

Why Ethics and Compliance Will Always Matter

“There is no such thing as business ethics. There is only one kind—you have to adhere to the highest standards.”

Marvin Bower, former managing partner
of McKinsey & Company

Imagine this nightmare scenario: A publicly traded company whose domineering leadership rules by fear. Dissenting opinion in any form is met with immediate termination of employment. A culture where written policies and procedures are few and far between and internal controls are shunned. Training is sporadic and lacking. Eventually, this company’s senior-most executives conspire to prematurely and fraudulently recognize revenue to meet or exceed Wall Street’s expectations. They conduct this massive fraud year after year. The board is totally in the dark and accepts management’s explanations and assurances without independent verification. When their accounting practices finally are scrutinized and the government starts an inquiry, these executives attempt a cover-up by fabricating a story, obstructing the investigation, and suborning perjury by instructing other employees to lie to the government and outside counsel. Ultimately, eight of the company’s senior executives including the CEO, CFO, and General Counsel, plead guilty to securities fraud and/or obstruction of justice charges. Shareholders lose over \$10 billion due to the massive accounting fraud. Employees are left shocked and demoralized that their leaders have lied and defrauded their company. Investors are also horrified at seeing their investments diminish and that no one in the company did anything to stop it. Add to this explosive mixture the fact that the company had no compliance

program. That's right, no compliance program. Think this couldn't happen? Think again because it did.

This all occurred at Computer Associates, now called CA, Inc. These blatant transgressions happened because an effective ethics and compliance program was not in place. Compliance involves many different elements; knowing and following all the relevant laws, rules, and policies is but one part of the mix. An effective compliance program would have made a difference at CA. A strong compliance program is absolutely necessary to protect an organization both internally and externally.

Compliance means following the law and more. It's making sure organizations adhere to all applicable legal requirements. It is a detailed and complex process. For any particular situation one must be aware of all potentially applicable laws and regulations—federal, state, local, as well as internal company-instituted rules. A company is obligated to be aware of and understand these rules and laws. That in itself can be an onerous process as even experienced and sophisticated lawyers sometimes have a difficult time deciphering the cryptic “legalese” that passes for statutory language. This compliance obligation is important as everyone in authority is charged with knowledge of the law. Ignorance of the law is no excuse. A person cannot escape a criminal charge or civil liability by claiming that he or she did not know the law was being broken. This is the role of compliance, to make sure people know the rules beforehand and help to ensure that they continuously follow them.

Knowledge and understanding of the law is the first step. Businesses also have to know to what and where it applies. Furthermore, once one has this information, one must implement it in an effective compliance program. But what does effective mean? A company must carefully craft a program, hire experienced compliance professionals, issue detailed policies and guidance, institute training, and promote all other aspects of the program to ensure the knowledge is spread to all who need it. This process must be continuous. The compliance program is the engine of compliance, putting all of this into effect.

Knowing the law and following it is only one side of compliance. Compliance goes much deeper than that, true compliance anyway. Simply following the law so that one doesn't get into trouble is not full compliance. State-of-the-art compliance involves a successful blending of compliance—following rules, regulations, and laws—with ethics—developing and sustaining a culture based on values, integrity, and accountability, and always doing the right things. True compliance ensures consistency of actions to eliminate, or at least lessen, opportunities for harm from criminal conduct or other compliance failures. It means going beyond the minimum requirements. More importantly, it involves the ongoing

commitment from senior leaders in the organization to promote ethical conduct and compliance with the law. Leading by example and establishing the tone at the top set the stage for every other element of compliance.

The problem that can occur is when people use compliance as an excuse; those who profess to believe in it but use a compliance program to mask their own negligence or even wrongdoing. It may be said that this is even more dangerous than having no compliance program at all. That is because it gives shareholders, employees, vendors, and the public the false belief that the company cares about following the law when in fact, all it wants is to deceive others into believing so. Let us not forget that Enron had a 65-page code of conduct, but in the end, it was nothing more than empty words.

Enacting a compliance program and instituting training programs but not supporting them through lack of funding, lack of skilled personnel, or by management undercutting them in various ways, is also dangerous and counterproductive. Real compliance means that one believes in what one is doing day in and day out. It is not merely lip service; it's putting your money where your mouth is. This is the two-tiered approach to compliance—one's actions and one's mindset. An organization cannot have effective compliance without both of them. One alone will not work. This is tied into the idea of setting a positive tone at the top. If management believes in compliance and reinforces it by their actions, over and over again, then people below will follow their lead.

ETHICS IS JOB ONE

Executives are constantly confronted with the realities of business compliance. They must ensure compliance with their internal rules and policies. Those from public companies must follow the requirements of the Sarbanes-Oxley Act and other reporting enhancements. All organizations must follow federal, state, and local laws and all must comply with the United States' Federal Sentencing Guidelines, which mandate the creation of compliance programs. Moreover, a raft of other laws must be complied with, from anti-bribery rules to free trade provisions. Yet, chief among these requirements is the idea of ethics, the concept that lies at the heart of every corporate governance requirement.

Ethics include integrity and proper business conduct; it refers to standards and values by which an individual or organization behaves and interacts with others.¹ The famed Greek philosopher Aristotle in his *Nicomachean Ethics* argued that "moral behavior is acquired by habituation" and that without question, "moral behavior is good."² It is no different today. Ethics and compliance are clearly on the minds of executives, as well as investors, the public, and the government. Ethics has become a hot

button topic, thanks to the many corporate scandals of the past years. This is hardly news to anyone. Despite the increased awareness given to ethics and compliance programs, the problem has not been solved. For instance, the Hewlett-Packard (HP) spying and pretexting scandal involved key executives and illustrates that there is more to successful compliance than just a code of conduct. HP had a comprehensive Standards of Business Conduct (including, slightly ironically now, several pages on how to handle sensitive information), yet it still was engulfed by negative front-page headlines and a shakeup among its leadership. Even great corporations like HP can, at times, face compliance failures. Merely having a program in and of itself is not the solution to protecting a company and keeping it in good graces with shareholders and the government. A truly successful compliance program goes far deeper.

