CHAPTER 1

Compliance: Law and Society

After reading this chapter, you will be able to:

- Understand the basic structure of an enterprise governance framework.
- Deepen your understanding of the relationship between governance and compliance.
- Develop a conceptual foundation for evaluating your enterprise's current governance and compliance program.
- Understand the structure of a holistic governance and compliance framework.
- Appreciate the reasons for unified enterprise framework.
- Review the balance between governance and compliance in public and commercial enterprises.

Defining the Scope

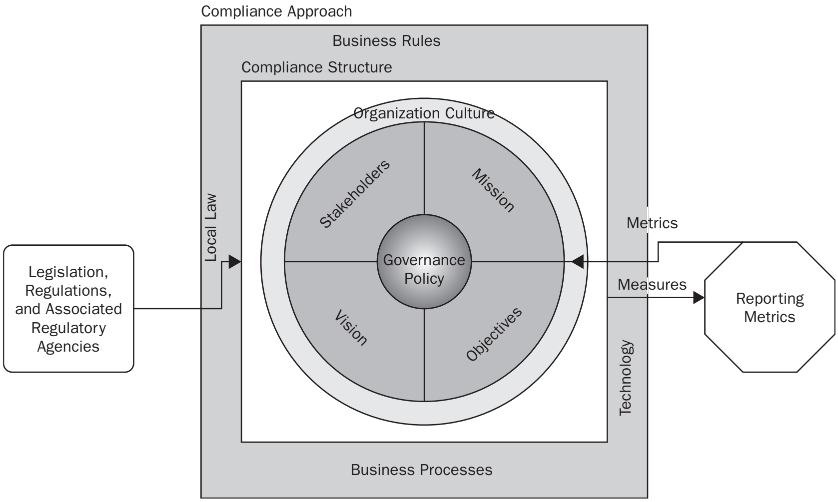
Governance policy and compliance rules can no longer be passive guidance for CEOs, managers, supervisors, and employees. Members of corporate boards must take an increasingly active role in fulfilling their fiduciary responsibilities of oversight with proactive governance structures and compliance frameworks.

As Mike McDuffie pointed out earlier, a board of directors is no longer *window dressing*, and, therefore, must be a contributing factor in establishing solid governance across the enterprise. Organizational compliance rules must proactively implement the governance policy as well as ensure adherence to law. Adding to this complex picture is the organizational culture and operational management of the enterprise. Over the course of this chapter we will explore some of these interdependencies and try to peel back the layers, as shown in Exhibit 1.1, enough to clarify the relationship between governance, compliance, and operations.

Enterprise governance policy is the core of processes, customs, policies, and rules that guides and influences the way in which an organization is directed, administered, or controlled. Governance generally provides guidance on the relationships and a role of the people involved and includes an alignment of the rules to the goals of the enterprise. Enterprise governance is, for the benefit of the stakeholders (shareholders, owners, or citizens), designed to provide guidance from the board of directors, management, and, ultimately, the employees in the proper operation of the enterprise. It is often a set of lofty statements aligned to the enterprise mission and goals.

EXHIBIT 1.1

Organizational View of Compliance



Given this definition, it is clear that enterprise governance is not simply an outline for managing external regulations but is a high-level set of guidelines to the complex issue of enterprise operations. The focal point of governance, and its operational counterpart compliance, is accountability and fiduciary duty. The primary objective of governance, as outlined in Exhibit 1.1, is to provide a framework under which compliance is built. Governance, if structured and managed well, provides guidance to the operational processes and supporting systems that lead to good institutional behavior that in turn leads to shareholder protection and economic efficiency. Governance is about the delicate balance between appropriate workplace behavior and economic gains.

Governance Point of View

From the Real World

Corporate Governance at Merrill Lynch

Merrill Lynch believes that good corporate governance is a critical factor in achieving business success. The board of directors has long adhered to best practices in corporate governance in fulfillment of its responsibilities to shareholders and to oversee the work of management and the company's business.

