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**Challenges Facing Corporate Ethics
and Compliance Programs
A Research Report from Ethos International, Inc. ©**

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Background for the Research

In 1985, the first corporate ethics office was created at General Dynamics^{*}, on the advice of the Ethics Resource Center (ERC), a Washington, DC nonprofit organization. The Center's advice was sought by the president of General Dynamics as that company contemplated actions that it might take to be restored as a trusted government contractor, after having been suspended in the face of allegations of widespread unethical and illegal conduct.

The corporate ethics office was conceived as a place where employees could report unethical conduct confidentially, even anonymously, to top management, if they were unwilling to report it to their direct supervisor, or if chain-of-command reporting had already proven ineffective. The ethics office was also to be a resource for employees facing difficult decisions, who might not be certain what the right thing to do was, especially in a company with new standards of conduct and a self-conscious effort to change its culture. Employees in such situations could seek the confidential advice of the ethics office, if they were afraid or embarrassed to ask their own manager.

General Dynamics' ethics initiative came to the attention of President Reagan's Blue Ribbon Commission on Defense Management, chaired by David Packard (the "Packard Commission"). At the Commission's invitation, ERC drafted recommendations on self-governance for the defense industry. Those recommendations, published in the 1986 Packard Commission's report to the President, led directly to the Defense Industry Initiative on Business Ethics and Conduct (DII), a voluntary commitment by the largest defense contractors to implement ERC's recommendations for ethics programs modeled on that adopted by General Dynamics.

Over the next ten years, ERC assisted over one hundred fifty other companies, in a cross section of industries, in the implementation of similar ethics programs, including top-down discussions of the role of the ethics office, as well as a company's values and standards of conduct, in informing decision making and behavior in the workplace. The ethics office help-lines of ERC client companies typically handled calls from approximately five per cent of employees each year, with as many as two-thirds of those contacts being for advice and counsel, clarifying company standards and expectations and preventing misconduct that might have resulted from misguided attempts to achieve business objectives.

In November, 1991, the U.S. Sentencing Commission issued federal guidelines for the sentencing of corporations and other organizations convicted of criminal conduct. An important

* A few years earlier, Dow Corning created an ethics office but not initially for the purposes served by current ethics and compliance offices. At Dow Corning, the ethics office was established as a focal point for dealing with public concerns about the safety of silicone breast-implants.

part of the Commission's report was the articulation of mitigating factors that were to be considered in calculating the penalties to be assessed for violations. According to the attorney who was then counsel to the Commission, the elements of the DII ethics program commitment served as a template for the seven minimum requirements for an effective program and for the mitigating factors that courts were to assess.

Understandably, many additional companies became interested in programs that might "prevent and detect violations of law." Codes of conduct and hotlines for reporting misconduct began appearing in companies where previously management had shown little interest, but where now their attorneys successfully made the argument for mitigation, just in case something should happen and one of their thousands of employees put the company at risk. Excellent advice; however, because these new initiatives were undertaken on the advice of counsel to prevent and detect violations of law, they often found their home in the corporate legal department.

In 2002, passage of the Sarbanes-Oxley Act required CEOs and CFOs to certify the effectiveness of their companies' financial controls and the truthfulness and reliability of their quarterly and annual financial statements (Sec. 302). It also required attorneys practicing and appearing before the SEC to become 'whistleblowers', if they had evidence of a material violation of securities law or breach of fiduciary duty by the company, disclosing the evidence to the company's chief legal counsel or to the CEO. Moreover, if there was not an appropriate response, attorneys were further required to disclose the evidence to a committee of outside directors or to the full board (Sec. 307). These and other requirements of Sarbanes-Oxley reinforced the corporate focus on compliance and, in many companies, led to the designation of the General Counsel or another senior attorney as the Chief Compliance Officer, and the transformation of corporate ethics activities into compliance functions, or the subordination of them thereto. (Potential problems created by this arrangement are discussed in the Principal Findings and Commentary section below.)

Listing requirements for companies whose securities are traded over the New York Stock Exchange and NASDAQ were changed in 2003 to reflect the heightened concerns about corporate governance and legal compliance. Listed companies are required, among other things, to have a majority of independent directors who "must meet at regularly scheduled executive sessions without management." Additionally, a governance committee of independent directors is responsible for developing and recommending to the full board a set of governance principles applicable to the company. The audit committee, also of independent directors, is further required to adopt and disclose corporate governance guidelines based upon those adopted principles. Each listed company is required to "adopt and disclose a code of business conduct and ethics for directors, officers and employees."

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, as well as to "reflect the emphasis on ethics and values incorporated into recent legislative and regulatory reforms." 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" (emphasis ours). The revised Guidelines place responsibility on top management to "ensure that the organization's program is effective" and 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.” Moreover, the person responsible for the daily management of the program—not some executive to whom he or she may report—should report directly to the board and meet regularly with the board or the committee charged with oversight of the program to discuss its operations and effectiveness.

Revisions to the Guidelines also revisit training, making it, in effect, mandatory, not only for employees, but also for high level management and the board of directors, as well as the company’s agents, “as appropriate”.

The potential for preventing misconduct by utilizing help-lines as a means for employees to “seek guidance” concerning potential conduct, as well as to report wrongdoing or criminal conduct, further enhances the ethics function of company programs.

Risk assessment is an important new emphasis in the revised Guidelines, not only to inform a company’s standards of conduct and ethics and compliance training but, through periodic reassessments, as a means of refining and revising programs to identify emerging risks and to better manage continuing ones.

Guidelines revisions also call for companies periodically to evaluate the effectiveness of their programs, although the Guidelines are silent on the best means for conducting such evaluations, as well as the criteria for “effectiveness”.

Research Methodology

The research methodology included in-depth interviews with a number of ethics and compliance officers, prior to development of a brief questionnaire for broader data collection. That data was analyzed by the research team, which prepared a draft report for discussion by interested ethics and compliance officers. Based on that input, the interviews conducted prior to fielding the questionnaire, and follow-up interviews, this final report has been prepared for dissemination to ethics and compliance officers, corporate officers and directors.

In the summer of 2006, questionnaires were mailed to ethics and compliance officers at six hundred twenty five organizations. Eighty-four were returned undeliverable, due mostly to changes in personnel heading some programs. Corrections were made and questionnaires resent in September. One hundred twenty seven completed questionnaires were returned before data analysis began in early November. Of forty-seven questions asked, all but one were structured as multiple-choice in order to minimize the time required for completion and to limit ambiguous responses.

Survey questions were based on the experience of the researchers (see Appendix) and interviews with current ethics and compliance officers. Areas of interest were identified for inquiry, data gathering and clarification. These included:

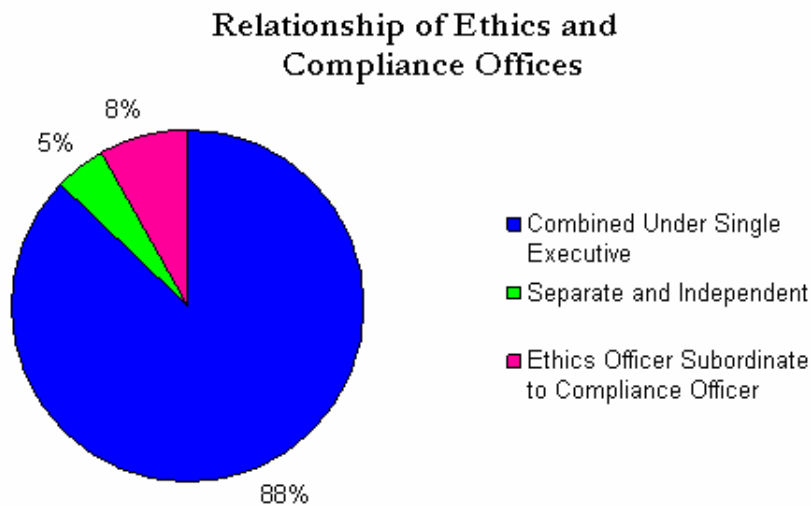
- The relationship between ethics and compliance offices, where those responsibilities have been separately organized;
- The background, professional preparation and development of ethics and compliance officers, as well as their relationships with corporate executives and boards of directors.
- The role of ethics and compliance offices in conducting due diligence for possible mergers or acquisitions;
- Cost-cutting pressures on ethics and compliance offices;
- Corporate pressures to curtail or divert ethics and compliance investigations;
- Internal and external evaluations of ethics and compliance program effectiveness, including peer reviews;
- Methodologies for assessing the risks of serious misconduct occurring in companies;
- The utilization of employee “hotlines” and “help-lines” and the variables that determine their effectiveness in identifying and preventing misconduct;
- The principal causes of illegal and unethical conduct.

Principal findings are summarized below, along with possible implications for the relative success of different program elements under various circumstances.

Principal Findings and Commentary

One hundred twenty seven companies (20% of those invited to participate) returned the questionnaire. More than half (53%) of the respondents work for relatively small companies, with fewer than 10,000 employees. The small sample size and disproportionate participation by smaller organizations suggest that the data should not necessarily be considered representative of the larger universe of institutional ethics and compliance programs. Nonetheless, interesting features of the programs reported herein, and certain of the data correlations, may prove valuable to organizations as they compare their own activities and strive to strengthen the leadership of executives and board members and to improve the trust and participation of employees in protecting the reputation of the organization and their own integrity.

1. Relationships between Ethics and Compliance Offices.



Most programs (88%) integrate ethics and compliance responsibilities under one senior executive officer. Only five per cent of respondents report that ethics and compliance offices are separate organizations, independent of each other; however, the ethics office is subordinate to the compliance office in another eight per cent. None of the respondents report the compliance function being

subordinate to the ethics office.

The senior executive in charge of integrated ethics and compliance programs is usually an attorney (55%). Where compliance programs function independent of ethics initiatives, they are even more likely to be directed by attorneys (63%). Ethics offices, whether independent of compliance or subordinate to it, are most frequently led by professionals from finance or audit (37%) or human resources (33%).