The push toward compliance, especially since the enactment of the Sarbanes-Oxley Act and the reaction to the scandal culture of the Enron era, could almost be described as an “ethics fad.” Sarbanes-Oxley strengthened corporate accountability and governance of public companies through rules covering conflicts of interests, financial disclosures, board oversight, and certification of financial statements.³ The Act’s passage left companies hurrying to comply. All of a sudden, every company had to have an ethics code; if there wasn’t one there was scrambling to get one, or else be left behind. This rush merged with heightened concerns stemming from the penalties imposed on companies for ethical breaches. From the lighter treatment afforded to companies who came clean and “restated” their earnings, as compared to those formally investigated and charged by the government, companies got the message that it was in their best interest to cooperate and that having a compliance program would be something that would lessen potential penalties should the company commit further misdeeds.

Companies that the government caught red-handed had to pay very stiff financial and reputational penalties, not to mention the personal impact on those executives prosecuted and sent to prison. This sent companies searching for ways to avoid this disastrous outcome. At the same time, ethics enjoyed a renewed focus throughout the corporate world, first as companies struggled to understand the new requirements placed on them by the passage of Sarbanes-Oxley, and then rushed to embrace ethical conduct for chief executives and others. The ethics fever swept every industry and that was a good thing, a very good thing. While this practice makes compliance easier, there is still much to do as compliance lapses and criminal conduct persist. The Securities and Exchange Commission (SEC) has continued its strong enforcement program over the last few years. The results of SEC enforcement activity in Fiscal Years 2005–2006 in Compliance Insight 1.1 illustrate that we still have a long way to go for complete compliance.

COMPLIANCE INSIGHT 1.1: SUMMARY OF SECURITIES AND EXCHANGE COMMISSION ENFORCEMENT ACTIVITY, FY2005–FY2006, COMPLIANCE AND ETHICS LEADERSHIP COUNCIL RESEARCH, 2007

574 enforcement actions filed in 2006

\$3.3 billion total in disgorgement and penalties ordered against securities law violators in 2006

\$28.5 million average settlement in 2005, an increase from \$26.4 million in 2004

\$7.5 million median settlement in 2005, a 19% increase from \$6.3 million in 2004

657 amended filings in 2005 for financial restatements of public companies due to accounting errors, a 58% increase from 2004

300 officers and directors barred in the last three years due to allegations of individual malfeasance

1,228 CEO departures from U.S. companies in 2005, an increase of 102% from 2004

129 CEO changeovers in the Fortune 1000 in 2005, an increase of 32% from 2004

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Ethics and ethical behavior are not things that can merely be created, or attained solely through corporate expenditure. They require a deeper commitment, one that can only be achieved through time, effort, and yes, expenditure. Though it is cliché, quality matters here far more than quantity. In many senses, a little goes a long way. Building a world-class compliance program requires smart decisions in building it, maintaining it, and sustaining it; by doing so, a company will be able to achieve truly effective compliance over the long term.

THE NYPD AND AN ETHICAL CULTURE

A commitment to ethical conduct cannot be accomplished by simply initiating a program and then checking the box that the process is complete.

Building a culture of compliance takes time. Integrity and character bring out the best in people and are critical components in ethics and compliance. Yet, human beings are not perfect creatures and tend to falter from time to time. The importance of ethical conduct needs to be nurtured, reinforced, and repeated over and over again lest people forget and stray from the course. There is no better example of this continuous need for attention to ethical conduct than the various police corruption scandals that have impacted the New York City Police Department (NYPD) over the past 100 years. Even legendary institutions can face the firestorm created when law enforcement officers forget their oaths and turn to crime and corruption. Compliance Insight 1.2 details the major corruption scandals that the New York City Police Department has faced over the years.

The feeling of *déjà vu* that the NYPD faced was due to not learning from the past. The NYPD of the 21st century has made great strides in understanding that ethical lapses can seriously impact a long-standing reputation. In building their compliance program, the NYPD starts with police recruits as soon as they enter the police academy. Look at what is presented to recruits in their *Police Student's Guide: Introduction to the NYPD*:

Our history is a source of great pride to us, and we have very little tolerance for officers who do not treat our hard won reputation with the respect it deserves. . . . When things go right in this Department—when we succeed in reducing crime; when we make spectacular arrests; when we make dramatic rescues—our actions are described in news reports throughout the country and across the world, and our officers are treated like heroes. But, when things go wrong—when officers are caught in scandal, or when they make some tragic mistakes—the same reporters and leaders who are quick to praise us are quick to condemn us. When this happens, the public often does not recognize that the problem may be limited to one or only a few officers. Instead, in the eyes of many people, we all become suspect, and the mistakes and sins of a few are generalized to all of us. This breeds distrust among the public, and makes it tougher for all of us to do the job the way we should. . . . Make certain that you carry yourself in a manner that brings only respect to yourself and to your brothers and sisters in this Department.⁴

Warren Buffett, the billionaire investor and CEO of Berkshire Hathaway, Inc., has said “It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you’ll do things differently.” The NYPD understands this and so must all organizations. Yet, we often fail to learn

