A Crisis of Ethic Proportions

By John C. Bogle

I recently received a letter from a Vanguard shareholder who described the global financial crisis as "a crisis of ethic proportions." Substituting "ethic" for "epic" is a fine turn of phrase, and it accurately places a heavy responsibility for the meltdown on a broad deterioration in traditional ethical standards.

Commerce, business and finance have hardly been exempt from this trend. Relying on Adam Smith's "invisible hand," through which our self-interest advances the interests of society, we have depended on the marketplace and competition to create prosperity and well-being.

But self-interest got out of hand. It created a bottom-line society in which success is measured in monetary terms. Dollars became the coin of the new realm. Unchecked market forces overwhelmed traditional standards of professional conduct, developed over centuries.

The result is a shift from moral absolutism to moral relativism. We've moved from a society in which "there are some things that one simply does not do" to one in which "if everyone else is doing it, I can too." Business ethics and professional standards were lost in the shuffle.

The driving force of any profession includes not only the special knowledge, skills and standards that it demands, but the duty to serve responsibly, selflessly and wisely, and to establish an inherently ethical relationship between professionals and society. The old notion of trusting and being trusted—which once was not only the accepted standard of business conduct but the key to success—came to be seen as a quaint relic of an era long gone.

> We must establish a 'fiduciary society.'

The proximate causes of the crisis are usually said to be easy credit, bankers' cavalier attitudes toward risk, "securitization" (which severed the traditional link between borrower and lender), the extraordinary leverage built into the financial system by complex derivatives, and the failure of our regulators to do their job.

But the larger cause was our failure to recognize the sea change in the nature of capitalism that was occurring right before our eyes. That change was the growth of giant business corporations and giant financial institutions controlled not by their owners in the "ownership society" of yore, but by agents of the owners, which created an "agency society."

The managers of our public corporations came to place their interests ahead of the interests of their company's owners. Our money manager agents—who in the U.S. now hold 75% of all shares of public companies—blithely accepted the change. They fostered the crisis with superficial security analysis and research and by ignoring corporate governance issues. They also traded stocks at an unprecedented rate, engaging in a dangerous spree of speculation.

Adam Smith presciently described the characteristics of today's corporate and institutional managers (many of whom are themselves controlled by giant financial conglomerates) with these words: "[M]anagers of other people's money [rarely] watch over it with the same anxious vigilance with which . . . [they] watch over their own . . . they . . . very easily give themselves a dispensation. Negligence and profusion must always prevail."

The malfeasance and misjudgments by our corporate, financial and government leaders, declining ethical standards, and the failure of our new agency society reflect a failure of capitalism. Free-market champion and former Federal Reserve chairman Alan Greenspan shares my view. That failure, he said in testimony to Congress last October, "was a flaw in the model that I perceived as the critical functioning structure that defines how the world works." As one journalist observed, "that's a hell of a big thing to find a flaw in."

What's to be done? We must work to establish a "fiduciary society," where manager/agents entrusted with managing other people's money are required—by federal statute—to place front and center the interests of the owners they are duty-bound to serve. The focus needs to be on long-term investment (rather than short-term speculation), appropriate due diligence in security selection, and ensuring that corporations are run in the interest of their owners. Manager/agents need to act in a way that reflects their ethical responsibilities to society. Making that happen will be no easy task.

Mr. Bogle, founder and former chief executive of the Vanguard Group of Mutual Funds, is author of "Enough. True Measures of Money, Business, and Life" (Wiley, 2008).