Commentary. Given the influence of the 1991 Sentencing Commission Guidelines with their recommendations that organizations create programs that would “prevent and detect” criminal violations of the law, and the re-enforcing effect of Sarbanes-Oxley’s focus on the responsibilities of senior executives and the board of directors, it is not surprising that so many companies rely on their lawyers to organize, manage or oversee the mechanisms for employees to report misconduct or to seek advice about proper behavior. Who better to teach employees about the law, to manage investigations into possible criminal actions, or to brief board members about related issues, risks and potential liability? As sensible as this may seem, there are at least three problems that may be created by this arrangement.

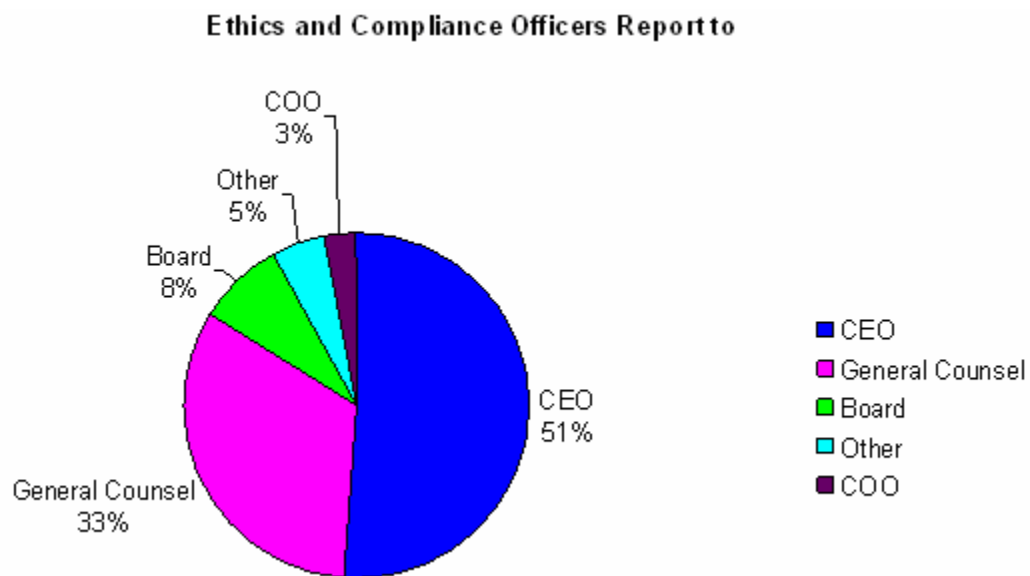
First, the ethics office, merged with or subsumed under the compliance function, often reports, not directly to the CEO and to the board of directors, but through the legal department, relieving top management and independent directors of both the responsibility and the opportunity for a full, direct report from and interaction with the ethics officer. *Even absent allegations of illegal conduct, employee concerns about such matters as fairness, trust in management, performance pressures from managers or customers, and the gathering of competitors’ intelligence are ethical issues deserving the attention of the chief executive and the knowledge of the board.*

Second, utilization of the ethics help-line declines when it goes through the legal department or to a compliance office headed by an attorney. Employees are less likely to report misconduct, if they believe that doing so will result in their being deposed and, eventually, disclosed. Corporate attorneys have a client, and that client is the corporation, not the employee. This is both necessary and proper, but it has a chilling effect on employees’ expectation of and desire for confidentiality.

The third problem is that lawyers’ expertise is not in ethics (except as that pertains to their own profession’s standards of conduct), but in understanding and ensuring compliance with the legal and regulatory requirements for doing business. Consequently, when called upon to assume responsibility for deterring and detecting violations of law, lawyers’ emphasis is likely to be not on ethics, but compliance. Moreover, if corporate attorneys believe (as those participating in the survey reported herein overwhelmingly do) that the principal cause of misconduct is ignorance of laws, regulations and company policies, then their responsibility is best executed by compliance training for employees, targeting the legal requirements for particular job responsibilities. By contrast, managers are experienced in the business environment, processes and activities which may lead to, or result in, improper conduct. They know that *the fundamental causes of unethical and illegal conduct are not ignorance of the law or policies, but failures of leadership, pressures to meet aggressive goals, and their own desire to meet expectations—their boss’s, their teammates’, their own.*

Addressing a flawed strategic planning process that creates undue pressures to achieve short-term profit and performance objectives may not be on the legal department’s agenda, much less an incentive and reward system that measures results without assessing the means by which they were achieved. Products that are shipped before testing is completed, 35 day months when sales are pulled forward to meet targets, the drawing down of reserves to mask revenue shortfalls, bribery in developing markets —these all may surface, be investigated and disclosed, employees disciplined and fired, while systemic drivers of such conduct go unrecognized and unaddressed.

2. Management reports. The officer in charge of the ethics and/or compliance office usually reports directly to the CEO (51%); however, one third report to the General Counsel instead. Eight per cent report directly to the board of directors.



Among issues of concern to respondent ethics officers who report to the compliance office or to the General Counsel are:

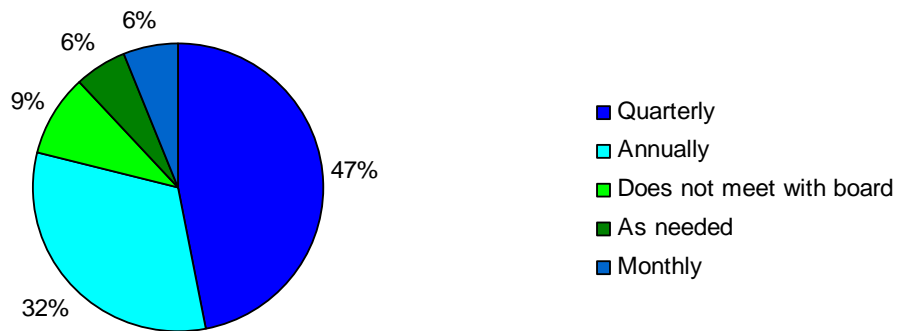
- Little or no direct reporting to the CEO;
- Little or no direct reporting to the Board of Directors;
- A lack of understanding among some compliance officers, especially attorneys, about the causes of misconduct;
- A consequent focus on compliance training, even by the ethics office, where the objective of training sessions may be little more than an explication of the organization’s standards of conduct.

Commentary. The revised Guidelines place responsibility on top management to “ensure that the organization’s program is effective” and 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.” Moreover, the person responsible for the daily management of the program—not some executive to whom he or she may report—should report directly to the board and meet regularly with the board or the committee charged with oversight of the program to discuss its operations and effectiveness.

3. Board reports. Ethics and/or compliance officers usually meet with the Board of Directors at least quarterly (53%); however, those who do not report to the CEO meet less frequently with the board, with those reporting to the General Counsel meeting least often with the board or not at all.

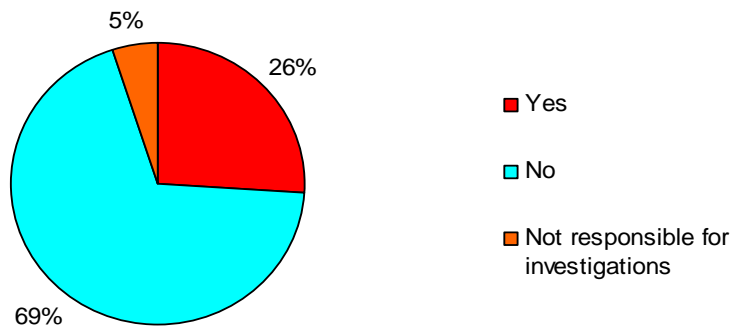
Meetings with Board of Directors



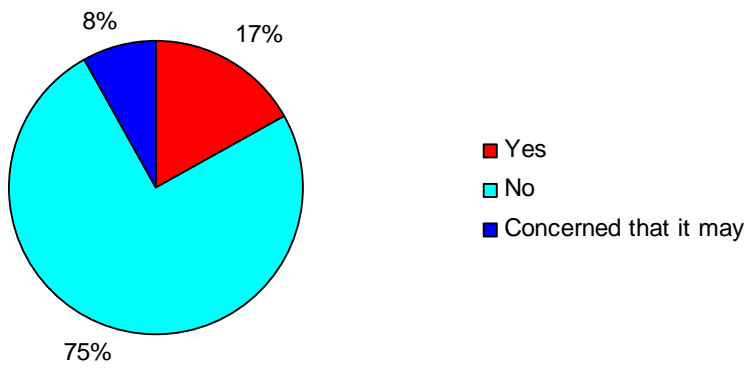
Commentary. The revised Sentencing Guidelines require the board to be “knowledgeable about the content and operation” of the program, while exercising “reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.” Occasional, even annual, meetings of the ethics/compliance officer and the board of directors might be sufficient to meet the knowledgeability requirement of the Guidelines, but *oversight* of its implementation and *effectiveness* seems a much higher standard that might require not only more frequent meetings, but more active participation in the assessment of program effectiveness. Directors might do well to err on the side of aggressive oversight, rather than risk accountability for an ineffective program.

4. Pressures on the Ethics/Compliance Offices. Ninety four per cent of ethics/compliance offices are responsible for investigations into alleged misconduct. One-fourth (26%) of these reported that their performance objectives included an increased rate of case closure over the previous year. Efforts to achieve these objectives caused more than one in four to report either that *the quality of investigations had suffered* as a result (17%) or that they were concerned that this would happen (8%). Nine percent reported that *decisions whether to open a case had been affected*, and another 18% were concerned that such would result from the increased objectives.