COMPLIANCE INSIGHT 1.2: A BRIEF HISTORY OF NYPD POLICE CORRUPTION

The New York City Police Department is considered by many to be the premier police department in the world. Yet, even the best sometimes falter. Police corruption can infect even the most professional of law enforcement organizations. Consider these very public police corruption investigations of the New York City Police Department over the last 100 years:

- **Lexow Committee (1894):** *Systematic police extortion and pay-offs from gambling operations*
- **Curran Committee (1913):** *Systematic monthly police extortion of gambling and brothel operations*
- **Seabury Commission (1932):** *Police Department involvement in extortions from speakeasies, bootleggers, and gamblers*
- **Helfand Investigation (1955):** *Large-scale protection by police of a gambling syndicate*
- **Knapp Commission (1972):** *Corrupt police officers were either “grass-eaters” or “meat-eaters”^a*
- **Mollen Commission (1994):** *Shakedowns and protection by corrupt officers but also trafficking in cocaine and other drugs*

Why include an historical overview of police corruption in a book on compliance? To remind us that corruption, criminality, and non-compliance are always present. It often takes a major and very public incident for us to take notice and do something. Approximately every twenty years for the last century, corrupt police activities reached such a peak that investigating bodies were commissioned to conduct public inquiries to determine the corrupt acts and recommend solutions to the scandals. There are important lessons for us here. Rather than wait for the public scandal that does so much reputational damage for us to take remedial action, we must continuously apply state-of-the-art compliance standards to ensure that history does not repeat itself, as was the case with the New York City Police Department.

^aThe Knapp Commission investigation of police corruption in the New York City Police Department found two categories of corrupt officers. They were either “grass-eaters” or “meat-eaters.” Grass-eaters were the overwhelming

majority who generally took small payoffs from business owners, gamblers, and others to look the other way on infractions. Grass-eaters usually did not solicit these payoffs but did not refuse them either. Meat-eaters were a small percentage of corrupt officers but were constantly on the prowl for large-scale financial scores involving narcotics, gambling operations, and other serious offenses. For more information, refer to the Commission to Investigate Allegations of Police Corruption and the City's Anti-Corruption Procedures, *The Knapp Commission Report on Police Corruption* (New York: George Braziller, 1973), 65.

from the past. The disclosure of stock option backdating scandals in 2006 at dozens of companies, large and small, in the United States brought back distressing memories of the accounting scandals of just a few short years ago. How could so many smart people forget the lessons of Enron, WorldCom, Adelphia, and others? The sheer number of companies involved is striking. Much of the misconduct took place a number of years ago and was only recently disclosed. Still, the participants were chief executives and other high level employees who should have known better. More importantly, their compliance programs did not work. A further discussion of the backdating of stock options can be found in Chapter 2.

WHAT IS COMPLIANCE?

Compliance is a state of being in accordance with established guidelines, specifications, or legislation.⁵ The Compliance and Ethics Leadership Council defines compliance as “a company’s or an individual’s observance of relevant laws, regulations, and corporate policies. . . . Companies must have various programs, policies, and controls in place in order to be defined as being ‘compliant’ with certain laws, rules, regulations, or policies.”⁶ The United States Department of Justice (DOJ) has strongly reinforced the importance of effective compliance programs. The DOJ defines compliance programs as follows:

Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own. However, the existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for

*criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program. In addition, the nature of some crimes, e.g., antitrust violations, may be such that national law enforcement policies mandate prosecutions of corporations notwithstanding the existence of a compliance program.*⁷

The key to effectiveness is whether the program is adequately designed to ensure compliance. The United States' Federal Sentencing Guidelines for Organizations (FSGO) state that "to have an effective compliance and ethics program, an organization shall exercise due diligence to prevent and detect criminal conduct; and otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."⁸ The constantly evolving compliance landscape requires executives and managers to constantly ensure that their programs are "best in breed" to fully protect organizations.

Organizations that run afoul of the law and commit crimes such as fraud, face severe penalties from the courts. Under the FSGO, organizations found guilty can face additional penalties based on certain aggravating factors calculated by a "culpability score." As stated in the FSGO, the factors contributing to increased penalties and fines include whether:

- Senior executives within the organization "participated in, condoned, or [were] willfully ignorant of the offense;"
- "[T]olerance of the offense by substantial authority personnel was pervasive throughout the organization;"
- There was prior history of a similar offense in the company's past; and/or
- The organization obstructed justice by impeding the investigation or prosecution.⁹

The FSGO also provide a significant "carrot" or benefit in that there are mitigating factors that can significantly lessen the penalties for criminal convictions. The questions that will determine if these factors are to be considered include:

- If the subject "organization had in place at the time of the offense an effective compliance and ethics program;"
- If the organization promptly "reported the offense to appropriate government authorities" once they became aware of its existence;
- If the organization "fully cooperated in the investigation;" and

- If the organization “clearly demonstrated recognition and affirmative acceptance of responsibility for its criminal conduct.”¹⁰

While quality matters more than quantity, a solid compliance program needs a proper balance between the two. An under-funded and unsupported program is doomed to fail. Without sufficient support by the company and the management, a program cannot succeed in its objectives of changing and influencing employee behavior. Compliance requires direct input by company leadership, and the key support of a qualified compliance officer running a reliable compliance department, accessible to the rank and file to answer their questions and provide them with appropriate direction. However, spending too much money (without proper guidance on how to spend and direct funds) can lead to incredible inefficiency, and be just as ineffective as not spending.

The “Icarus Effect”

Professor David A. Skeel of the University of Pennsylvania Law School proposes an interesting theory in evaluating corporate scandals. He describes the “Icarus Effect,” three factors that combine to create each of America’s great corporate scandals. Icarus, in Greek mythology, was given wings made of wax and feathers by his father, the inventor Daedalus. Daedalus warned Icarus not to fly too close to the sun, as the wings would melt and Icarus would plummet to his death.¹¹ Sadly, seduced by his newfound power, Icarus disregarded his father’s warning and suffered the deadly consequences.

