



## Ethics & the Board

Integrating Integrity into Business Strategy

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# Ethics and the Board

## Integrating Integrity into Business Strategy

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# Introduction: Being Proactive Is Critical in Challenging Times

In an era of cataclysmic repercussions of ethical breaches throughout the world, it is critical for senior management—and even more so for boards of directors—to exercise proactive oversight on issues of business integrity and compliance.

This report provides a 360-degree, high-level overview, inventory, and analysis of “touch points” between issues of business integrity and the role of the governing body of a business. It examines the “who, what, when, and how” of ethics and compliance and the board by asking:

- **Who** are the senior level players that are critical to the identification and resolution of ethical issues in a business?
- **What** are the key procedural and substantive business integrity and compliance issues that boards need to address?
- **When** should boards be informed about, and monitor, ethical issues and when should they proactively intervene?
- **How** should boards tackle and resolve ethical issues—from the pedestrian to the material—in a manner consistent with their fiduciary responsibilities?

During times of great economic and ethical crisis and challenge, boards have additional burdens and responsibilities. They need to take proactive measures to support executive management in the oversight, management, and mitigation of the increasing ethical challenges. At the end of the day, it’s all about risk and reputation management. It is paramount for the governing body of a business to take the full measure of its responsibility and comprehend the ways business integrity and governance intersect with business strategy.

## WHO: The Critical Players

Ethical issues arise at just about any level, anywhere, any time in a company's daily activities. It can be an issue concerning the conduct of procurement, or someone feeling bullied by colleagues, or a request for a bribe, or the false or unrealistic assumptions in a financial pro forma. However such issues arise, there are a few key players who should get involved and whom employees should turn to for consultation and advice. These include managers/supervisors, legal, finance, human resources, ethics and compliance (E&C) officers, and other members of senior management.

### Key Senior Management

**Chief executive officer** Regardless of whether a company has a chief ethics and compliance officer (CECO), the chief executive officer (CEO) is the guardian of the corporate culture. No matter how many policies or procedures a company has, the CEO's conduct, style, tone, and example is the practical rule book that employees ultimately follow. Regardless of how effective a CECO is, employees take their integrity cues from the CEO. Moreover, it is a CEO's behavior, not necessarily what he/she says, that has the most dramatic impact on employee opinion about a company's culture of integrity. The CEO's own behavior is the truest barometer of integrity within the organization.<sup>1</sup>

**Chief operating officer** As the key deputy of the CEO, the chief operating officer (COO) has almost as much responsibility to set the tone on integrity issues as the CEO.

**Executive and mid-level business unit leaders** If these leaders (the heads of business divisions, the presidents of regional and business lines, the people who lead the profit centers and their deputies) don't set the tone within their business operations, even when the CEO does, their behavior can act as a deterrent to the conduct of business with integrity. Sometimes referred to as "tone in the

middle," such action is also very important from middle management throughout the organization. But here again the middle managers will take their cue from the senior managers, who will take their cue from the CEO.<sup>2</sup>

**Chief financial officer** Often the top officer responsible for implementing the SarbanesOxley Act of 2002 (SOX) in the United States and other legal compliance requirements—internal controls, risk management, procurement, accounts payable and receivable, technology, stock options, mergers and acquisitions, and a host of other key business and financial matters—the chief financial officer (CFO) is the architect of the organization and, as such, is in charge of the way a business organization lives and breathes.<sup>3</sup>

**Chief risk officer** In charge of enterprise risk management (ERM), the chief risk officer (CRO) should be a key partner to the CECO on ethics and compliance issues and should ensure that risk assessment and risk management throughout the enterprise consist of transparent and thorough processes.

**Chief internal auditor** The chief auditor—the keeper of the internal controls system and checker of transparency and possible financial fraud in an organization—is able to understand where the weaknesses are, and makes certain that the relevant business areas are audited for ethics and compliance issues. The chief auditor should be a key partner of the CECO on a variety of ethical issues, from reports to the audit committee of the board to planning and implementing compliance audits within the organization.

<sup>1</sup> For a discussion of the importance of "tone at the top," see Patricia Harned, "The Risk of Being Ethically Tone Deaf at the Top," *Compliance Week*, September 2006.