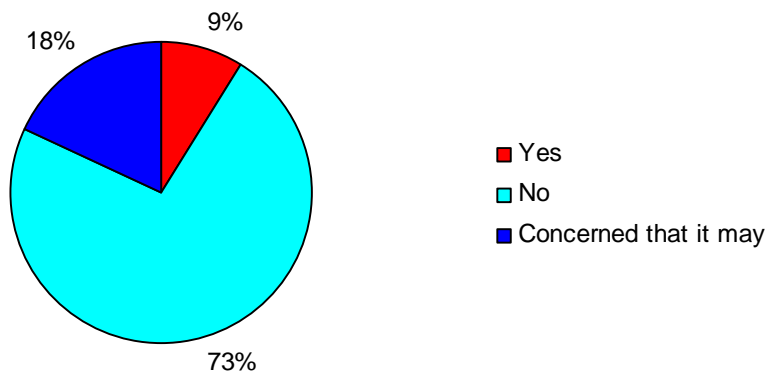
Increased Rate of Case Closure Objective



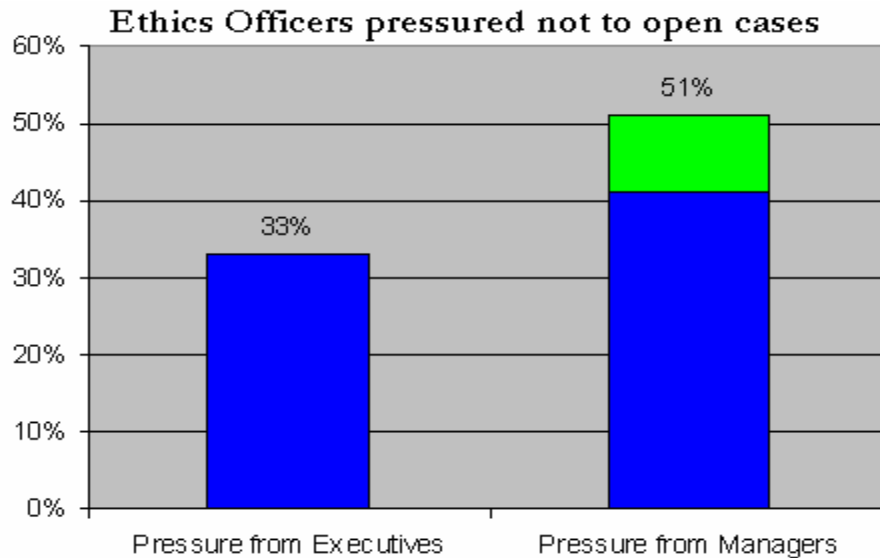
Consequent Decline of Investigation Quality



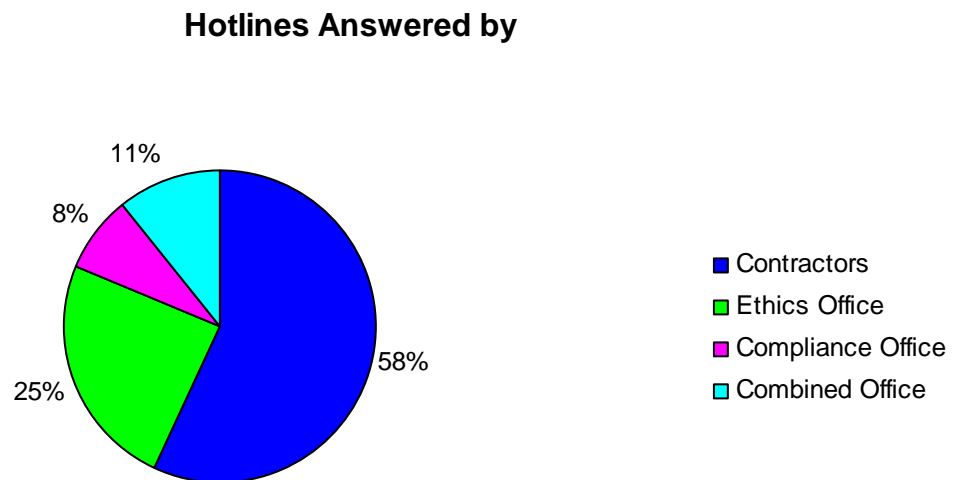
Decision to Open Case Affected



Queried about pressure *not* to pursue an investigation into alleged misconduct, none of the respondents reported experiencing such pressure from members of the Board of Directors. However, *one in three (33%) had felt such pressure from corporate officers, though rarely. More than half (51%) of the ethics/compliance officers had experienced pressure from managers or supervisors not to pursue investigations, with 10% reporting that it occurred frequently.*

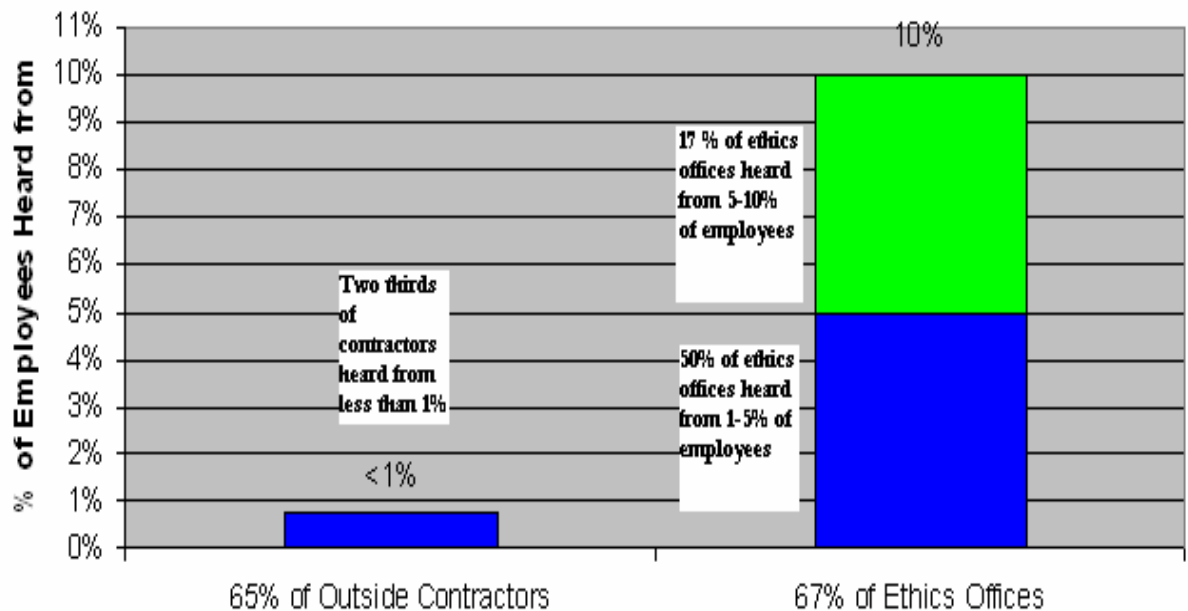


5. “Hotlines/helplines”. Most “hotlines/helplines” for reporting possible misconduct are answered by outside contractors (58%). Where handled internally, these calls are most likely to be answered by the ethics (25%) or compliance (8%) office or, where those functions have been integrated, by the combined ethics and compliance office (11%).



Commentary. The outsourcing of this service is being contemplated by an additional eleven per cent of respondents. Those considering such a move should be aware that *outside contractors, as reported by survey participants, generally experience a lower utilization rate by employees reporting misconduct.* Nearly two-thirds (65%) of outside contractors heard from *less than one per cent* of employees in the twelve months prior to the survey. By contrast, half of the ethics offices heard from one to five per cent of employees, and 17% of ethics offices heard from five to ten per cent of employees during the same period.

Utilization rate affected by who answers hotline



More significantly, when employees call the “hotlines/helplines” seeking advice about situations they face, and the actions they should take, ethics offices are again the preferred resource, with 22% of them reporting that they heard from five to ten per cent of employees, and twice as many (44%) that they received such calls from one to five per cent of employees in their organizations in the prior year. The ethics/compliance officer typically has considerable familiarity with company policies and practices and in many cases can offer immediate assistance to the caller. By contrast, *not one of the respondents outsourcing the ‘hotlines/helplines’ 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.*

6. Causes of misconduct. Perceived causes of misconduct within one’s organization varied, depending on the background of the respondent.

Lawyers considered the most important causes of misconduct to be:

- Ignorance of corporate policies and procedures (2.58*),
- Ignorance of legal and regulatory requirements (3.25) and

- Ignorance of the organization's code of ethics (3.39)

And the least likely causes they considered to be:

- Lack of leadership on ethics/compliance from senior management (5.21*)
- Desire to meet performance expectations (5.92)
- Management's pressure to reach aggressive goals (6.0) and
- Inadequate financial controls (6.54)

By contrast, those who came from a background in management viewed the matter very differently. They perceived the most important causes of misconduct to be:

- Lack of leadership on ethics/compliance from senior management (2.25)
- Management's pressure to meet aggressive goals (3.5)
- Desire to meet performance expectations (3.75)

And the least likely causes they considered to be:

- Ignorance of legal and regulatory requirements (5.67)
- Ignorance of the organization's code of ethics (5.75)
- Ignorance of corporate policies and procedures (6.0) and
- Inadequate financial controls (6.3)

Further, the data show that the perceptions of those with a background in risk management or regulatory affairs are nearer the lawyers' perspective, and those from finance and human resources reflect more closely the views of managers.

Commentary. The perceptions of compliance and ethics officers about the causes of misconduct, whatever those perceptions may be, are likely to inform the content, and possibly the format, of training they provide for employees. They may also affect communications about the purpose and objectives of the ethics/compliance office and its hotlines and helplines. And they may determine what is considered worthy of the time and attention of other corporate officers and the board of directors.

It is also possible that the background of the ethics/compliance officer, to the extent that background is known to employees, may itself affect what employees report to the ethics/compliance office. For instance, knowing that the ethics/compliance office is directed by an attorney may influence employees to report legal--rather than ethical, management or personnel--issues over the hotline or helpline.

