

# Ethics and Compliance Responsibilities of the Board

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*This paper is addressed to Board Members who want to fulfill their ethics and compliance responsibilities, and to the General Counsels, Corporate Secretaries and Compliance Officers who support the Board in their efforts. It will be especially useful for companies with significant operations and incorporated entities in the United Kingdom and the United States.*

## Duty to act in the best interests of the company

The fundamental duty of the board member is “to act in the best interests of the company.”<sup>2</sup>

This is not just a legal responsibility, but an ethical one. When shareholders elect directors, we trust that they will represent our interests to the best of their abilities.<sup>3</sup> The UK Companies Act provides guidance that board members of any jurisdiction are well advised to heed.

*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—*

- (a) The likely consequences of any decision in the long term,*
- (b) The interests of the company's employees,*
- (c) The need to foster the company's business relationships with suppliers, customers and others,*
- (d) The impact of the company's operations on the community and the environment,*
- (e) The desirability of the company maintaining a reputation for high standards of business conduct, and*
- (f) The need to act fairly as between members of the company.”<sup>4</sup>*

Board members need to take ethical criteria into account in their own actions and decisions. As with so much else in modern life, this ethical mandate has become regulated in many aspects. For example, the UK Companies Act and various SEC regulations attempt to define conflicts of interest and demand transparency and/or recusal when it happens. Good boards recognize that autonomy from management is not a legal mandate but essential for good governance and will take all appropriate actions to ensure that they are perceived as such.

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<sup>2</sup> UK Companies Act, section 172.

<sup>3</sup> This trust is enshrined in various laws in the US as having a “duty of care” and a “duty of loyalty.”

<sup>4</sup> UK Companies Act, section 172.

A review of corporate scandals where boards or board members are involved reveal several other areas where board members must be sure their ethical headlamps are on.

**Insider Trading.** This should be a low risk area for the savvy, experienced people who become directors of corporations, but if Rajat Gupta, then board member of Goldman Sachs and Proctor & Gamble, can screw up, anything is possible.

**Conflicts of Interest.** Chesapeake Energy's board approved special deals for its CEO and founder that appeared to create a potential conflict between his interests and that of the company's, and raised questions about their independent judgment. CEO Aubrey McClendon is now leaving the company. The News Corp. board received tremendous criticism for placing their loyalty to the CEO (Rupert Murdoch) over shareholders of the company during the multiple scandals that unfolded in 2011/2012.

**Mergers, divestitures and acquisitions.** Del Monte and Barclays paid fines due to a perceived conflict of interest (Barclays made money from the buyer and the seller, and the Board approved.). More common is the saga unfolding at Dell, where board members have been accused of being too closely aligned with the CEO who wants to take the company private, instead of representing all shareholders.

**Responding to bad news/crisis.** This can be big, as when some fault BP's board for not getting an American out in front of the issue in the media immediately after the tragic explosion in the Gulf, or Penn State's board in their handling of the child molestation allegations. It can be about less public bad news as well. Best Buy's Founder and Chairman lost his job after mishandling an allegation that his CEO was involved in an inappropriate relationship with another employee. And pension funds (along with the media) asked Wal-Mart's board where they were when allegations of rampant corruption in their Mexican real estate operations—including allegations made directly to some board members.

**Hiring/firing the CEO.** Boards can fail their ethical obligations here in many ways. They can fail to do due diligence. Almost half of HP's board failed to meet with a prospective CEO before he was hired. Leo Apotheker lasted less than a year. They can fail to hold CEOs accountable after learning about misconduct. For example, Bausch & Lomb's board, upon hearing that their CEO falsified his resume, decided that reducing his bonus was sufficient because he was such a valued performer. Several legal missteps later, Bausch & Lomb's new CEO was someone who had built his career as an ethics and compliance officer. Or finally a board can get everything wrong. Yahoo's board did not ensure due diligence sufficient to detect resume falsification by a new CEO, then after they found out decided they could overlook it, and finally caved and let him go in a firestorm of criticism.

To recap, Boards of Directors must obey the law, avoid conflicts of interest, act ethically, set the right tone and hold management accountable for principles and performance. None of this may be particularly revelatory for the members of most boards, who understand the importance of their roles as guardians of the firm. However, in addition to incorporating ethical criteria in their own decision making, board members are also charged with ultimate oversight of their company's ethics and compliance program, to which the remainder of this paper is devoted.

## **Duty to oversee ethics and compliance programs**

In the US, the Principles of Federal Prosecution of Business Organizations emphasize the role of the Board:

*In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct. For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are internal audit functions conducted at a level sufficient to ensure their independence and accuracy; and have the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law.<sup>5</sup>*

The United States Sentencing Guidelines for Organizations, widely used by prosecutors, regulators and monitors in evaluating the effectiveness of a compliance program, also highlight the role of the Board.

