



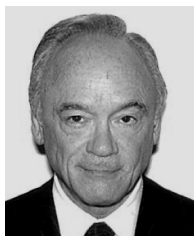
YEARS

ENGAGED DIRECTORS
EFFECTIVE BOARDS

DIRECTORS MONTHLY

December 2007

Volume 31 Number 12



By Gary Edwards

Compliance, Ethics, and Corporate Culture: A Call to Action for Board Leadership

Don't just check the box without thinking about the ethical culture you want your organization to achieve.

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"We thought we'd done all the right things; we had an ethics leader, ethics advisors assigned around the company, and an anonymous ethics-line to report suspected violations. It wasn't enough."

—W. Jim McNerney, Boeing Chairman, President and CEO, April 27, 2006.

Boeing's experience is, unfortunately, not unique. The same is likely true for companies you serve. Understanding why and how boards must reengage on the critical topic of corporate ethical culture is essential to their success.

Background. Much of current corporate efforts to prevent and detect misconduct triggered by mitigation provisions of the U.S. Sentencing Commission's Guidelines for the Sentencing of Organizations (1991), rely on mechanisms first put in place in General Dynamics (GD) in 1985 and shortly thereafter adopted by signatory

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companies to the Defense Industry Initiative on Business Ethics and Conduct (DII), including:

- The requirement for codes of ethics in ordinary language, distributed to all employees;
- Universal ethics training, including the application of the code's provisions to each employee's job responsibilities; and, most significantly,
- The creation of ethics offices where employees could report unethical or illegal conduct (anonymously, if desired), and where they could turn for confidential advice when facing difficult ethical decisions.

These early corporate ethics offices had direct, regular reporting relationships to CEOs and to boards of directors. Prior unethical and illegal practices (for example, mischarging work done for fixed-price contracts to cost-plus contracts) were no longer tolerated by the government, and companies needed to convince employees that changes in business practices were real and permanent. They needed employees' cooperation in self-policing to ensure that new standards of conduct were fully implemented.

Initially, corporate ethics offices worked well, both in the defense industry and in many other industries. Many companies heard from 5% of their employees through the ethics office and its hotlines each year. The programs had a strong preventive aspect, as companies found that 65–85% of ethics office contacts were from employees seeking advice about prospective conduct, not just reporting misdeeds. However well these ethics offices may have functioned in the 1980s and 1990s, they are no longer meeting the needs of companies today.

What's Wrong with Current Programs?

There are at least four problems with the structure and function of most current corporate ethics and compliance programs:

1. The wrong people are in charge;
2. Hotlines aren't working, but outsourcing them acknowledges—without repairing—a lack of trust in the corporate culture;
3. Leaders fail to shape ethical culture;
4. Short-term metrics drive rewards.

1. The Wrong People Are in Charge. Last fall, ethics and compliance officers were surveyed about their programs, and the results were released by Ethos International, Inc. Among the 127 respondents, ethics and compliance functions had been integrated under one senior executive in 112 of the organizations, with the executive in charge usually an attorney (55%). Where compliance programs functioned independent of ethics initiatives, they were even more likely to be directed by attorneys (63%). Why

are the lawyers in charge?

In 1991, the U.S. Sentencing Commission issued guidelines for the sentencing of organizations convicted of criminal conduct. An important part of the Commission's work was the articulation of mitigating factors in calculating penalties for violations. Codes of conduct and hotlines began appearing in companies where previously management had shown little interest, but where now their attorneys argued for mitigation when their employees engaged in conduct that could put the company at risk. Because these initiatives were undertaken to prevent and detect violations of law, they often found their home in the legal department.

In 2002, the Sarbanes-Oxley Act required CEOs and CFOs to certify the effectiveness of their companies' financial controls and the veracity of their financial statements. These and other requirements of Sarbanes-Oxley reinforced the focus on compliance and, in many companies, led to the designation of the general counsel or another senior attorney as chief compliance officer, and the transformation of corporate ethics activities into compliance functions.

