Regular communication included a daily fact sheet detailing developments in the investigation and the firm’s business occurred within and outside of Salomon Brothers which was designed to keep, employees informed, to begin remolding the company’s core values, and to demonstrate the commitment to transparency. As Maughan explains; managing ethics is a mixture of discipline and leadership. “I lead by example, but when things go wrong, you can’t turn a blind eye. Leadership must enforce values through punishment. If they don’t exercise that power, then values can’t be upheld. People begin to believe the behavior is okay”. (Paige, 1994)

One of the key ways they were able to move the company toward transformation was in drilling down into the previous culture of Salomon Brothers and finding the root-cause of the issues which allowed actionable changes that ensured compliance with standards in the future. Swapping out senior leadership and providing investigators unrestricted access to information also demonstrated a willingness to identify the corruption without hiding other violations. Through these actions, Warren Buffett and Deryck Maughan were able to turn Salomon Brother’s firm around and bring it back into good standing with the government and public.

THE “NEW ETHICAL MANAGEMENT” STRATEGY

In October of 1991 when Buffett distributed a letter to the shareholders he wrote; “At Salomon we simply want no part of any activities that pass legal tests but that we as citizens would find offensive. Salomon Brothers foundation will be about ethical
behavior and nothing less will be tolerated” (Sims, p69). Buffett and Maughan wanted positive change for Salomon Brothers and understood the unethical practices left a tarnished image on the company; it was their job to show everyone what the basis of the clean-up efforts and rebuild would be.

Although the road to transformation was not easy, with solid leadership in place, Buffett took a proactive approach to the investigation by explaining, “My job is to clear up the sins of the past and to capitalize on the enormous attributes this firm has”. Salomon had to provide proof of the actions they were taking to change their standards, so on September 4, 1991, at a Congressional hearing Buffett unveiled changes in Salomon’s compliance system intended to “make Salomon a leader in setting new standards in regulatory behavior in the financial services industry” (Paine, p. 127). This was Buffett’s way of conveying to Congress and society what Salomon’s vision was for the future of the company and its workforce.

As part of this new management strategy, communication was a top priority with the rapid series of events taking place at Salomon, continued articles in the newspapers and rumor mill within the financial industry. Upper management had immediate responsibility to communicate to the employees of Salomon what the new vision is for the company would be and the goal of turning a crisis into an opportunity. In addition, painstaking effort was taken to convey to employees what their role will be in the success of the company; give them the power to make decisions understanding and enforcing opinions and ideas would be valued and not pushed aside as well as establishing the expectation their actions would be expected to be consistent with the new vision of the company. As Ciulla writes about transformational change in the book
Ethics, the Heart of Leadership: “We have entered into a new age where employees are partners and part of the team; all employees are leaders in their own way” (Ciulla, p60). Creating a good, strong leadership team was crucial to the transformation of the company with attention to bringing effective leaders at every level dedicated to accomplishing success for the company with integrity, dedication and honesty.

**DID SALOMON MAKE THE RIGHT DECISION?**

In the face of a crisis, it is easy to sit back second guess the decisions made based on information available at critical points in time. In retrospect and looking back at the entire incident, we concur Salomon Brother’s should not have pleaded guilty to the minor criminal charge order regarding the Treasury auction matter in 1991. Although financially speaking it would have been in the firms best interest; ethically speaking, it was in Salomon Brother’s long-term interest to not plead guilty. Had they plead guilty, the firm may have missed the opportunity to be investigated which provided an invaluable occasion for lessons learned and to prove what Salmon Brother’s stands for. This crisis allowed the company to bring in new leadership who shed a light into the dark corners of the organization and cleaned up common unethical industry practices making Salomon Brothers a strong ethical company once again.

In addition, terminating Mozer and Murphy sent a clear message to employees at Salomon Brothers, federal investigators and the public. Warren Buffett may have initially taken investors off guard by opening its doors and books to investigators; however, in the long run it proved there was a violation, but it was an isolated incident involving a handful of employees. Working with investigators enabled the scrutiny to highlight what indeed had happened and enable a renewed trust to be built with the
employees and the company’s clients. Improving communication with its employees, taking ads out in newspapers and allowing government inspector’s unrestricted access to information shows that Salomon Brothers were transparent in what they were doing. In a nutshell, I don’t think anyone could have done things any better. Unethical acts can come back on leaders and companies like the plague. Leaders have to continually set an example for their followers, their actions have to be equal to their beliefs and values; walking the walk. As a leader your actions speak louder than your words. You have to know who you are and what you stand for in order to become an effective leader. Effective leadership begins with change, and change begins with a desire. “Leadership, by contrast, is about coping with change” (Kotter, p. 40).

CONCLUSION (G. Blake Contribution)

In Joseph Badaracco's discussion from the article The Discipline of Building Character, he outlines what a defining moment in leadership really means as one asks; “what combination of shrewdness and expediency, coupled with imagination and boldness will help me implement my personal understanding of what is right?” (Badaracco, 1998; p. 97). For Buffet and Maughan, the trading scandal of 1991 was a defining moment both as leaders and for the organization as they began forming the character of Salomon Brothers through committing to irrevocable courses of action that shaped and molded the company's professional identity. Certainly, both had to step back from this issue at some point and ask; “who is the company?” and the work associated with turning a company with corrupt leadership to one of transformational leadership was a challenge met head-on. Truly the essence of transformational leadership occurs when individual attention is moved toward the larger cause turning
Ethical Philosophies in Leadership

self interest into collective awareness and acceptance on the purpose and mission of the group. Thus true role modeling and leadership.
WORKS CITED


**Exhibit A:** Organizational Ethical Center of Gravity

- **Amoral Leadership, "Negative Shift"**
- **Moral Leadership, "Virtuous Shift"**
- **WorldCom, Andersen**
- **Alcoa, Costco**

Leader's impact on ethics mindfulness

Organization's Ethics Center of Gravity