*The organization's governing authority (Board) 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.<sup>6</sup>*

As part of this oversight, the Board is charged with receiving periodic reports from the ethics and compliance officer, providing direct access to that officer, and receiving training appropriate to board member roles and responsibilities.

UK guidance for Board oversight is not as broad as in the US, but the UK Bribery Act allows companies to defend themselves from bribery charges when an employee or agent bribes on their behalf, if they can demonstrate adequate procedures designed to prevent employees and agents from such bribery. The UK government provides companies six principles to use in setting up "adequate procedures," the second of which is "Top Level Commitment." It reads

*The top-level management of a commercial organisation (be it a board of directors, the owners or any other equivalent body or person) are committed to preventing bribery by persons associated with it. They foster a culture within the organisation in which bribery is never acceptable.<sup>7</sup>*

In most large multinationals the primary responsibility for oversight is assigned to the Audit Committee or an Ethics Committee. This is appropriate. However the entire Board has responsibilities as well. All Board members should be satisfied that the ethics and compliance program is functioning as it should. And Board members need to be vigilant in assessing whether the company's leaders, including fellow board members and themselves, are living up to the "high standards of business conduct" called for in the UK Companies Act.

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<sup>5</sup> US Principles of Federal Prosecution of Business Organizations, incorporated into the US Attorneys' Manual.

<sup>6</sup> US Sentencing Guidelines for Organizations.

<sup>7</sup> UK Bribery Act, Guidance about commercial organisations preventing bribery

## Elements of an effective compliance program—the basics

The elements of an effective ethics and compliance program (according to the US Sentencing Guidelines) are presented side by side with the UK Principles to guide organizations in preventing bribery in Table 1 (attached). As the table suggests, there is almost complete overlap between the UK Principles to develop adequate procedures to prevent bribery and the US elements of an effective ethics and compliance program. This reduces the complexity of the board responsibility, but underscores the need for genuine oversight.

**Table 1:** Comparison of principles to guide organisations in preventing bribery (UK Bribery Act) with elements of an effective compliance program (US Sentencing Guidelines)

UK Principle	US Sentencing Guidelines
1. Proportionate procedures	Clear standards and procedures
2. Top level commitment	Board knowledge and oversight, management assurance, single leader with responsibility, authority, resources and access
3. Risk assessment	Assessment of risk to inform all elements of compliance program
4. Due diligence	Do not hire or promote leaders who are unethical
5. Communication and training	Communication and training
6. Monitoring and review	Monitoring (including upward reporting), assessment and remediation
	HR processes that align incentives and discipline with compliance program goals

## Elements of an effective compliance program—the reality

The bar for what constitutes an effective compliance program is higher now than it used to be, and is higher for larger companies and for companies that have faced challenges in the past. Programs must be real, not “tick the boxes,” as emphasized in the Principles of Federal Prosecution of Business Organizations:

*Indicting corporations for wrongdoing enables the government to be a force for positive change of corporate culture . . . Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed, implemented, reviewed, and revised, as appropriate, in an effective manner.*<sup>8</sup>

The US Sentencing Guidelines clarify further.

*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*

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<sup>8</sup> US Principles of Federal Prosecution of Business Organizations, incorporated into the US Attorneys' Manual.

*organizational culture that encourages ethical conduct and a commitment to compliance with the law.*<sup>9</sup>

Morgan Stanley is an example of a company that reaped the benefits of having a “real” compliance program. The US Department of Justice and the Securities and Exchange Commission charged a Morgan Stanley employee in China with violations of the Foreign Corrupt Practices Act. However they declined to charge Morgan Stanley, citing their Compliance Program that included

- Clear written standards that were updated periodically to account for developments in the law and evolving business risks.
- Documented, frequent communications with employees regarding compliance, including training and certifications.
- Reporting mechanisms for employees.
- Controls to detect improper payments and ongoing monitoring, with special attention paid to high-risk regions or activities.
- Comprehensive and documented risk-based due diligence of third parties and potential business partners.
- Ongoing assessments, audits, and remediation of problems.

When investigators went to the accused person’s office after learning of allegations, they even found the firm’s anti-bribery policy on top of his desk! In the case of Morgan Stanley, a regional compliance professional had assessed the high risk of bribery in the region, and aggressively trained and communicated to all employees the firm’s standards. He worked to shape the culture of the organization, and given that only one employee was charged, was apparently successful (often in cases like this many employees are involved.)

Prosecutors, regulators and monitors want to know if the program is effective, not just on paper. Does it impact the behaviors of employees? Does it foster a culture of integrity?

Board members know that they can seemingly discharge their compliance oversight responsibilities and still be exposed to risk—at least reputationally—if information is not flowing to them appropriately or if the tone at the top is bad or inconsistent. How does a Board engage in appropriate oversight given this reality? The following section offers practical guidance to improve Board oversight.