Skeel identifies three “Icaran” factors: risk-taking, competition, and manipulation of the corporate form. Risk-taking is perhaps inherent in the corporate structure. The market rewards those who take successful risks in developing new products and technologies. Risk-taking often leads to innovation. Moreover, the types of people who rise to the highest level of corporate America tend to be bold, confident, and willing to take risks. After all, these are the types of traits that allow one to climb the corporate ladder. A would-be executive is unlikely to make it far up the corporate ladder without taking some risks. Risk-taking is not a bad thing. Corporate governance rules expressly allow for some measure of risk taking; the business judgment rule, for instance, protects rational business decisions, even if a judge or jury thinks them too risky or would have chosen a different course of action.

Executive compensation also encourages risk-taking. The majority of executive compensation is in the form of stock options. These options reward risk, since they are “all upside and no downside: they promise a big payoff if the company’s stock price goes up, but there’s no cost to the CEO if

she gambles with the company's business and the stock price plummets."¹² Even though risk-taking has some distinct and crucial benefits, if it gets out of hand it can doom a company. Any level of risk-taking must be tempered with reasoned and rational thought.

Competition can reinforce managers' incentives to take risks. The marketplace is a tough environment with many different entities all competing for the same dollar. Increasing market pressure to achieve a certain level of financial success or more commonly to return to past levels of success often pushes management to make risky decisions in hopes of appeasing investors and Wall Street. Unfortunately, many times these competitive-driven risks turn out to be short-sighted and ill-advised.

Manipulation of the corporate form is the final factor. "The ability to tap huge amounts of capital in enterprises that are set up as corporations, together with the large number of people whose livelihoods depend in one way or another on the business, means that an Icaran executive who takes excessive or fraudulent risks may jeopardize the financial lives of thousands of employees, investors, and suppliers of the business."¹³

Individually, all of these factors are elements of a typical market, and in fact all can be used positively. Risk-taking and competition allow for the creation of better products, and the corporate form allows for distinct benefits, such as the ability to raise large amounts of capital and limited liability, and gives people an incentive to take risks and create a new and successful product or service. However, when these factors operate unrestrained, in conjunction with each other, they can create disastrous scandals. These Icaran factors will be on full display in Chapter 3 that details a brief history of corporate scandals and those responsible.

Compliance Program Individuality

Ideally a compliance program should be both industry-specific and unique; it should be tailored to fit the requirements of the individual company, its needs, and the overall compliance requirements of its particular industry, but should also reflect the compliance requirements imposed on all corporations and the laws that they must all follow. Each organization must ensure that their compliance programs are getting the individualized attention they need. If a code of conduct is nothing more than a cookie cutter guidebook, it is unlikely to truly foster a lasting change in the corporate compliance culture. A company may spend far more time on the appearance than the content of these codes.

With slick graphics, photos, and inspirational quotes, they may look like little more than the advertising material given out to potential customers. In fact, when perusing through the manuals given out at various

companies, they all start to blend together. Many seem to come from the same exact template, with similar language. These are, essentially, nothing more than boilerplate codes of conduct. One even starts to see identical quotes appearing time and time again. What this shows are the misplaced priorities by the companies who issue them.

First, as noted above, it reflects a preference of style over substance, on the appearance over the content. Second, it shows the lack of attention paid to the full importance of a compliance program. Setting up a cookie cutter program means that the company scrambled to put something in place as soon as possible, such that it will not be anywhere as effective as it could be or the company hopes it to be, or that the company puts a low priority on having a truly effective compliance program. For these companies, the appearance of a good program is more important than actually creating a culture of compliance. It also shows that the company has not put in the effort needed to customize the compliance program to the individual needs of the company and its unique culture.

Most importantly, the focus on image and the lack of individuality ignores the great benefits a company can reap by putting a good program into place. Among other benefits, a strong compliance program can create better employee productivity and morale, higher profits, and a stronger reputation among consumers and investors. It can catch problems before they reach the level where they can hurt the company and its stock price as well as absorb the valuable time of employees who should be working to benefit the company, not to clean up its internal mess. With a strong program, an organization can take advantage of lessened sentences under the Federal Sentencing Guidelines for Organizations, as well as having a beneficial position when dealing with prosecutors should problems arise. It also will be more able to portray a wrongdoer as a rogue employee, rather than as a symptom of an endemic and widespread problem within the company.

Returning to the issue of slickly produced codes of conduct, it should be recognized that allowances must be made to get the employees' attention. It is an open question as to how many of the rank and file employees actually take the time to read the manuals they are given, much less internalize and fully understand them. This gap can be filled by having solid training programs to engage the employees and to make sure they know what they need to know and conversely, to make sure that they are not overwhelmed with information that is above their level and is best handled by superiors.

Additionally, good management oversight sets a good example for them to follow and can make sure that employees are acting in the proper manner. Having experienced compliance officers available to answer more specialized

questions is helpful because there is no way that every contingency is addressed in the distributed materials.