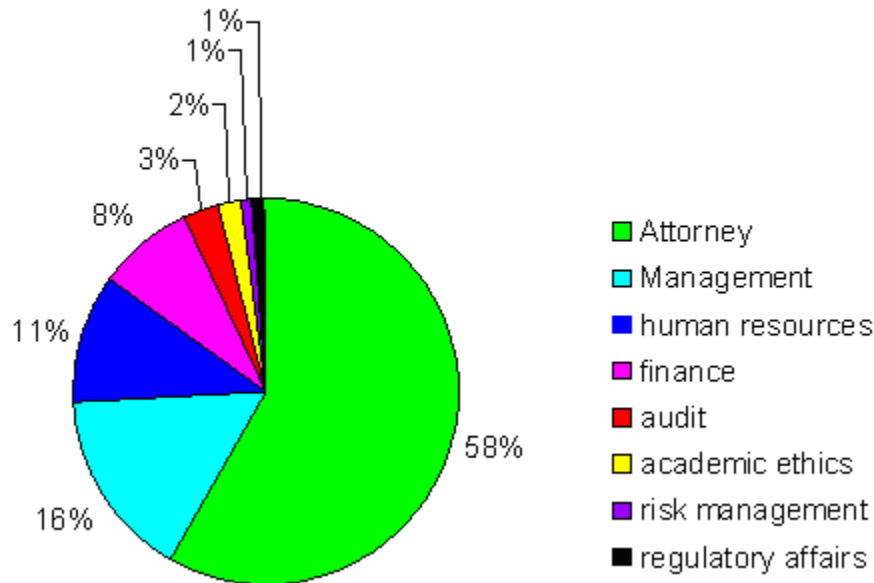
7. Background, preparation and development of ethics and compliance officers.

Respondents, including those not in charge of the ethics/compliance function, were overwhelmingly attorneys by training (58%). Others reported backgrounds in management (16%), human resources (11%), finance (8%), audit (3%), academic ethics (2%), risk management (1%) and regulatory affairs (1%).

* Respondents were invited to rank in order of importance nine possible causes of misconduct, with #1 being the most important cause and #9 the least important. The numbers reported parenthetically here represent the average

rank given by ethics/compliance officers with similar backgrounds. The lower the average number, the more important a particular cause of misconduct to officers with that background.

Backgrounds of Ethics and Compliance Officers



Sixty-one per cent of respondents stated that they received training before assuming their responsibilities as ethics/compliance officers. It is worth noting, however, that nearly one half (48%) of those who reported receiving training prior to assuming their ethics/compliance responsibilities received all or a substantial part of that training outside of formal, company-provided instruction. Specifically, eleven per cent relied on training received at professional conferences they attended; sixteen per cent received relevant training while holding prior positions; and twenty one per cent learned “on the job” from other employees.

Training, however provided, was more likely to address dealing with allegations of misconduct, than with preventing misconduct by advising employees. Training addressed:

- How to respond to employees alleging misconduct by other employees (45%)
- How to conduct investigations into allegations of employee misconduct (52%)
- How to respond to employees with questions about the company’s code of ethics or similar policies on business conduct (35%)
- How to respond to employees with requests for advice about ethics/compliance issues they face at work (35%)

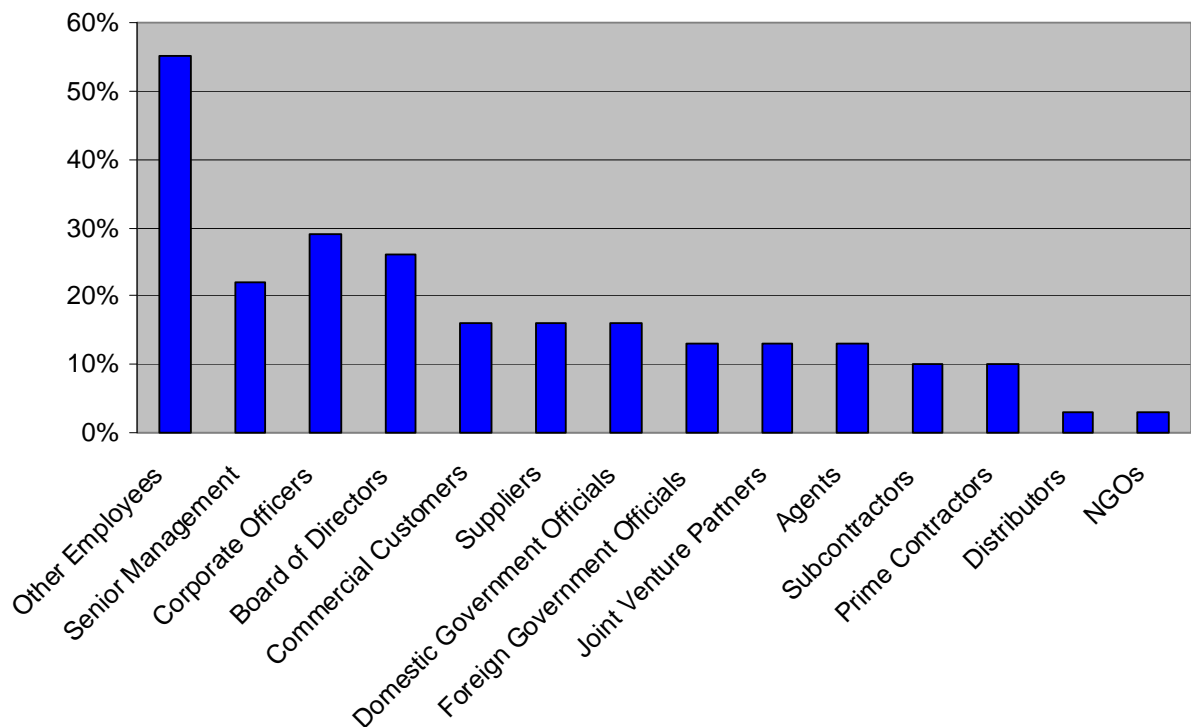
As a result of provided training, ethics/compliance officers were likely to be better prepared for responding to and investigating allegations of employee misconduct, than the possible misconduct of executives and board members. Specifically, of those who received training prior

to assuming their ethics and compliance responsibilities, such training included how to deal with allegations of misconduct involving:

- Other employees (55%)
- Senior management (22%)
- Corporate officers (29%)
- Board of Directors (26%)

Even fewer respondents were trained to handle potential misconduct involving the organization's relationships with its customers, suppliers, regulators and other external parties.

- Commercial customers (16%)
- Suppliers (16%)
- Domestic government officials (16%)
- Foreign government officials (13%)
- Joint venture partners (13%)
- Agents (13%)
- Subcontractors (10%)
- Prime contractors (10%)
- Distributors (3%)
- NGOs (3%)



Those respondents who were taught how to design training programs for their organizations were nearly twice as likely to learn about compliance training (29%) as ethics training (16%), and more likely to be prepared to train corporate officers and managers, than hourly employees or the board of directors:

How to design *compliance* training programs for

- Corporate officers (47%)
- Managers and supervisors (47%)
- Hourly employees (37%)
- Board of Directors (26%)

How to design *ethics* training programs for

- Corporate officers (26%)
- Managers and supervisors (26%)
- Hourly employees (21%)
- Board of Directors (21%)

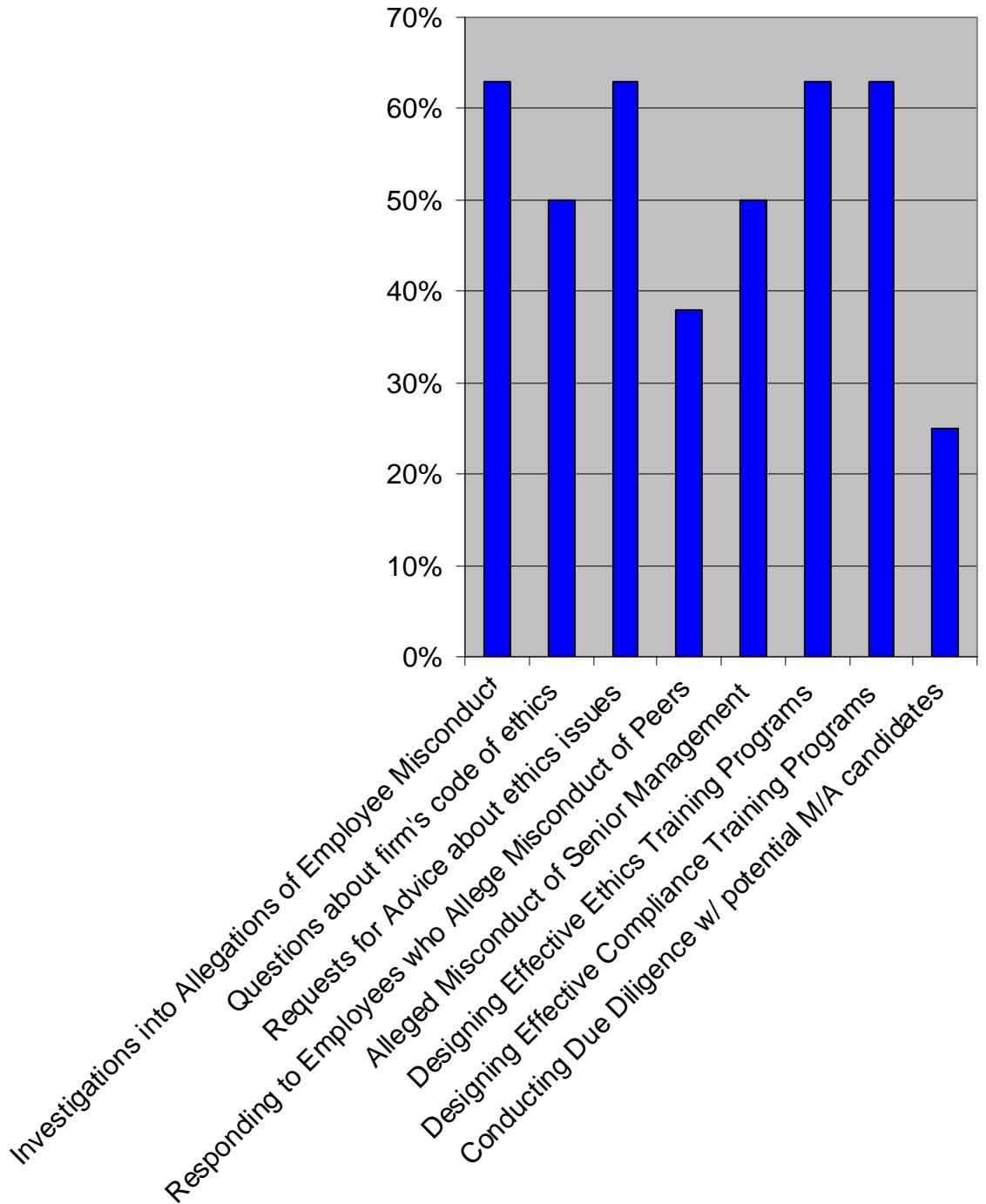
Conducting due diligence regarding the ethics/compliance standards and practices of possible merger or acquisition candidates was a subject of respondents' training in six per cent of the smallest companies (10,000 or fewer employees) and in one third (33%) of companies with 25,000-50,000 employees. Additionally, such training was specifically identified as needed, although not provided, by another one third (33%) of companies with 25,000-50,000 employees, by one fourth (25%) of companies with 50,000-75,000, and another one fourth (25%) of those with 75,000-100,000 employees.