## **Effective board oversight of ethics and compliance**

Using the US Sentencing Guidelines as an organizational schema, key weaknesses in ethics and compliance programs are identified. Understanding where one’s corporation is in regard to these weaknesses will help board members determine whether the ethics and compliance program they are overseeing is a paper program or an effective one.

### **Risk Assessment**

This has been a rich field for consultants, yet many companies miss the mark. First, the overall Enterprise Risk Management/Process (ERM/ERP) rarely provides sufficient guidance for

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<sup>9</sup> US Sentencing Guidelines for Organizations.

identifying and prioritizing ethics and compliance risks. Second, because the Sentencing Guidelines call for an assessment of criminal risk, many fail to consider the kinds of ethical risks that can be far more costly to a company than a legal fine. Mattel had legal liability when suppliers used lead paint; the far greater cost was damaging trust in the brand. And finally, some E&C functions ignore vast areas of risk because they are not responsible for mitigation in these areas (e.g., safety, employment practices.) The risk assessment should be an assessment of the major ethical and legal risks the firm faces, including what areas and businesses face higher levels of risk. Mitigation is a separate (and equally important) issue. The Board must ensure that the process is thoughtful and that major issues do not slip through the cracks because it was “somebody else’s job.”

### **Standards**

In theory, this covers all compliance related policies and procedures. In practice, the Board should focus on the Code of Conduct. Is it written clearly given the demographics of the readers? Is it written to help employees do the right thing, or as a “cover your ass” exercise by management or lawyers? Is it distributed in a way that makes sense for the workforce? (Paper books for an organization of networked 20-somethings make no sense.) Does it emphasize the real risks the company faces? Is it short and relevant enough that a board member would read it? Unfortunately many Codes miss some or all of these marks. Codes set the tone for the rest of the program, and the company needs to get this right.

### **Communications and Training**

Effective training—for the Board or other employees—needs to meet the smell test of employees and a skeptical outsider, like a US Attorney General. Would an Attorney General reviewing the training content and attendance documents believe training indicated a genuine commitment to ethics and compliance in light of the risks and circumstances in your company and industry?<sup>10</sup> Would employees find it credible? We have talked to many employees whose experience with off the shelf computer based training is so bad that their faith in the commitment of management to do the right thing diminishes rather than improves.

### **Company leadership**

The Guidelines 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. The two biggest challenges for leaders in this regard are in accountability (see below) and a balanced approach in communications and decisions. Out of balance leaders only talk about financial performance and only take seriously financial metrics. Balanced leaders also talk about other key principles of the company (e.g., safety, integrity, respect, innovation), and consider metrics in these areas in making decisions.

### **Ethics and compliance office structure**

The Guidelines note that the Ethics Officer should report to and have access to the Board or designated Board Committee, and that the Board should ensure that this person has adequate resources to do the job. In practice, the best programs we have seen feature a strong relationship between the Ethics Officer and the Chair of the appropriate Board Committee. Nothing can replace this informal relationship. However the Board should institute other measures, like going into

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<sup>10</sup> The DoJ *Principles* advise that “prosecutors should determine “*whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it.*”

executive session with the EO at least annually. A key question to ask in an executive session is “is the E&C function structured right?” Many still report to the General Counsel, and there is widespread skepticism amongst regulators and the E&C profession that this is the right structure for the firm. Also ask: “Does E&C have the right resources to drive the program throughout the organization?”<sup>11</sup> And “What can we do to help?”

### **Accountability and HR practices**

The 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. In general, boards will want to ensure that human resource processes support the firm’s stated goals in performance and principles. Specifically, reviewing the consequences flowing from misconduct involving high level leaders or “stars” to ensure appropriate disciplinary action is an important role for Boards.

### **Auditing, monitoring and assessment**

Companies benefit when employees and contractors raise potential issues of misconduct promptly. Yet many alternative reporting channels such as Hotlines are minimally marketed or positioned as a last resort. Review the marketing and metrics of upward reporting. If there are outliers within the business (or the entire firm is an outlier!) ask for explanations.

Board members will also want to know that high risk areas are monitored, and that the program is being periodically assessed.

### **Culture**

When a policy and “the way things are usually done around here” conflict, the latter wins. Culture prevails. Board members need to inform themselves as fully as possible about the company’s

#### **More questions to ask your Ethics/Compliance Officer**

##### **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 of Conduct?

##### **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 for entitlement?

##### **Risk**

What are the major compliance and reputational risks we face? Are there any risks that aren’t being addressed as they 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?

##### **Training**

Is your training targeted to an employee’s roles and risks, and to address emerging risks, not just historic ones? What measurements do you have of effectiveness and employee perceptions of the training?

<sup>11</sup> The DoJ *Principles* direct prosecutors to look at overall resources. “Prosecutors should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation’s compliance efforts.”

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.

### **Tone and Execution**

Regardless of the structure, 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.*”