

Ethics and Compliance: What Fortune 500 Boards Should do Now

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Fourteen years after the original Sentencing Guidelines were published, many smaller companies still have only a few rudimentary elements of an effective ethics and compliance program in place. Fortunately, by 2005 virtually every Fortune 200 company—and most Fortune 500 companies—have established a basic ethics and compliance program. It is to directors of these companies that we direct this white paper.

It is very easy to err on either side of the “proper oversight” of ethics and compliance continuum that directors were charged with in the Caremark decision and which was reinforced in the 2004 revision to the Sentencing Guidelines. Some boards, having reviewed the existence of fundamental elements like a Code of Conduct, training, and a “Hotline,” are wont to believe that everything is OK. Others, alas, educated by Worldcom and Enron and whipped into a frenzy of hypervigilance by lawyers and consultants with a vested interest in such a state, micromanage ethics and compliance to the detriment of the enterprise.

Amazingly for a product of Washington, D.C., the new Sentencing Guidelines for Organizations offer a reasonable middle ground of guidance for board members concerned about their ethics and compliance role. As a one sentence summary, these Guidelines provide reductions in penalties when an organization convicted of a crime shows evidence of an effective ethics and compliance program, and increase penalties when such a program is absent. The Guidelines are being used by judges in making sentencing decisions, by the Department of Justice in making prosecutorial decisions (to indict or not to

Questions to ask your Ethics/Compliance Officer

(These questions expose the main weaknesses we see in ethics and compliance programs in 2005. Several Boards we work with are implementing periodic executive sessions with the Ethics Officer to increase the odds these questions will be answered with full candor.)

Assessment

How do you know the program is effective?

Accountability and HR processes

How are we at discipline? Are top performers and high level people held accountable to the Code?

Culture

How does our culture support or undermine our commitment to integrity? Do we have a “make plan at all costs culture?” Is candor rewarded or punished? How much fear of retaliation is there?

Leadership

Do leaders—not just the CEO but line and functional leadership—set the right tone? How are they perceived by employees? Are they role models for accountability or entitlement?

Risk

What are the major compliance and reputational risks we face? How do you know? Do these differ by geography or line of business? What are we doing to address these risks? Are there any activities or parts of the company that you feel aren't being addressed by the program that should be?

Resources

Do you have the resources you need to do your job appropriately? Do you feel you have access to the CEO and us whenever you need it?

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indict), and by various regulatory arms of the government in making judgments of good faith compliance efforts as well.

The Guidelines state that *“to have an effective compliance and ethics program, an organization shall (1) exercise due diligence to prevent and detect criminal conduct; and (2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”* The use of the word ethics, and the emphasis on organizational culture, are both direct consequences of Enron, which had many elements of a compliance program in place but by most accounts did not have an ethical culture. And of course, whenever there is a conflict between a rule and culture, culture wins. This adds a burden on the ethics officer, because it means checking the compliance boxes is no longer sufficient, if it ever was. The Guidelines add a burden to the Board, too:

“The organization’s governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.”

While all board members should have a general knowledge of the program, the oversight duty is most often assumed by the Audit Committee, although some corporations utilize a governance or corporate responsibility committee to the same effect. What is appropriate oversight? In our experience, the elements of the Sentencing Guidelines frame oversight responsibilities. We have outlined below the key areas of the Sentencing Guidelines that board members should consider carefully in 2005.

Risk Assessment

One major change in the Guidelines is that they suggest that the ethics and compliance program should be based on an organization’s risks. There is no need for a one size fits all program, nor any need to get into an “arms race” of constantly escalating best practices. A considered assessment of the legal (and we would add reputational) risks can help an ethics program focus scarce resources on the right people and the right areas. Board members should note that this is an area in which even the best companies are struggling to get their arms around. Many are attempting to combine this with an integrated ERM (Enterprise Risk Management) process, which is appropriate as long as steps are taken to ensure that compliance and reputation are not after the fact additions to a process focusing on financial and insurance risks.

Communications and Training

Several of the guidelines emphasize the importance of clear standards, communications and effective training for employees, the board, and agents as appropriate. Both the word “effective” and the explicit inclusion of board members are new, and constitute a matter of some debate within the ethics and compliance priesthood. Our advice is simple. Effective training—for the Board or other employees—needs to meet the AG and the employee smell test. Would an Attorney General reviewing the training content and attendance documents believe training indicated a genuine commitment to ethics and compliance in light of all circumstances in your company and industry? Would employees find it credible? For the Boards where we have done training this has translated into sessions ranging from 45 minutes to four hours, including an interactive, case based segment.

Leadership

In the wake of the scandals of 2001-2004, the new Guidelines substantially beef up structural advice for ethics and compliance programs. The Guidelines also emphasize that senior management is

responsible for ensuring that the corporation has an effective program. Combined with the emphasis on culture, this guideline highlights the importance of leadership in setting the right tone, largely by being role models for integrity. In our experience, the two biggest challenges for leaders in this regard are in consistency of discipline (which we discuss later,) and in failing to see how accepting lavish gifts and entertainment can send messages of entitlement or bias to other employees.

In addition to the aforementioned oversight role of the Board, the Guidelines also note that the Ethics Officer or person with day to day responsibility for ethics and compliance should report to and have access to the Board or designated Board Committee, and that the Board should ensure that this person have adequate resources to do the job. Because of the disparate ways companies organize compliance activities, there are no good universal benchmarks in either headcount or financial outlays. The view of the ethics officer should receive careful consideration here.

Accountability and HR practices

The new Guidelines recognize the central management truth that what gets measured—and rewarded—gets done. As straightforward as this is, many companies struggle with disciplining high level employees or top performers who violate company standards. The Guidelines raise the bar even further by calling for discipline when management fails to take appropriate steps to prevent or detect illegal conduct. Citigroup's recent terminations of three very high level officers for failure of oversight in the company's Japanese private banking subsidiary was an extraordinarily visible symbol of this Guideline in action. In this environment, boards will want to review consequences flowing from misconduct involving high level officials to ensure appropriate disciplinary action.

Auditing, monitoring and assessment

The Guidelines continue to call for robust mechanisms for employees to report issues. Our research indicates that most companies with robust programs receive calls/emails on business conduct issues at a rate of .5% to 2.5% of U.S. employees per year. Call rates fall off substantially overseas. Counts outside this range are not a problem per se, but are worthy of exploration.

The Guidelines also emphasize the need for auditing compliance efforts and compliance risks, and for periodically assessing the effectiveness of the program. Boards should receive reports on each.

Culture

We end where we began. Board members will want to inform themselves as fully as possible about the company's culture. No culture will be "perfect" from a compliance and integrity perspective—any institution with human beings and goals and incentives and competition will face challenges. Yet directors will want to look for signs of "win at all costs," "rules don't matter," and "candor gets you in big trouble," as they assess risks and remediation steps in the companies they oversee.

In the final analysis, ethics and compliance management is just like all other kinds of management. It is less about rhetoric and checking the boxes, and more about tone and execution. Boards and leaders are well advised by Nobel Prize winner Albert Schweitzer, who wrote *"Example is not the main thing in influencing others. It is the only thing."*