There are at least three problems that may be created by this arrangement:

- The ethics office merged with or subsumed under the compliance function, often reports to the legal department, relieving top management and independent directors of the responsibility and the opportunity for a full report from, and interaction with, the ethics officer;
- Utilization of the ethics hotline often declines when channeled through legal or compliance offices headed by an attorney (employees are less likely to report misconduct if they fear that doing so will result in being deposed and exposed);
- Most lawyers' expertise is in ensuring compliance with legal and regulatory requirements for doing business, not ethics.

Fairness, loyalty, trustworthiness, respect, and a sense of responsibility for others are important values in the workplace and in society, but only the most egregious violations of these values are matters for legal enforcement. In any

Director Summary: The author argues for corporate ethics programs independent from attorney-headed compliance programs; in-house hotlines; long-term strategies; and board self-review to strengthen employee and consumer confidence in corporate ethical cultures.

The best company ethics offices hear from only 5-10% of employees, suggesting that there may be a lot going on that no one is willing to report.

company, law provides a floor for acceptable conduct; ethics sets higher standards and expectations for how we treat fellow workers, customers, suppliers, and the communities in which we operate.

2. Hotlines Aren't Working. Our recent survey found that most hotlines for reporting misconduct are managed by outside contractors (58%). Nearly two-thirds (65%) of outside contractors used by respondents heard from less than 1% of employees in the twelve months prior to the survey. By contrast, half of the ethics offices heard from 1-5% of employees, and another 17% of ethics offices heard from 5-10% of employees during the same period.

More significantly, when employees call hotlines seeking advice about situations they face, and the actions they should take, ethics offices are again the preferred resource, with 44% of them reporting contact from 1-5% of employees, and another 22% receiving such calls from 5-10% of employees in their organizations the prior year. By contrast, not one of the respondents outsourcing the hotlines reported that any employees had called those lines to seek answers about the company's code of ethics or for advice about ethics or compliance issues at work.

Clearly, employees are more likely to report misconduct to, or seek ethics advice from, a company's ethics office rather than a vendor. But the larger picture reveals more. A 2005-2006 KPMG Integrity Survey found that 74% of responding employees reported that they had observed misconduct at work in the prior twelve months. The National Business Ethics Survey, published by the Ethics Resource Center (ERC), noted a 10 percentage point decline in the number of employees who were willing to report misconduct observed in the workplace, from 65% in 2003 to 55% in 2005. Yet the best company ethics offices hear from only 5-10% of employees, suggesting that there may be a lot going on that no one is willing to report.

If employees don't call a hotline, maybe it's because they report misconduct to their supervisor. Both KPMG and ERC surveys found that employees prefer to discuss matters of ethics with their immediate boss. That is what employees say that they want to do, but that is not what happens. Employees in ERC surveys cite two principal reasons for this: first, they do not believe that corrective action will be taken; and second, they fear retaliation.

In an insightful article, "Why Employees Are Afraid to Speak" (*Harvard Business Review*, May 2007), James Detert's and Amy Edmondson's research reveals that half of employees fear to speak, not only about misconduct, but even to share ideas that would improve their company's business. Some employees reported that they had experienced negative consequences from speaking-up; for others, their silence was responsive to a "culture of collective myths" about the bad experiences of others.

The authors conclude that "Making employees feel safe enough to contribute fully requires deep cultural change that alters how they understand the likely costs (personal and immediate) versus benefits (organizational and future) of speaking up."

3. Leaders Fail to Shape Ethical Culture. Much of the success of early ethics programs can be attributed to significant participation by employees at every level. Interviews and focus groups often served as a means of building understanding and support for ethics initiatives, while identifying issues confronting employees. Universal training was also a roll-out of the ethics message, with commitment from the board and top management. The ethics office and its hotline were introduced as confidential means for employees to get assistance without risk.

At that time, ethics training appropriately focused on communicating the new or revised standards of conduct. Real and hypothetical case studies were used to illustrate application of the standards to everyday business situations. Factual analysis and principled reasoning were utilized to reach ethical decisions and, sometimes, to illustrate that guidance was needed. Such training continues to be valuable for new employees and for current employees whose responsibilities may change. It reinforces and strengthens a company's ethical culture.