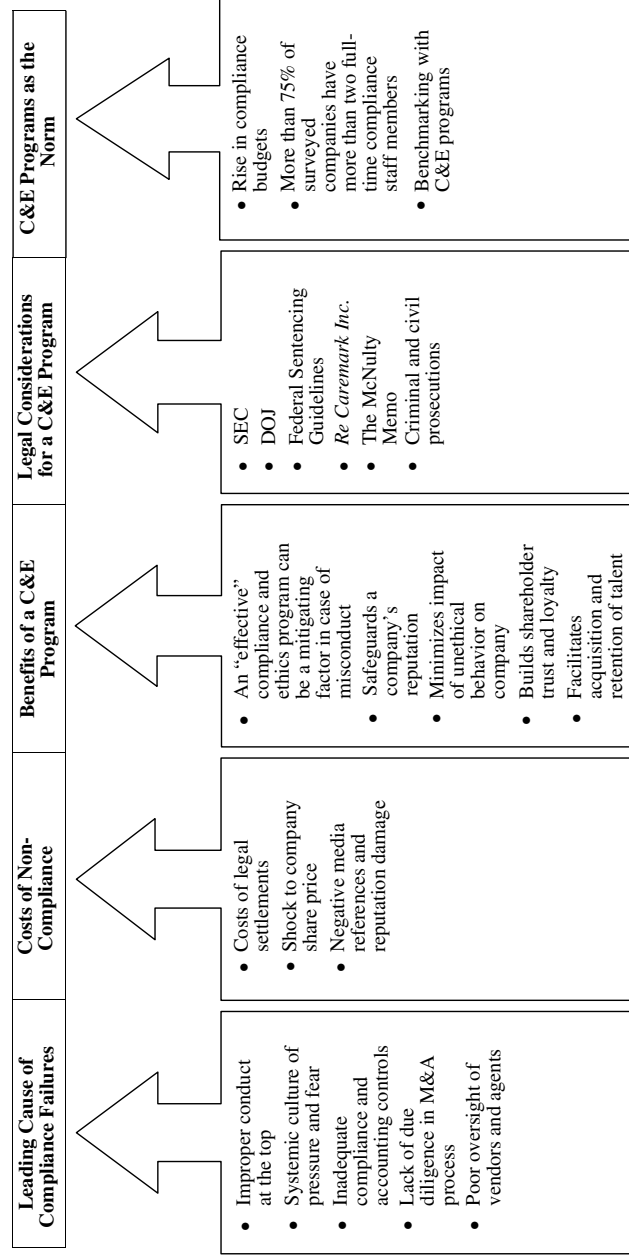
BUILDING THE BUSINESS CASE FOR ETHICS

Running an ethical company that places a high value on compliance is not just simply a good idea. It also makes good business sense. One hears all about the importance of business ethics, the damage that can be caused by scandals, and the legal benefits and requirements, as outlined in places such as the Sentencing Guidelines. But less is heard about how an ethical business with strong corporate governance will outperform companies that don't focus on ethics.

Moreover, executives can damage their business and its future if they do not properly value ethics. "Too many corporate executives regard an ethics program as an expense that adds nothing to a company's bottom line. Even more disturbing, some executives fear that an emphasis on business ethics could put their company at a competitive disadvantage. They are unconvinced that ethics and profits are reconcilable."¹⁴ Of course, this is not the case and ethics can even provide a company with an edge in a fiercely competitive global economy, as a reputation for ethical behavior can distinguish it from rivals. "Enlightened business leaders, however, know that building an ethical business culture is a powerful means of maximizing shareholder value and increasing business profits."¹⁵ In the end, ethics increases the bottom line. The strong link between corporate management's public commitment to ethics and the corporation's financial performance has been borne out by numerous studies.¹⁶

According to Professor Curtis C. Verschoor of DePaul University, "well-managed companies that take their ethical, social, and environmental responsibilities seriously . . . have stronger long-term financial performance than the remaining companies in the S&P 500 Index."¹⁷ A 2004 study, building on prior research done by Verschoor and others, demonstrates the benefits that are associated with superior governance attributes. The study analyzed companies in the Standard & Poor's 500 by measuring Market Value Added (MVA), which is the value of a company above and beyond what had been contributed by investors, i.e., the company's financial growth. Companies classified as having superior corporate governance substantially outperformed their less ethically focused competitors, to the tune of an average of \$9.4 billion in 2004.¹⁸ "This study provides powerful new evidence supporting the belief of many investors that firms having attributes of strong corporate governance . . . actually deliver superior financial returns to their shareowners. Corporate management and boards of directors should also

COMPLIANCE INSIGHT 1.3: BUILDING THE BUSINESS CASE FOR A COMPLIANCE AND ETHICS PROGRAM, COMPLIANCE AND ETHICS LEADERSHIP COUNCIL RESEARCH, 2005



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recognize the value the market is placing on attributes of good corporate governance, especially a well-managed program of ethics and compliance.”¹⁹ Compliance Insight 1.3 reinforces the importance of building a business case for an appropriate compliance and ethics program.

Another study, by the Aspen Institute and management consulting firm Booz Allen Hamilton, similarly found a financial benefit from strong corporate values. “Public companies that report superior financial results also report greater success in linking values to operations in areas that foster growth, such as initiative and innovativeness.”²⁰ Again, the study found a strong correlation between strong financial performance and a focus on ethics and core values. “Among financial leaders—public companies that outperform their industry averages—98% include ethical behavior/integrity in their values statements, compared with 88% for other public companies. Far more of these financial leaders include commitment to employees, honesty/openness, and drive to succeed.”²¹ These same financial leaders also report that their practices are very effective in promoting initiative, adaptability, and innovativeness and entrepreneurship, at twice the rate of other public companies.²²

Ethics are also beneficial in another business area, hiring and retaining top quality employees. Unethical behavior not only impacts a company’s bottom line, it also impacts its workforce. It affects current employees as well as the company’s ability to attract qualified new ones. A study by the consulting firm LRN “provides new evidence that links a company’s ability to foster an ethical corporate culture with an increased ability to attract, retain and ensure productivity among U.S. employees.”²³ Among the study’s findings:

- 94% of employees say it is critical that they work for an ethical company.
- More than one-third of respondents reported leaving a job for ethical reasons.
- 56% say their employer embraces ethics and corporate values in everything it does.
- 30% say their company merely toes the line by following the law and company policies.
- 9% say they work at a company where they do what they are told, are not encouraged to ask questions about what is right or wrong, or they often see management and peers acting in questionable ways.²⁴

While most organizations value ethics, strangely, some do not as evidenced by the many corporate frauds we have witnessed over these last few years. Employees are very sensitive to this, are acutely aware of their

organization's culture, and pay attention to the tone set from the top and around them. Unethical behavior has a strongly deleterious effect on employee morale and distracts employees from the company's business at hand. One in four workers reported seeing unethical or even illegal behavior where they work; of those who saw unethical behavior, 89% said it affected them.²⁵

An ethical reputation also pays dividends in hiring. Of 800 MBA graduates surveyed, 97% were willing to be paid less to work for an organization with a better reputation for corporate social responsibility and ethics. This survey provides even more evidence that good corporate citizenship helps to attract superior management talent.²⁶

COMPLIANCE OBSTACLES

I met a person who works at a well-known technology firm. She and I started discussing compliance. She commented that with all the advances in technology today, there had to be a way to develop software tools to automate and ensure compliance. She felt that technology is the key to solving compliance concerns. I remarked that that was a noble goal, and while the power of technology and software is immense, ultimately technology and tools are no substitute for the human factor. It always comes down to people. One cannot automate integrity and honesty. Either people have it or they do not. Compliance Insight 1.4 is a sad example of what can happen when a company is not committed to building and maintaining a compliance program.

True corporate responsibility requires all companies, public or private, large or small, foreign or domestic, to have effective compliance programs. An organization can have 100% of its employees complete code of conduct training but that will not ensure that everyone will comply with the code. An organization can have a hotline in place but that will not guarantee that an employee will call to report an allegation of fraud that he or she discovers. Compliance must be embedded into the fabric of an organization so that it continues no matter who the CEO is. As Thomas Friedman of the *New York Times* wrote in one of his columns, "The greatest restraint on human behavior is not a police officer or a fence—it's a community and a culture."²⁷

KEN LAY ON ETHICAL CONDUCT

On April 6, 1999, The Center for Business Ethics at the University of St. Thomas in Houston, Texas sponsored a conference entitled *Corporate*

COMPLIANCE INSIGHT 1.4: OBSTACLES ENCOUNTERED IN IMPLEMENTING A COMPLIANCE PROGRAM

It's fair to say that building an effective compliance program is critical to any organization today. There must be support from the highest levels of leadership as well as an ongoing and honest commitment to successful implementation. One of the worst approaches is to have a compliance program as simply "window-dressing" with no real intent to actually follow through on compliance requirements. The following is an example of an actual company that did just that. Some details have been changed so as not to identify this company or the source of this information.

In 2005, the company was a privately-held, service-oriented entity with over 50,000 employees, \$3 billion in annual sales, and several hundred million dollars in debt. Anticipating going public with an initial public offering and the resulting Sarbanes-Oxley reporting requirements, a decision was made to create a compliance department with reporting to the General Counsel. Several new hires were authorized: a Chief Compliance Officer, a Manager of Contract Compliance, a Manager of Licensing, a Regulatory Specialist, and a Quality Assurance Specialist.

The compliance department was initially assigned the responsibility for review and oversight of the company's licensing and regulatory affairs, contract compliance, whistleblower hotline monitoring and oversight, administration of corporate policies and procedures, internal corporate investigations, quality assurance reviews, and field compliance reviews. Initial plans also included a small staff that would be assigned the responsibility to conduct internal audits and internal corporate investigations.

Almost at the onset, it became clear the Compliance Department was simply "window dressing." Little, if any, corporate support was provided toward achievement of the Compliance Department's initial goals. The company's strategic plan included aggressive pursuit and acquisition of a number of competitors, which required continued in-house due-diligence procedures, corporate re-formation activities, and re-licensing and re-branding of a new business entity, all of which were tasked to the Compliance Department. Several months after the department was formed, the General Counsel was terminated for no apparent reason, leaving this important position vacant for over seven

months. This left the department without vital support at the highest executive level.

To make matters worse, the Chief Executive Officer was not involved in the day-to-day operations of the company and was focused primarily on new acquisitions. It was widely known that the Chief Financial Officer did not support the audit functions originally envisioned for assignment to the Compliance Department. As a result, the CFO provided neither financial nor other support vital for the success of the new entity. The CFO was indifferent to the compliance operation and felt no need to maintain an open line of communication with any operation other than those who directly reported to him.

In early 2006, the company reported a sizable loss. Shortly after the hiring of a new General Counsel, the Manager of Contract Compliance position was eliminated and the responsibilities of the position were reassigned to the Regulatory Affairs Specialist. This created a significant void in original plans to monitor and audit any of the approximately 4,300 contracts in effect with clients, which was an important component of the original compliance program. Using the money saved from this position, the CFO reclassified a number of financial management positions and created several new titles and moved the positions to his staff. Among the new titles the CFO created was a Chief Auditing Executive, which was done without the knowledge of the General Counsel or Compliance staff.

Due to the poor financial earnings of the company, the auditor/investigator positions were never filled and the Chief Compliance Officer (CCO) served as the sole corporate investigator and internal auditor in addition to his other duties. The CCO monitored, audited, initiated, and conducted investigations based upon allegations received through the whistleblower hotline. Generally, following receipt and investigation of a hotline issue, an investigative report would be prepared and issued to corporate management.