<sup>2</sup> For a discussion of the importance of "tone at the middle," see Kirk O. Hanson, "Ethics and the Middle Manager: Creating Tone at the Middle," *Markkula Center for Applied Ethics*, May 2008, <http://www.scu.edu/ethics/practicing/focusareas/business/middle-managers.html>

<sup>3</sup> Since Enron, reports of CFOs who have been criminally investigated, prosecuted, or convicted are countless. Among companies whose CFOs have been implicated in one way or another in their companies' troubles are the CFOs of Enron, WorldCom, Adelphia, Nortel, Quest, HealthSouth, Tyco, Parmalat, Royal Ahold, Siemens and most recently, Stanford Financial.

**Chief legal officer/general counsel** The general counsel or chief legal officer (GC) should be a partner to the CEO and the CECO on a variety of ethics and compliance issues. In some organizations, the GC oversees the ethics and compliance function and has added responsibilities and challenges regarding integrity issues, which are compounded by the complexities of the attorney client privilege, conflicts of interest, and reporting obligations. The legal function plays a significant role in maintaining the organization's ethical culture through the manner in which it provides business advice and its interpretation of the organization's values and standards.<sup>4</sup>

**Chief human resources officer** The top human resources officer is a key partner to senior management and the CECO in both the handling of front-line ethical issues involving employee relations (e.g., harassment, bullying, unfair treatment) and the implementation of key ethics and compliance program elements (e.g., codes of conduct, behavioral norms, training, performance management systems, and collaboration on internal investigations).

**Chief information/technology officer** While the role of the chief information officer (CIO) is focused on technology and systems, so many ethics and compliance issues increasingly involve the use, abuse, and misuse of technology. The CIO and CECO are key partners in addressing a growing variety of issues ranging from email usage, privacy, electronic discovery, and business continuity to such recent phenomena as the workplace usage of Facebook, Twitter, and the blogosphere—the full ethics and compliance implications of which are only slowly being grasped.

**Chief governance officer/corporate secretary** The corporate secretary (CS) is the chief governance officer and keeper of the company's official books and governance records, and as such ensures that compliance and proper procedure takes place regarding the governance of the company. Many ethical issues stem from how governance

is observed within a company—from the very structure and composition of a board to the individuals on the board and how they are selected.

**Head of investor relations/external/government/media relations** There are several additional senior-level positions with strong connections to integrity issues and that deal with external stakeholders—including shareholders, the media, regulators, customers, and non-governmental organizations. Among these are the head of investor relations, the head of media and communications, and the head of government and external relations. Each of these positions has a key role to play in the management of ethical issues, whether dealing with aggrieved customers, negative publicity, government lobbying, or public relations and advertising.

**Chief ethics & compliance officer** The CECO or the person who assumes the mantle of promoting, educating, overseeing, and implementing a company's ethics, compliance, business integrity, and/or corporate responsibility program is a critical player on whom the success of both the inspirational and practical pieces of a program depends. To be successful, the CECO needs to have both the support of senior executive management and the board and a finely tuned sense of what the business requires in terms of ethics and compliance management.<sup>5</sup>

## The Board of Directors

Although executive management, namely the CEO, effectively and practically sets the tone for business integrity (or the lack thereof) in a company, the board could be said to ultimately set such a tone by providing (or not providing) oversight, and acting (or not acting) as a guardian of the company's charter. The board's role in a business is somewhat akin, but on a smaller scale, to the role the United States Supreme Court or the French Constitutional Council plays in protecting and interpreting the constitutions of those countries. Thus the role of the board should extend to providing business integrity oversight and guidance to the executive management of a business.

<sup>4</sup> *The Ethics & Compliance Handbook: A Practical Guide from Leading Organizations*, (Waltham, MA: The Ethics & Compliance Officer Association Foundation, 2008) pp. 35-38. See discussion of pros and cons of the CECO reporting to the GC, versus CECO as a stand-alone function reporting directly to the CEO and/or the board. This book, published by the ECOA, outlines in extensive detail each of the key components of a solid ethics and compliance program as inspired by the U.S. Sentencing Guidelines and practical experience.

<sup>5</sup> For a full discussion of the CECO role and how and where it should develop, see Patricia Harned and others, *Leading Corporate Integrity: Defining the Role of the Chief Ethics & Compliance Officer* (Washington D.C.: Ethics Resource Center, 2007).