Forty per cent of respondents stated that they received no training before assuming their responsibilities as ethics and/or compliance officers. Of these, approximately one-fourth (27%) said that no training had been needed. Three-fourths (73%) said that training was needed in such areas as:

- How to conduct investigations into allegations of employee misconduct (63%)
- How to respond to employees with questions about the company's code of ethics or similar policies on business conduct (50%)
- How to respond to employees with requests for advice about ethics/compliance issues they face at work (63%)
- How to respond to employees alleging misconduct by other employees (38%)
- How to deal with alleged misconduct of senior management, officers and board members (50%):
- How to design *ethics* training programs for the following (63%):
- How to design *compliance* training programs for the following (63%):
- How to conduct due diligence regarding the ethics/compliance standards and practices of possible merger or acquisition candidates (25%)

Percentage of Untrained Ethics Officers Wanting Such Training

Types of Training Most Wanted



Commentary. Given prior observations, it is not surprising that the majority of respondent ethics/compliance officers have a background in the law; that more of them have been taught to

design compliance training than ethics training; and that they are more likely to be trained how to investigate misconduct, than how to prevent it. It is quite surprising, however, that forty per cent report receiving no training prior to assuming their responsibilities as ethics/compliance officers, and that most of the training provided to their peers in other companies seems to have been external or informal.

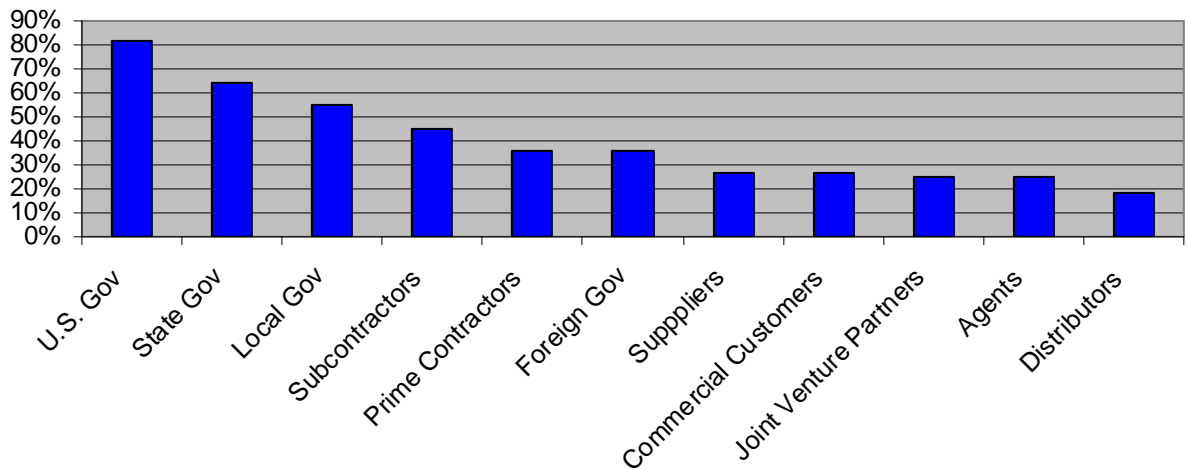
It is encouraging that when asked to consider what training was needed before assuming their responsibilities, respondents recognized equally the need for training to conduct investigations and to advise employees about ethical issues and questions. One might expect that over time the range and utility of preparatory training for ethics/compliance officers will substantially improve, both internally and through professional associations.

8. Due diligence for mergers and acquisitions. Nearly one-third (31%) of respondent ethics/compliance offices have been involved on behalf of their organizations in due diligence regarding the ethics/compliance standards and practices of possible merger or acquisition candidates. Of these, nine percent report that they are involved regularly, another sixty-four percent occasionally, and twenty-seven percent only rarely.

Due diligence most often involved an assessment of the other company's relationships with:

- U.S. government officials and agencies (82%)
- State government officials and agencies (64%)
- Local government officials and agencies (55%)
- Subcontractors (45%)
- Prime contractors (36%)
- Foreign government officials and agencies (36%)
- Suppliers (27%)
- Commercial customers (27%)
- Joint venture partners (25%)
- Agents (25%)
- Distributors (18%)

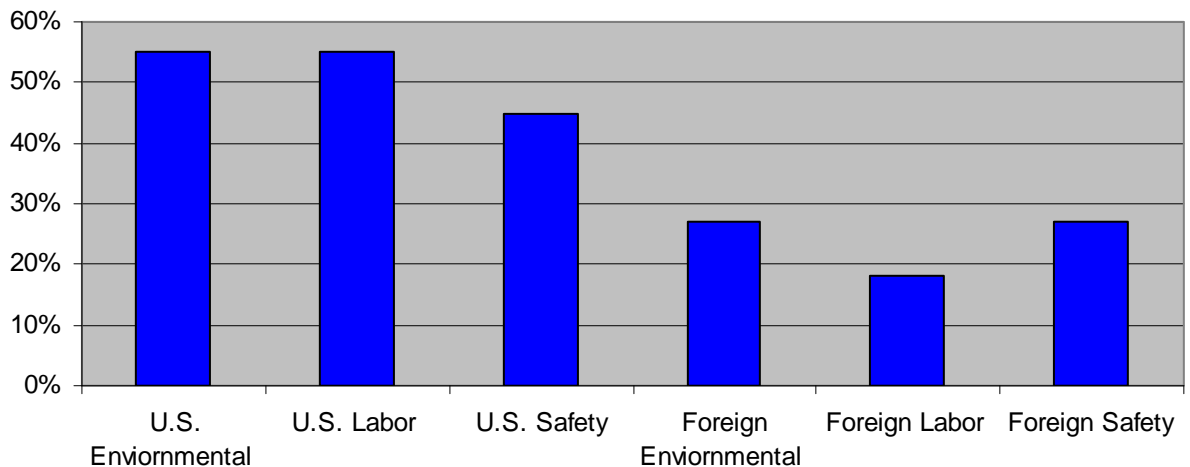
Due Diligence for M&A Target's Relationships With



Due diligence also frequently involved an assessment of the other company's:

- Environmental protection performance in the U.S. (55%)
- Labor relations in the U.S. (55%)
- Workplace safety performance in the U.S. (45%)
- Environmental protection performance in other countries (27%)
- Workplace safety performance in other countries (27%)
- Labor relations in other countries (18%)

Due Diligence for M&A Target's Practices



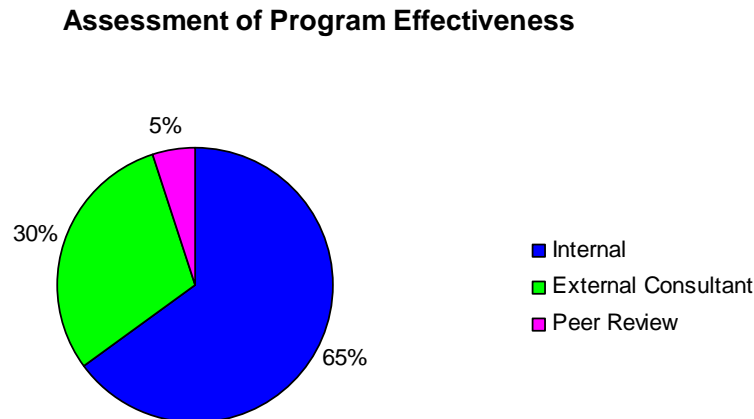
Interestingly, none of the respondents reported conducting due diligence with respect to the other companies' relationships with nongovernmental organizations (NGOs), nor concerning their philanthropic activities in the U.S. or in other countries.

Due diligence also involved assessment of key elements of the other company's ethics/compliance program, including:

- Code of ethics and related policies and procedures (64%)
- Ethics training program (64%)
- Compliance training program (64%)
- "Hotline"/"helpline" (55%)
- Ethics/compliance officer's reporting relationship to senior management (55%)
- Ethics/compliance officer's reporting relationship to the Board of Directors (45%)

Commentary. Given the relatively small sample size and the weighting toward smaller companies, it is surprising and encouraging to find this much involvement of the ethics/compliance personnel in the conduct of due diligence for mergers and acquisitions. Considering both the risks to reputation of acquiring a company whose ethical standards and practices prove inferior to one's own, and the challenges of managing different corporate cultures into congruence, there seems great opportunity for ethics/compliance professionals to contribute substantial value to M&A teams in their evaluation of prospects.

9. Assessments of Ethics/Compliance program effectiveness. The most recent assessment of the effectiveness of the ethics/compliance program occurred in 2006 for twenty-three per cent of the respondents. Another thirty-four per cent of the programs were assessed in 2005. Surprisingly, forty-three per cent reported that no assessment had yet been done, although eleven per cent plan one in the next twelve months.



Most often (65%), program effectiveness has been *internally* evaluated. Thirty per cent hired external consultants to assess the program's effectiveness, and five per cent relied on a peer review by ethics/compliance personnel from another company.

Assessment of program effectiveness typically included the solicitation of input from employees at all levels, through interviews, focus groups and surveys, as well as the examination of

corporate and ethics/compliance department policies and procedures, documentation and other records.

Individual interviews were most likely to be conducted with managers (87%), corporate officers (80%), and first-line supervisors (73%). Surprisingly, individual interviews were *least* likely to be conducted with members of the Board of Directors (33%), with more companies reporting individual interviews with hourly employees (40%) than with board members.

Group interviews mostly targeted hourly employees (60%), with managers (20%) and supervisors (20%) participating less often in such forums.