As we rapidly approach the decade mark of the Enron Corporation collapse, the concept of governance continues to evolve as a key stakeholder tool. Clearly understanding the point of view required in a governance policy is critical to establishing a good policy. Today, the concept of stakeholder theory, as described by Professor R. Edward Freeman (1984), seems to express the leading point of view of governance responsibility. Essentially, Professor Freeman states, it is the responsibility of the enterprise to convert the inputs of investors (owners) into usable (salable) outputs that, in turn, generate benefit (economic profit or social good).[1] Complexity grows as the number of stakeholders in the modern enterprise view has grown to include employees, unions, suppliers, and, today, the public (represented by regulatory agencies and associations). Translating, monitoring, and measuring this equation into a unified policy is challenging. As the board and senior management have become not only morally but also legally responsible for compliance, they are increasingly taking the proactive step of seeking management and technology partners to support, execute, and audit the governance policies and guidelines they set forth.

Starting a Compliance Program

The start of a compliance program often requires an assessment, conducted by auditors, of the legislation and regulations with which the organization must comply, the conflicts between them, and reconciliation with the corporate governance policies.

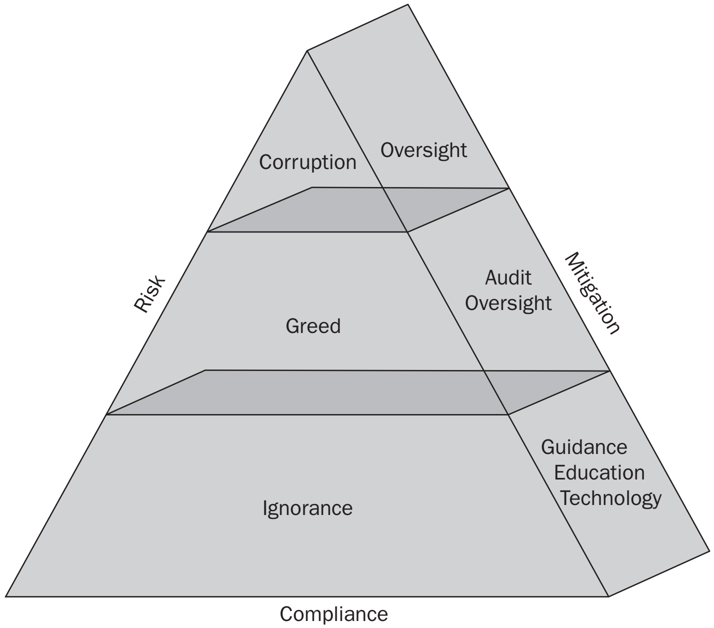
After this audit, the organization needs to understand how current policies, procedures, and local regulations are affected, and the organization needs to design a benefit-driven strategy to address these points. The organization also needs to understand how the results of the audit affect the technologies the company utilizes and will eventually require.

What decisions and behaviors should be managed for sound governance and compliance? Private- and public-sector businesses face a multi-tiered challenge best described in layers:

To be successful in a compliance-oriented world, a well-run organization should demand a sustainable, benefit-driven approach. Strategic benefits can accrue from a well-designed, holistic compliance strategy. For example, an organization required to meet Sarbanes-Oxley needs to have a robust and controls-based approach, such as Control Objectives for Information and Related Technology (COBIT). A tactical and silo *regulation- and legislation-driven* approach can compromise the future ability of the organization to meet and benefit from compliance initiatives.

EXHIBIT 1.2

Compliance-Risk-Mitigation



Building a holistic program requires balancing the drivers of compliance with the risks faced by the enterprise and its officers. Understanding the causes of noncompliance, as outlined in Exhibit 1.2—corruption, greed, and ignorance—helps the organization build a risk mitigation plan.

- Ignorance is often the easiest challenge to address and the most complex to implement. The virtual and geographically dispersed workforce presents a challenge to any guidance and education program. The larger the workforce, the more challenging it is to ensure that knowledge is transmitted and understood by all parties. Technology, as we will discuss in Part II, can provide implicit guidance and explicit education.

- *Example:* An employee accidentally gives advance notice of a bid to a vendor, providing unfair advantage.