In the face of economic crisis and the deep erosion of public trust, it is the board's responsibility to protect the reputation of the enterprise and to promote an ethical culture from within. Given all of these challenges and as a result of the complexity of certain SOX requirements, setting the appropriate tone has been difficult and confusing for directors in recent years. While SOX requirements—including internal controls and certification systems—have provided guidance to senior executive management, they have not provided clear guidance on a wide spectrum of governance issues. The best way for directors to set the tone from an ethics and compliance perspective is to engage in the ethics and compliance infrastructure behaviors outlined in Table 1 (page 12) which closely follow the elements of a sound ethics and compliance program.<sup>6</sup>

Boards must come to grips with a key realization: a board's oversight responsibility with regard to ethics and compliance is as important as its oversight of financial, operational, and leadership issues. It is paramount that a board hold management accountable (up to and including termination and succession) for failure to comply with matters of ethics and compliance.

### The role of individual directors

Each member of a board needs to be carefully vetted and selected. Until recently, many board members have been chosen because of their prominent positions in business or finance—other CEOs, CFOs, retired business leaders—or for their close connections and friendships with the CEO. While it is critically important for a board to be composed of capable, experienced, high-level business people (who are often known to the CEO or other board members), caution needs to be exercised that such members are chosen first and foremost for their expertise and independence and only secondarily for any connection to, or friendship with, the CEO or other board members. The practice of appointing friends and allies to boards has too often led to passive board members not taking a proactive look at a company's business strategy or integrity program, thus depriving shareholders of some of the most valuable features of an effective board—objective governance, accountability, and transparency. While SOX

requirements have sought to ensure the participation of interested board members with specific subject matter expertise, the selection process still yields sometimes sleepy or disinterested board members.

The actual role of each board member is to provide oversight, guidance, and advice to senior management concerning a wide array of critical business matters ranging from leadership succession and executive compensation to financial oversight and business plan approval, and at critical times such as the planning of a large-scale merger or acquisition. The ideal board member will be an experienced individual who is as comfortable looking at financial statements and analyzing business strategy as s/he is in understanding how business integrity and corporate responsibility are carried out within the company. The reality in many businesses is that while most board members are well versed in the commercial and financial aspects of business, they often do not have great insight, experience, or training on issues of maintaining an effective business integrity program. As is discussed later in this report, there are several steps boards can take to remedy this shortfall through education and other measures.

### The role of business integrity at the board level

A critical integrity issue at the board level is the need to ensure that the board itself is complying with the company's code of conduct, certification processes, conflict of interest disclosure, etc. In other words, all board members, before becoming directors, should undergo extensive background checks and be subjected to a thorough due diligence process conducted by either the retention agency hired to recruit them or by the company's human resources department, or both. Additionally, new board members should be required to undergo an orientation program that not only covers the business overview and financial information, but also audit, material disclosure, integrity, and compliance issues. In addition to receiving an ethics and compliance orientation, directors should insist upon receiving regular ethics and compliance briefings as more fully described later in this report.

<sup>6</sup> As set forth in the United States Sentencing Guidelines, Chapter Eight, and as evolved over the past couple of decades by leading organizations. See *The Ethics and Compliance Handbook*, pp. 9-10. Also see: *The United States Sentencing Guidelines Manual*, Section 8B2.1, (2) (B), <http://www.ussc.gov/2004guid/CHAP8.htm>



## The role of board committees

Because of legal or practical requirements, and depending on such factors as what industry an organization belongs to—whether it is publicly listed or not, highly regulated or not—and a variety of other considerations, most boards have a number of committees. Among these committees are several that may have official or unofficial, broad or narrow responsibility over business integrity issues. More enlightened boards may even have a committee specifically set up to provide oversight on business integrity issues. Regardless of what it is called, a board should have a committee that officially and deliberately focuses on issues of governance, compliance, integrity, and corporate social responsibility. It is the violation of these types of issues and the absence of board oversight that has had a negative impact on the reputation of many businesses in recent years.

Historically, board committees that have been most closely linked to ethics and compliance issues are the audit and compensation committees. The following are some examples of the type of integrity issues such committees are set up to deal with:

### Compensation and benefits committee

The compensation and benefits committee (C&B committee) has come under increased scrutiny in recent years in the face of accusations of excessive executive compensation that is, seemingly, not tied to company results.<sup>7</sup> Accordingly, the C&B committee now has an increased burden of protecting the company's reputation by engaging in measures to ensure the integrity of executive compensation, such as:

- Establishing and maintaining competitive and equitable compensation and benefits policies tied to performance
- Discharging the board's responsibilities for compensating the company's executives
- Overseeing the competency and qualifications of senior management