A number of investigations focused upon the allegations of “ghost” employees within the company. If internal control deficiencies were identified incident to an investigation, including the “ghost” investigations, a separate audit report containing detailed findings and recommendations for corrective action would be issued to the CFO. The CFO generally ignored these recommendations and considered these issues to be immaterial and not indicative of corporate-wide

problems. The Corporate Controller, whose experience was quite limited, had a similar perception that there was little, if any, fraud inherent in his operation.

There was no interaction with the external auditors regarding compliance or fraud related issues. The auditors were shielded by the CFO from making any contact with Compliance Department personnel. Similarly there were no interactions with the Corporate Audit Committee, who generally met only with the CEO, CFO, and Corporate Counsel. Some of the primary concerns of the Audit Committee from a compliance perspective included their unusual interest in providing state-by-state breakdowns in employee relations issues, with little interest in the detection and prevention of internal corporate fraud. Why the external auditors didn't do more or exhibit professional skepticism is unknown.

The CCO clearly felt there was a lack of support at the highest levels of management. In frustration, the CCO left the company and took a position with another organization. Following his departure, there was little support demonstrated by senior executives to hire a replacement CCO. The tone at the top consisted of deaf indifference to the support of a robust compliance program. The program was permitted to fail, based upon the combined reckless indifference of senior executives, the board of directors, and audit committee.

Unfortunately for this company, its lack of commitment to compliance led to serious harm. The company had to restate several years of earnings because of improper accounting. This was allowed to happen because the compliance function languished without sufficient leadership or internal company support. In a true sign of this company's lack of ethical commitment, no senior executives have been fired or reprimanded, and the compliance office has all but been dismantled. This is a sure-fire recipe for disaster.

Governance: Ethics Across the Board. The conference brochure at the time stated the conference "will explore the changing nature and growing importance of corporate governance."²⁸ The late Ken Lay, who was Chairman and CEO of Enron at the time, was a conference speaker. The subject of his presentation oddly enough was "What a CEO Expects from the Board." In his own words, Lay spells out in theory what an ethical CEO should

expect from a board and what an ethical board should deliver. Lay said the following:

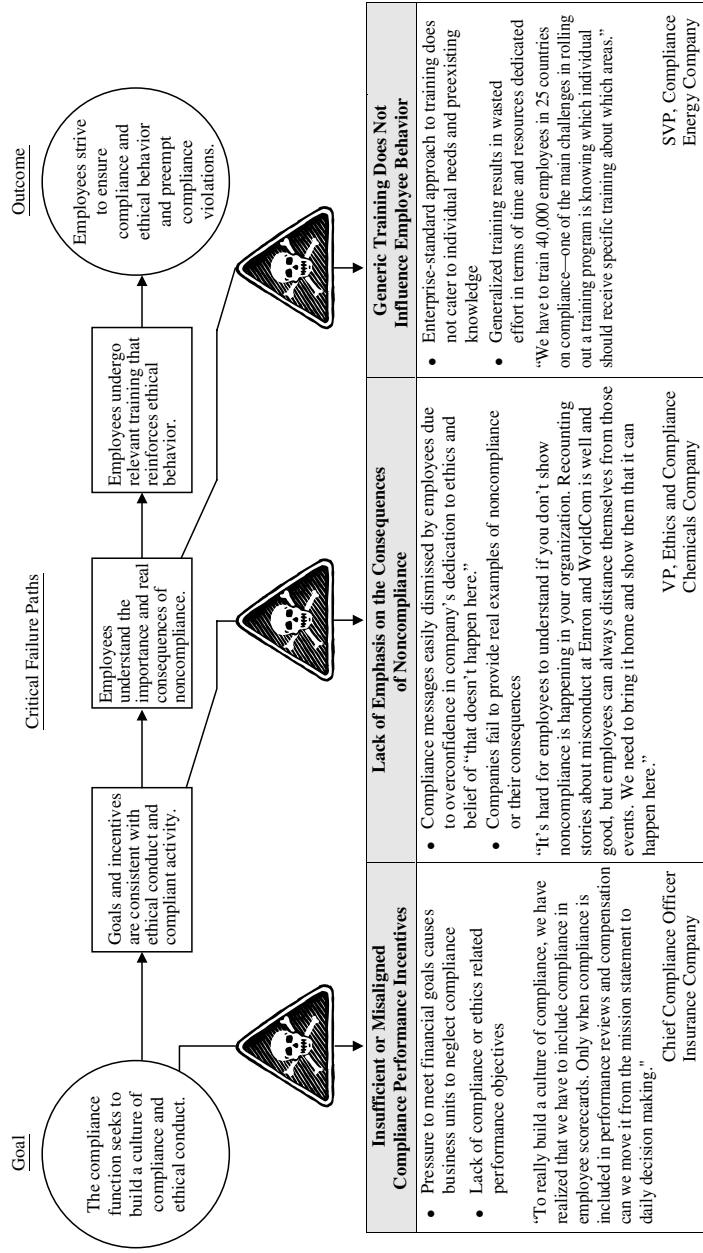
Like any successful company, we must have directors who start with what is right, who do not have hidden agendas, and who strive to make judgments about what is best for the company, and not about what is best for themselves or some other constituency. . . . The responsibility of our board—a responsibility which I expect them to fulfill—is to ensure legal and ethical conduct by the company and by everyone in the company. . . . What a CEO really expects from a board is good advice and counsel, both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders. And let me conclude by acknowledging that it is not an easy task to get all of this just right.²⁹

Whether he actually meant what he said at the time or it was just empty rhetoric, we will never know. What we do know is that nothing of what he said in 1999 was of any help to the investors and employees of Enron who ultimately suffered a severe financial and emotional toll as the company imploded. Compliance Insight 1.5 details some of the obstacles faced when embedding a compliance program within an organization.