- Greed requires constant vigilance through audits and monitoring. This form of mitigation gets a great deal of attention in the run-of-the-mill compliance books—written by auditors (of course). Though auditors comment that finding the greedy is not as much a technology challenge as it is a cultural and process issue, we will spend some time examining technology enablers to help management monitor and guard against the greed factor.
  - *Example:* In 1995 Nick Leeson, over a three-month period, used his position with Barings Investment Bank in Singapore to purchase 20,000 futures contracts worth about $180,000 each in a vain attempt to move the market. Some three-quarters of the $1.3 billion he lost Barings resulted from these trades. When Barings executives discovered what had happened, they informed the Bank of England that Barings was effectively broke. In his wake, Nick Leeson had wiped out the 233-year-old Barings Investment Bank. The $1.3 billion dollars of liabilities he had run up was more than the entire capital and reserves of the bank.
- Corruption is probably the most newsworthy of the challenges though not the most common. Guarding against corruption requires consistent and vigilant oversight by the board of directors and company executives. Technology can support the discovery and detection of corruption but certainly is not the front-line defense

against these actions. A strong and active board of directors and executives carrying out a well-architected and -monitored governance policy is the best offense.

- *Example:* Global Crossing, like Enron, collapsed into bankruptcy early in 2002, as Representative Felix Grucci (R-NY) stated, due to "absolute, unfettered greed." Charges of deceptive accounting practices and misrepresentation of assets by management demonstrated potential challenges to U.S. accounting practices in general and led to the passage of the Sarbanes-Oxley Act as the U.S. Congress moved to protect shareholder rights from greed in the executive offices.

Structuring Compliance

Compliance, as the granular delivery arm of governance, must address four major aspects to be effective:

1. Culture
2. Governance
3. Information management
4. Processes

Mitigating compliance risk requires, as discussed earlier, a solid governance policy supported by an organizational culture of compliance, along with tools to capture, document, collaborate, and record the processes, actions, and collaboration embedded throughout the environment.

One of the most intriguing complications of the governance/compliance challenge today is the global nature of work. Commercial, nonprofit, and government enterprises need to work locally but think globally. Even enterprises traditionally bound to the local economy, such as farming, find it necessary to consider the global economy when purchasing inventory or hiring workers.

Chapter Summary

Just as a house built on a solid foundation stands the test of time, an enterprise structured on a solid governance policy is well positioned to build an effective and efficient compliance program. It is the duty of the board of directors to ensure that governance policy is designed to address both legal compliance and strategic alignment. The handshake with the compliance program must clearly provide the board with transparency into enterprise operations and an understanding of how the program underscores required practices and fosters a culture of compliance to both regulation and enterprise policy.

Corporate governance provides a framework of checks and balances between the board, management, and investors that should produce an efficiently functioning corporation, geared to produce long-term value. All enterprise governance policies, regardless of country of origin, are the product of the blending of relevant legal, regulatory, and best-practice concepts. Each country's regulatory and corporate law system will shape the specifics of its corporate governance framework.

For example, corporate governance systems in the United States are shaped by a number of pressures including the Securities and Exchange Commission's (SEC's) regulatory oversight, which provides for:

- Stock exchange listing requirements
- Congressional ability to enact wide-sweeping federal legislation

- Local influences such as precedents set by the state courts
- The influence of institutional investors, including the power of proxy voting tactics, such as the filing of shareowner proposals

Although all of these influences can help focus attention on critical elements of good governance, they cannot tell corporate directors or officers how to determine whether the board has set appropriate goals for its own operations or whether the board is achieving success in reaching these goals. This portion of governance extends the responsibilities of the board and senior management in the realm of internal risk management.

The global nature of work is today, and will remain in the future, a governance and compliance challenge. A mobile workforce, with an employee in New York today and Peking next year, represents challenges on a number of fronts including personal, legal, human resources, and compliance. The mobile worker must be informed and prepared to comply with the policy and regulations in each new location. The shrinking world of work creates an expanding compliance vista for the enterprise and its workforce.

Note

1. R. Edward Freeman, professor of business administration at Dardem School, University of Virginia, is known for his work in stakeholder theory *(Managing for Stakeholders,* Yale University Press, 2007).