The top-down roll-out can also be a means of communicating desired changes in the company culture, perhaps bringing real, operating values into congruence with stated, aspirational values, or more closely linking ethical leadership and career advancement. Effecting changes in the culture can then be facilitated by linking, throughout the organization, the desired outcomes with the incentive and reward systems.

4. Short-term Metrics Drive Rewards. From CEOs, corporate boards, and down through the ranks, people tend to shape their behavior to achieve those objectives that are best rewarded. Too often ethics and compliance officers have been in the position of discouraging or prohibiting conduct that compensation policies and performance metrics reward.

The short-term orientation of companies is sometimes

blamed on market analysts, institutional investors, or private equity, and there are reasons for each to be focused on how companies are performing compared to how they may have performed last year or last quarter; but surely some of the responsibility lies with companies and their directors, particularly when it comes to strategic planning. The lack of adequately informed and participative boards in planning for the long-term success of companies has too often been reflected in the compensation structured for top management. When strategic planning and executive compensation are driven by short-term metrics, so is behavior throughout the enterprise. Compliance and ethics are then undercut by risk/benefit analysis at the personal level by anyone with contingent compensation. Cynicism about policies and focus on practices further erodes trust in leadership. Directors must ensure that strategic planning and performance metrics are aligned with the values, standards, and practices consonant with ethical decisions and legal compliance.

What Boards of Directors Can Do

In 2004, the U.S. Sentencing Commission revised the Sentencing Guidelines for Organizations, in part to redress an emphasis on compliance that did not adequately take into account the influence of the ethics and culture of an organization on its employees' decision-making and conduct. The prior admonition to implement "an effective program to prevent and detect violations of law" was replaced by a call for "compliance and ethics programs" that "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."

The revised guidelines place responsibility on the board of directors to be "knowledgeable about the content and operation" of the program, while exercising "reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program." Board members can take the following steps to meet the responsibilities for the ethical culture of their organizations:

1. Require the ethics and compliance officer(s) to report (separately) to the audit or governance committee at least quarterly and to the full board at least annually, on ethical and legal risks encountered, and their perception of management's leadership in building a community of trust.
2. Ensure that both hotline and helpline functions are staffed by ethics professionals. If the hotline has been outsourced, bring it back in-house. Outsourcing underscores a lack of trust and undermines the commitment to build an ethical culture.
3. Lead the way in corporate-wide ethics assessments, beginning among directors, and then with top management. The senior management team also should

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assess the organization's ethics, separately from the board. The purpose of these sessions is two-fold: to address identified ethics risks to the corporate reputation and brand; and to build trust and community within the company's leadership through candid, direct conversation. Similar sessions should flow down through the entire organization. The ethics assessments are an essential part of cultivating an ethical culture of openness and trust.

4. Ensure that management updates the standards of conduct and compliance training materials, as necessary, to reflect issues and risks identified and discussed throughout the ethics assessments.
5. Adjust performance measures and compensation to reflect the board's commitment to an ethical corporate culture. Compensation for top management should reflect not only the achievement of specified near-term financial objectives, but also advancement of long-term prospects for the growth in value and performance of the company and its assets. (The Aspen Institute's publication, *Long-Term Value Creation: Guiding Principles for Corporations and Investors* provides a useful resource for boards and management in this area.)*

If directors answer this call to leadership, they will serve well the interests of investors, employees, and the larger public, helping to build communities of trust in business. ■

Gary Edwards serves as chairman and CEO of Ethos International, Inc. He is the former president of the Ethics Resource Center, where he designed the first corporate ethics office in any company for General Dynamics. In 1985, at the request of The Packard Commission, he wrote the Recommendations on Defense Industry Self-Governance, leading to the Defense Industry Initiative on Business Ethics and Conduct.

Ed note: NACD recently subscribed to the Aspen Principles dedicated to promoting the long view. Please see pages 18-19 of this issue for more information.