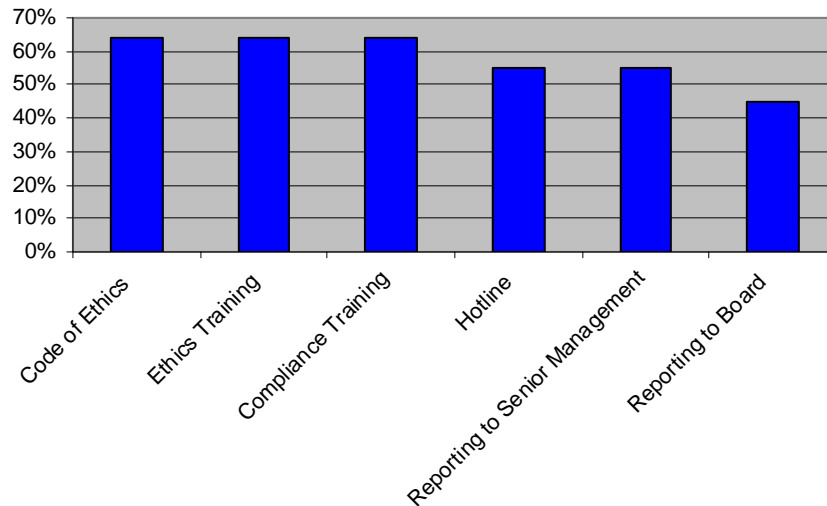
Surveys proved the most popular way of soliciting employee participation in the program assessments:

- Hourly employees (88%)
- First-line supervisors (50%)
- Managers (50%)
- All employees and managers (13%)

Corporate and departmental policies, procedures and records also were examined as part of the assessment, especially as these pertained to

- The operations of the ethics/compliance “hotline / “helpline” (84%)
- Confidentiality of communications to the ethics/compliance office (74%)
- Confidentiality of ethics/compliance office investigations (63%)
- The mission of the ethics/compliance office (63%)
- Interpretations by the ethics/compliance office of the company’s code of ethics (53%)
- Due process for employees accused of misconduct (42%)
- Interpretations by the ethics/compliance office of the corporate policies and procedures (37%), and
- Coordination of the corporate ethics/compliance office activities with those of
 - Human resources department (32%)
 - Law department (32%)
 - Internal audit (26%)
 - Corporate security (21%)
 - Ethics/compliance offices in divisions or subsidiaries of the company (21%)

Documents and Procedures Examined in Program Evaluation



Ethics training and compliance training were equally likely to be examined at all levels of the organization in assessing program effectiveness:

Ethics training for

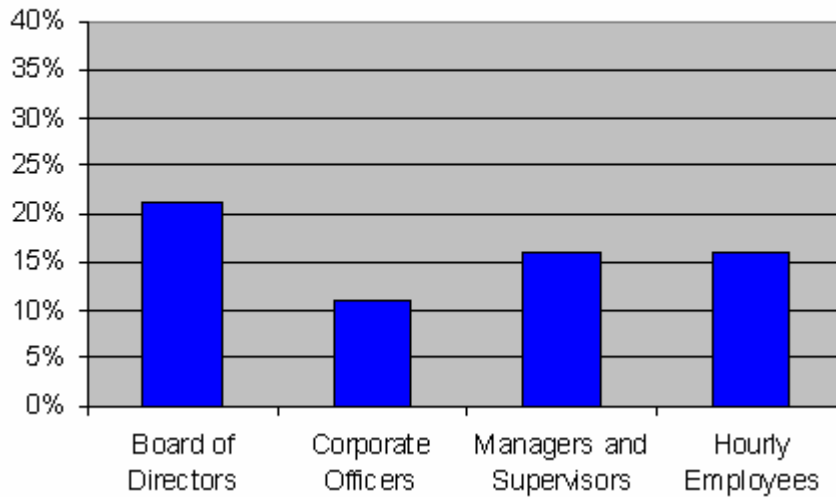
- Board of Directors (42%)
- Corporate officers (42%)
- Managers and supervisors (47%)
- Hourly employees (42%)
- Board of Directors and all officers, managers and employees (5%)

Compliance training for

- Board of Directors (42%)
- Corporate officers (42%)
- Managers and supervisors (42%)
- Hourly employees (42%)

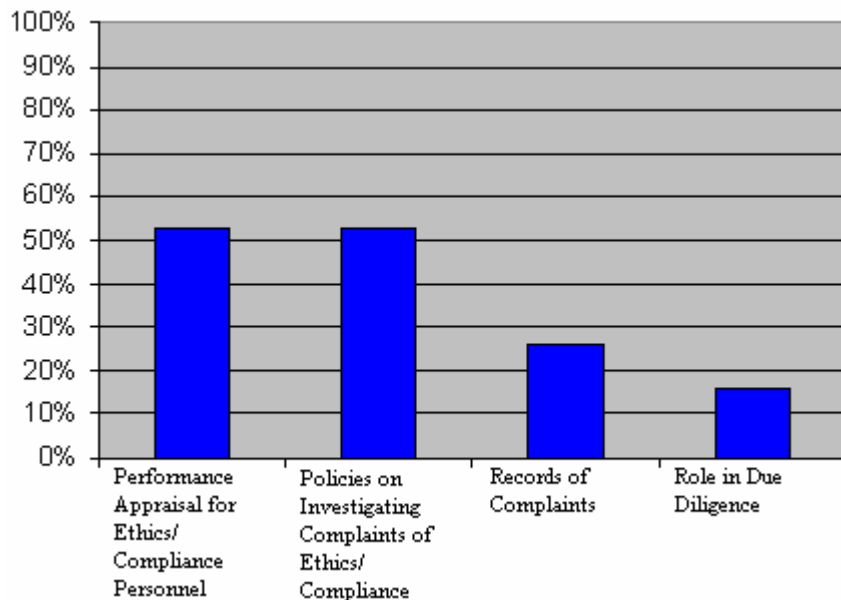
Remarkably, only one in five respondents examined whether ethics/compliance office recommendations had been implemented by the Board of Directors (21%), and fewer still looked for follow through by corporate officers (11%), managers and supervisors (16%), or hourly employees (16%).

Percent of Personnel Following Recommendations



Also examined as part of the ethics/compliance program assessment were:

- Performance appraisal policies and procedures for ethics/compliance office personnel (53%)
- Policies and procedures for investigating complaints about the ethics/compliance office (53%)
- Records of complaints about, and investigations of, the ethics/compliance office (26%)
- The role of the ethics/compliance office in due diligence for mergers and acquisitions (16%)



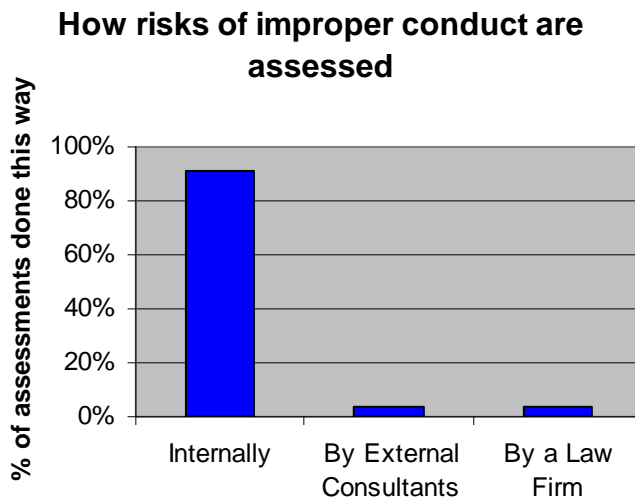
Commentary. Although forty-three per cent of respondents had yet to undertake any assessment of their program's effectiveness, that number may not reflect the level of activity among larger organizations. But even were it reflective of the entire universe of programs, it is perhaps of less concern than that *two-thirds of those who have evaluated their ethics/compliance*

program have seen no need for an independent, objective assessment, relying instead on an internal perspective.

Are these self-assessments able to identify or correct a disregard for board input on program development and evaluation? Do they discover the absence of due-process protections for employees accused of misconduct? How will they find that ethics/compliance recommendations to the board and senior management aren't implemented, if they don't even think to check? If ethics and compliance training aren't scrutinized by more than half of the respondents as part of the overall program assessment, what is the substance of these self-assessments? And who is checking the checkers? Why are there so few self-assessments examining the policies and procedures for dealing with possible short-comings, and even misconduct, within the ethics/compliance function?

10. Assessment of the risk of unethical and illegal conduct. The most recent assessment of the risk of improper conduct occurred in 2006 for forty per cent of the respondents. Another fourteen per cent of the respondents reported that risks had been last assessed in 2005. Surprisingly, more than one third (34%) reported that no risk assessment had yet been done, and only three per cent plan one in the next twelve months.

Most often (91%), the risks of improper conduct have been *internally* assessed. Four per cent hired external consultants to assess the organization's risks, and four per cent retained a law firm for that purpose.



Among the actions taken as part of the risk assessment were the following:

Individual interviews with

- Members of the Board of Directors (15%)
- Corporate officers (95%)
- Managers (80%)

- First-line supervisors (25%)
- Hourly employees (10%)
- U.S. government officials and agencies (10%)

Group interviews with

- Managers (50%)
- First-line supervisors (38%)
- Hourly employees (38%)

Surveys of

- Corporate officers (11%)
- Managers (22%)
- First-line supervisors (11%)
- Hourly employees (33%)
- All employees and managers (33%)

Commentary. Between interviews and surveys, respondents would seem at least to have adequate opportunity for input from officers, managers and other employees. It is curious, however, that so few indicate seeking the perspective of Board members, who collectively should represent a broad perspective on how things can and do go wrong in organizations. Moreover, if well informed about issues that have arisen through ethics and compliance activities, directors might be uniquely positioned to anticipate current and likely future risks that may confront the organization.