THE WARNING SIGNS OF COMPLIANCE FAILURES

Marianne Jennings is a professor in the W.P. Carey School of Business at Arizona State University and an expert on business ethics. She is a well-known speaker and prolific author on the subject. Her latest book is entitled *The Seven Signs of Ethical Collapse* in which she identifies the seven indicators of ethical collapse. While these signs are not a guarantee of an ethical collapse, they definitely can be used as potential harbingers of ethical challenges. These seven signs are: (1) the pressure to maintain the business numbers; (2) a culture of fear and silence; (3) a “bigger than life” CEO and awe-struck direct reports that won’t go against their leader; (4) a weak board of directors; (5) a practice of conflicts of interest; (6) a belief that the organization is above the law; and (7) that “goodness in some areas” such as corporate giving “atones for evil in others.”³⁰ An excellent best practice is to always consider red flags such as these in analyzing a compliance program’s level of potential risk.

COMPLIANCE INSIGHT 1.5: KEY OBSTACLES TO EMBEDDING COMPLIANCE IN THE BUSINESS, COMPLIANCE AND ETHICS LEADERSHIP COUNCIL RESEARCH, 2005



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NOTES

1. “Preempting Compliance Failures: Identifying Leading Indicators of Misconduct,” *Compliance and Ethics Leadership Council*, April 26, 2007.
2. Aristotle, *Nicomachean Ethics*, translated by Martin Ostwald, (Englewood Cliffs, NJ: Prentice Hall, 1962), xix.
3. Martin T. Biegelman and Joel T. Bartow, *Executive Roadmap to Fraud Prevention and Internal Control: Creating a Culture of Compliance*, (Hoboken, NJ: John Wiley & Sons, 2006), 64.
4. New York City Police Department, *Police Student’s Guide: Introduction to the NYPD*, July 2005, 4–5, home2.nyc.gov/html/nypd/html/dc_training/pdf/2005%20Police%20Students%20Guide/1st%20Trimester/01-Intro%20to%20the%20NYPD.pdf.
5. Definition of compliance found at PEMCO Corporation Corporate Services library site, www.pemcocorp.com/library/glossary.htm.
6. “Preempting Compliance Failures.”
7. Paul J. McNulty, “Principles of Federal Prosecution of Business Organizations,” Department of Justice, December 2006, www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf.
8. *Federal Sentencing Guidelines*, Chapter 8, Part B, Effective Compliance and Ethics Programs, www.ussc.gov/2005guid/8b2_1.htm.
9. *Federal Sentencing Guidelines*, Chapter 8, Part C, Fines, www.ussc.gov/2005guid/8c2_5.htm.
10. Ibid.
11. Though it is not as commonly remembered, in some versions of the tale Daedalus is also warned not to fly too low, so as to avoid the sea’s powerful waves. As Skeel puts it, “as with executive risk-taking, this account suggests, there are dangers in both directions [taking too much risk or completely avoiding it].” David A. Skeel, “Icarus and American Corporate Regulation,” *The Business Lawyer*, November 2005, 157, n. 10.
12. Ibid., 157.
13. Ibid.
14. Dr. John D. Copeland, “Business Ethics: Three Critical Truths,” 6, www.soderquist.org/resources/pdf/Copeland_ThreeTruths-publication.pdf.
15. Ibid.
16. Ibid., 9.
17. Curtis C. Verschoor, “Does Superior Governance Still Lead to Better Financial Performance?,” *Strategic Finance*, October 1, 2004, 13.

18. Ibid. Roughly 150–160 of the S&P were deemed to have “superior governance” in the years 2000–2004. The 9.4 billion number means, that in 2004, the MVA for a company with superior governance was 9.4 billion higher than a company that did not. In 2000, in the midst of the stock market bubble, the additional MVA was 28.6 billion while in the doldrums of 2003 it was \$5.8 billion. These numbers indicated that no matter the health of the stock market, superior governance is always valued, and is valued even more in a rising market, as 2004 was. Further research showed that the numbers were not skewed by the largest companies, as even middle-sized companies returned substantially more value to shareholders.
19. Ibid.
20. “New Study Finds Link Between Financial Success and Focus on Corporate Values,” Booz Allen Hamilton, February 3, 2005, www.boozallen.com/publications/article/659548.
21. Ibid.
22. Ibid.
23. “New Research Indicates Ethical Corporate Cultures Impact the Ability to Attract, Retain, and Ensure Productivity Among U.S. Workers,” LRN, August 3, 2006, www.lrn.com/about_lrn/media_room/press_releases/263. LRN specializes in legal, compliance, ethics, and governance solutions.
24. Ibid.
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26. Verschoor, “Superior Governance,” 13.
27. Thomas Friedman, “Calling All Democrats,” *New York Times*, February 10, 2005.
28. The Center for Business Ethics at the University of St. Thomas, Houston, Texas, at their conference overview site, www.stthom.edu/academics/centers/cbes/CorporateGovernanceEthicsAcrossTheBoard.html.
29. Kenneth L. Lay, “What a CEO Expects from the Board,” presentation at the Corporate Governance: Ethics Across the Board Conference, Houston, TX, April 6, 1999, www.stthom.edu/academics/centers/cbes/kenneth_lay.html.
30. Marianne M. Jennings, *The Seven Signs of Ethical Collapse: How to Spot Moral Meltdowns in Companies . . . Before It's Too Late*, (New York, NY: St. Martin's Press, 2006).