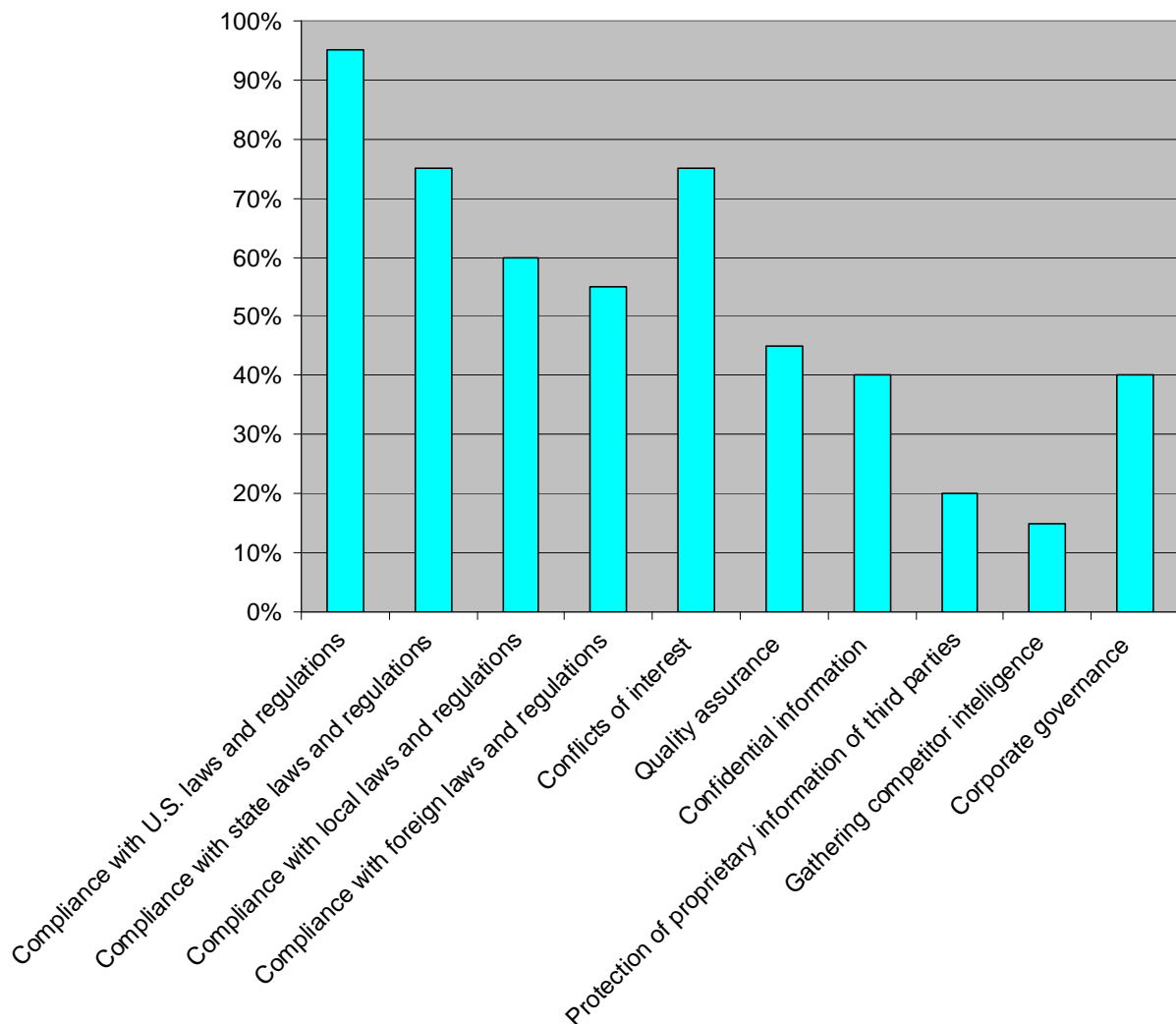
Other actions taken as part of the risk assessment included examination of the corporate and departmental policies, procedures and records pertaining to:

- Compliance with U.S. laws and regulations (95%)
- Compliance with states laws and regulations (75%)
- Compliance with local laws and regulations (60%)
- Compliance with foreign laws and regulations (55%)
- Conflicts of interest (75%)
- Quality assurance (45%)
- Proprietary information (45%)
- Confidential information (40%)
- Protection of proprietary information of third parties (e.g. suppliers, joint venture partners, et. al.) (20%)
- Gathering competitor intelligence (15%)
- Corporate governance (40%)
- Workplace health and safety (30%)
- Environmental protection (30%)
- Procurement (30%)
- Contracting (30%)
- Revenue recognition (30%)
- Marketing (25%)
- Sales (20%)

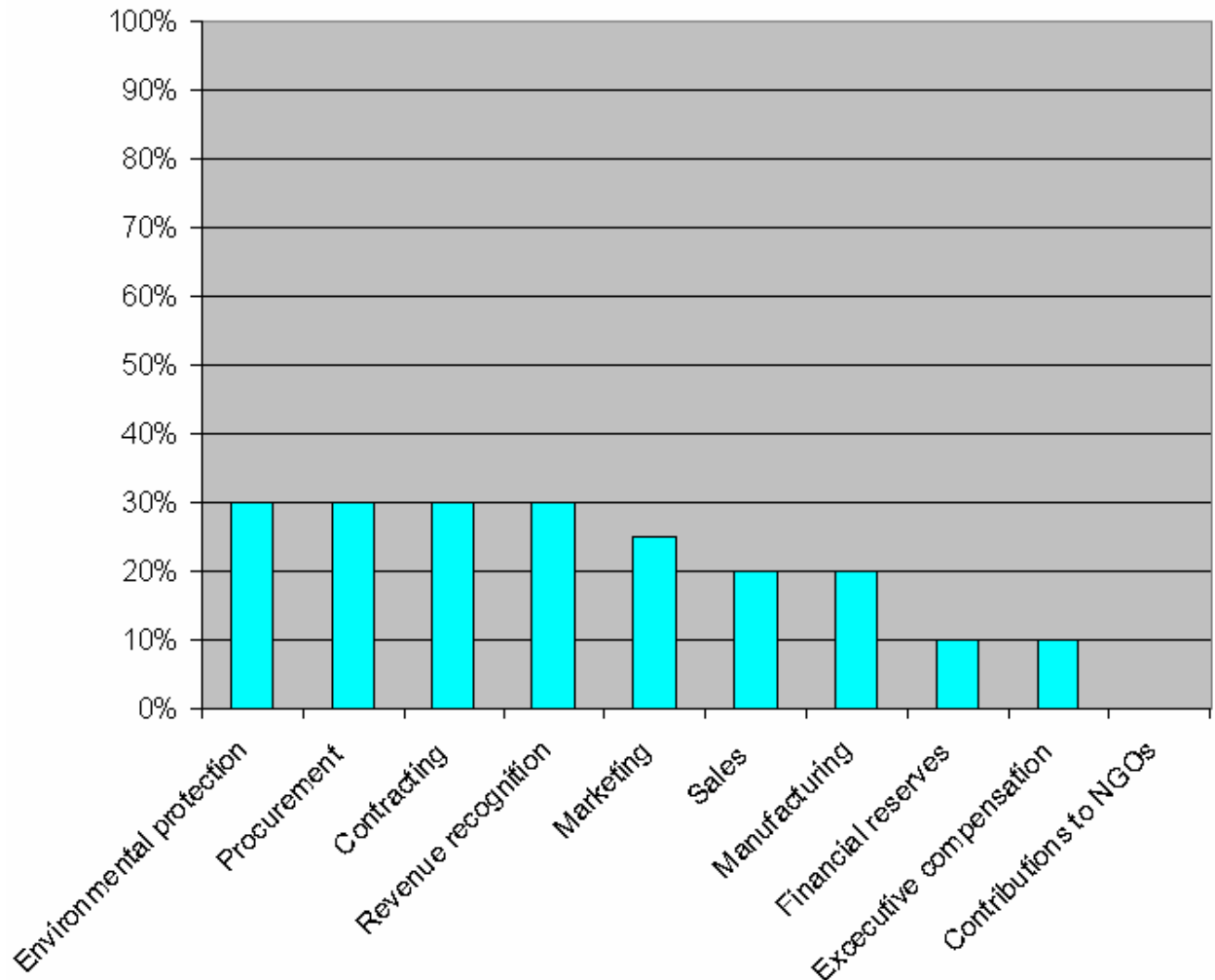
- Manufacturing (20%)
- Financial reserves (10%)
- Executive compensation (10%)
- Contributions to NGOs (0%)

Commentary. Clearly, respondents’ review of documents pertaining to corporate “policies, procedures and records” is focused on those documents that pertain directly to legal compliance in general, but not to particularly vulnerable areas of non-compliance risks, such as the protection of sensitive information (the company’s own and that of others) and possible procurement and contracting fraud. Given headline problems that companies have experienced in recent years in areas such as revenue recognition, financial reserves, executive compensation, and the improper possession or use of competitors’ proprietary data, the lack of attention to these issues in a risk assessment is startling.

Policies, Procedures, and Records Examined



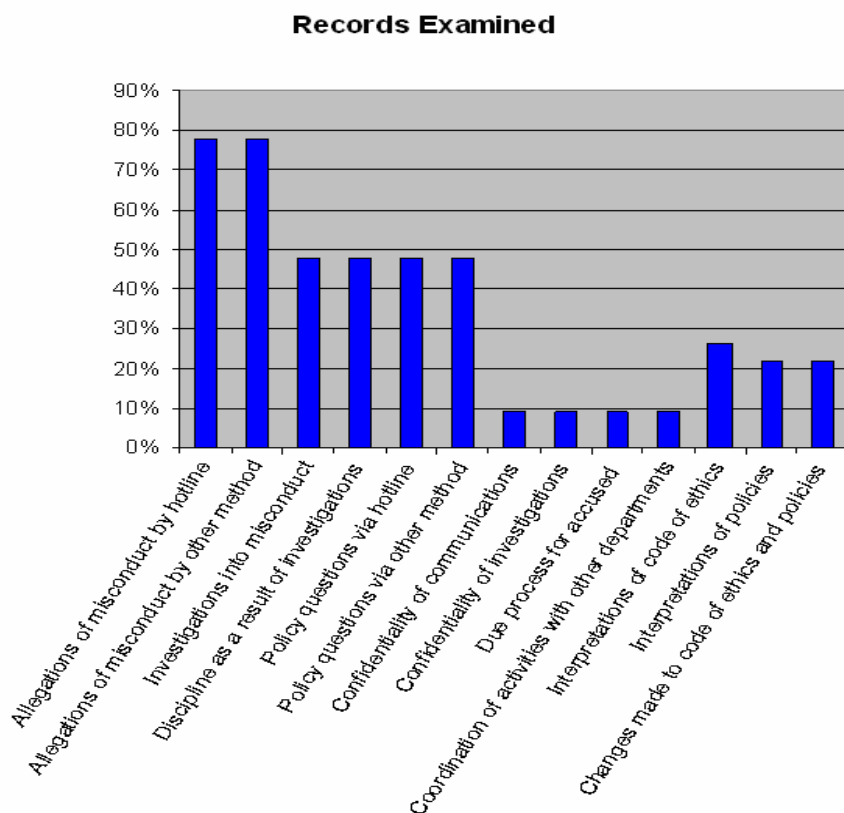
Policies, Procedures, and Records Examined



Additional actions taken as part of the assessment of the risks of unethical and illegal conduct involved examination of the ethics/compliance office's records pertaining to:

- Allegations of misconduct communicated to the ethics/compliance office through the ethics/compliance "hotline" / "helpline" (78%)
- Allegations of misconduct communicated to the ethics/compliance office by means other than the ethics/compliance "hotline" / "helpline" (78%)
- Investigations into alleged misconduct conducted by the ethics/compliance office (48%)
- Disciplinary actions taken as a result of ethics/compliance office investigations (48%)
- Questions about company policies communicated to the ethics/compliance office over the ethics "hotline" / "helpline" (48%)
- Questions about company policies communicated to the ethics/compliance office by means other than the ethics "hotline" / "helpline" (48%)

- Confidentiality of communications to the ethics/compliance office (9%)*
- Confidentiality of ethics/compliance office investigations (9%)*
- Due process for employees accused of misconduct (9%)
- Coordination of ethics/compliance office activities with those of
 - Ethics/compliance offices in divisions or subsidiaries of the company (17%)
 - Human resources department (17%)
 - Law department (13%)
 - Internal audit (13%)
 - Corporate security (13%)



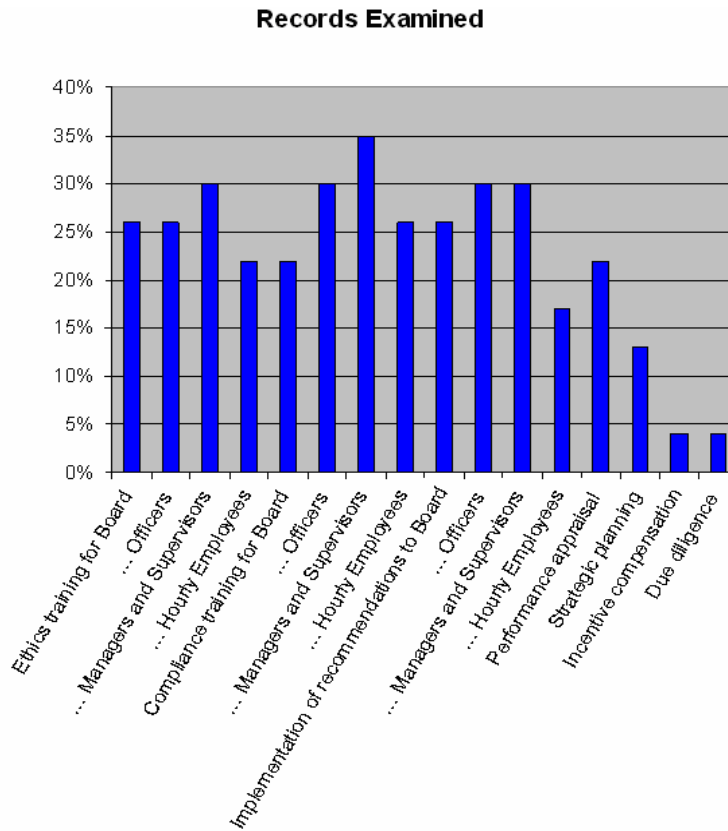
- Interpretations by the ethics/compliance office of the company's code of ethics (26%)
- Interpretations by the ethics/compliance office of corporate policies and procedures (22%)
- Changes made to the company code of ethics and related corporate policies and procedures (22%)

Assessment of the risks of unethical and illegal conduct also involved examination of the ethics/compliance office's records pertaining to:

- Ethics training for
 - Board of Directors (26%)
 - Corporate officers (26%)

* The apparently low level of consideration given to issues of confidentiality in communications with and investigations by the ethics/compliance office is less surprising than it seems at first. Ethics and compliance officers explained to us that confidentiality issues were covered in the assessment of program effectiveness, providing sufficient data for risk assessment as well.

- Managers and supervisors (30%)
- Hourly employees (22%)
- Compliance training for

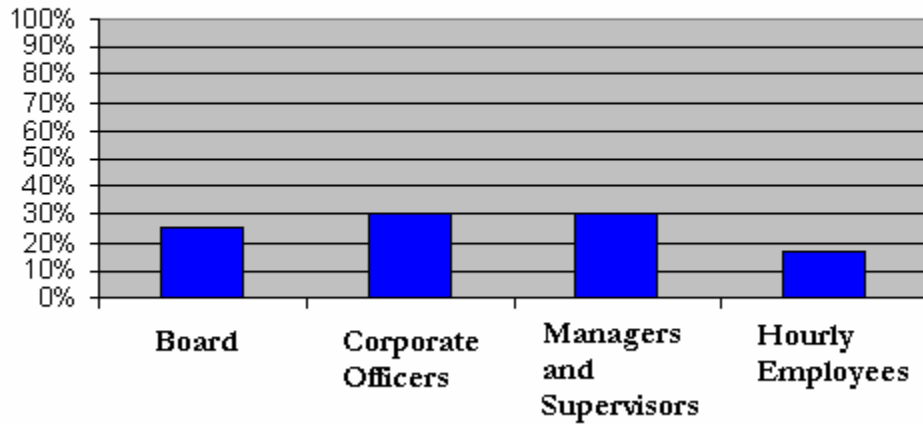


- Board of Directors (22%)
- Corporate officers (30%)
- Managers and supervisors (35%)
- Hourly employees (26%)
- Implementation of ethics/compliance office recommendations made to
 - Board of Directors (26%)
 - Corporate officers (30%)
 - Managers and supervisors (30%)
 - Hourly employees (17%)

- The performance appraisal process (22%)*
- The strategic planning process (13%)*
- Incentive compensation program (4%)*
- Due diligence in mergers and acquisitions (4%)*

* Authors' Note: Regarding the last four statistics in the risk assessment data above, it should be noted that including three of these topics only as part of Question 39 was a design error. The fourth, mergers and acquisitions, was treated more fully in Questions 40 and 41. The other three—performance appraisals, strategic planning and incentive compensation—also were meant to be explored beyond the context of ethics/compliance office records. Failure to do so is regrettable, but will be corrected in future research.

Follow up of Ethics/Compliance Office Recommendations done by



Commentary. Although checking whether ethics/compliance office recommendations were implemented was somewhat more likely to occur in the course of an organizational risk assessment than during an evaluation of the effectiveness of the ethics/compliance office, at best no more than 30% included such follow-up when assessing risks of misconduct. If ethics/compliance office recommendations are ignored or not implemented, it would seem that whatever risks those recommendations addressed would be likely to continue or to increase. In any event, once recommendations have been made, especially to the board and senior management, the ethics/compliance office has a professional obligation to follow-up to ensure implementation. Risk assessment, whether internally or externally conducted, should as a matter of course inquire about such possible recommendations and their status. Identifying and evaluating risks of misconduct is only the *beginning* of the process of managing those risks.

Concluding Observations and Recommendations

We caution again that the data reported herein is from a relatively small number of companies, most of whom have 10,000 or fewer employees. Cautions and concerns raised by respondents, and by us in our commentary, may therefore not be representative of the situation faced by other companies or their ethics/compliance officers. To those who participated in this research, our sincerest thanks and to you, and others who may find the data and analysis germane to their own companies and situations, we offer these recommendations:

1. **Independent, objective assessment.** The revised Sentencing Guidelines are clear that senior management and the board of directors have a shared responsibility to *ensure that the ethics/compliance program is effective*. The effectiveness of an organization's ethics/compliance program should be assessed by an independent, objective and experienced provider of such services, not by internal staff. Such assessments should be done regularly, engaging different vendors to gain the insights of their varied backgrounds and experience.
2. **Critical information flow.** Organizations should examine the level of employee utilization of hotline and helpline services. Closely consider how and by whom these services are provided. Outsourcing these services or placing them under the General Counsel's supervision will not encourage employees to seek advice on proper conduct and may reduce their willingness to report misconduct as well. Only inviting reports of misconduct misses the opportunity to provide advice and to answer questions that might clarify standards and expectations and reduce the risk of misconduct.
3. **Ethics/compliance leadership.** The most important qualifications for an ethics/compliance professional are integrity and competence. There is no shortage of either of these traits in the legal profession. Nonetheless, both data and comments from respondents suggest that a lawyer might not be the most effective choice to lead the ethics/compliance function. Lawyers face special hurdles that should be considered in hiring, reporting relationships and succession planning for ethics/compliance.
4. **Pressures on ethics/compliance personnel.** Ethics/compliance officers, like everyone else, respond to performance expectations, incentives and rewards and, like everyone else, can sometimes experience these as unwanted and negative pressures to do less than their best. If ethics/compliance officers feel pressure to close cases faster, or not to pursue certain cases, they should talk to someone higher than the source of the pressure. If necessary, the matter should be taken outside management to the lead director, chair of the audit committee, or another independent board member. Ethics/compliance officers must be free to exercise independent, professional judgment about which matters to pursue and how best to do so.

5. **Professional development.** Professional training not offered in the past is available now for ethics/compliance personnel. Such training is an important investment for a company's current program, as well as for succession planning. Give careful consideration to the range of training and development opportunities identified by respondents, especially those not provided, but needed.

Report prepared by
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