### Audit committee

The board of directors, primarily through its audit committee, is responsible for ensuring that the company maintains an effective ethics and compliance program, with periodic reporting mechanisms established to assist the board in meeting its governance and oversight responsibilities. Typically, the general counsel or the chief auditor reports periodically to the audit committee on regulatory and/or ethics and compliance matters, including cases of fraud, misappropriation of corporate assets, bribery, procurement fraud, etc.<sup>8</sup>

### Public policy and corporate responsibility committee

Some companies may have a committee that advises the board and senior management on company policies and practices that pertain to the company's responsibilities as a global corporate citizen, and its commitment to the highest standards of ethics and integrity in all its dealings. A committee of this kind often encompasses ethics and compliance concerns as well.

### Corporate governance committee

This type of committee makes recommendations to the board on matters pertaining to the effectiveness of the board, e.g., size and composition of the board; individuals qualified to become directors; nominees to the board for action at the next annual stockholders meeting; the structure and composition of the committees of the board; board compensation; and evaluation of the board's effectiveness. This committee also takes a leadership role in shaping the corporate governance of the company, including the development of a set of governance guidelines for board approval, rules on conflicts of interest, and, if there is no other responsible committee, issues of ethics and compliance.

<sup>7</sup> The Conference Board recently published a report on this topic: see Matteo Tonello, *Overseeing Risk Management and Executive Compensation*, Executive Action 292, December 2008. The Obama Administration, in response to the financial meltdown and scandals of 2008/2009, has offered a series of potential reforms to corporate compensation structures and incentives. See contemporaneous reports in the *New York Times*, the *Wall Street Journal*, and the *Financial Times* in April, May, and June 2009.

<sup>8</sup> A good discussion on how to present ethics issues to an audit committee can be found in: Patricia Harned, "How to Talk about Ethics to the Audit Committee," *Compliance Week*, February 2009.

## WHAT: The Procedural Touch Points

Over the years, especially in the United States but increasingly in Europe and Asia, companies have struggled to come up with a set of practices that helps them to manage business integrity issues. It all started with bribery and corruption convictions of several leading U.S. defense contractors in the late 1970s and the adoption, at that time, of the U.S. Foreign Corrupt Practices Act (FCPA).<sup>9</sup> It continued in the 1980s, also within the defense industry, with the creation of the Defense Industry Initiative (DII) through which leading defense contractors began to put together the outlines of what constitutes a solid ethics and compliance program.<sup>10</sup>

Much of the push to create a solid corporate infrastructure for dealing with ethics and compliance issues culminated with the adoption in the early 1990s of Chapter Eight of the United States Sentencing Guidelines (USSG), which outlined the contours of an effective ethics and compliance program.<sup>11</sup> In the 1990s, additional significant resources and material developments emerged in the field including the creation of the first professional association for ethics practitioners through the Ethics Officer Association, now known as the Ethics & Compliance Officer Association (ECO), and the adoption by the Organization for Economic Co-operation and Development (OECD) of its Anti-bribery and Corruption Convention which has allowed for the spread of FCPA-like legislation to 38 countries worldwide—eight of which are not OECD members.<sup>12</sup> Other governmental agencies throughout the world have sought to obtain from the board of directors or other governing body of an organization a formal commitment to maintain an effective ethics and compliance program.<sup>13</sup>

The eruption of Enron and other major scandals at the burst of the internet bubble in the early 2000s, and the proliferation of corporate social responsibility, non-governmental organizations (such as Transparency International, Greenpeace, and many others), and other stakeholder groups over the past two decades has increasingly pointed to the need for business to create an effective integrity infrastructure. And if all that weren't enough, the biggest and "baddest" of all scandals has just overcome the global marketplace with the worldwide financial meltdown of 2008-2009, due to the confluence of uncontrolled business and financial practices and regulatory laxity despite the adoption of SOX and other regulatory frameworks since the beginning of this century. If it wasn't clear before 2008, it is clear now that building a proper ethics and compliance infrastructure into a business is not just a nicety but an absolute necessity. The question throughout this period despite all of these developments is—where was the board?

<sup>9</sup> See Francois Vincke and Fritz Heimann, *Fighting Corruption: A Corporate Practices Manual* (Paris: International Chamber of Commerce Publications, 2003).

<sup>10</sup> For more on the DII, please visit their website at: [www.defenseethics.org](http://www.defenseethics.org)

<sup>11</sup> *The United States Sentencing Guidelines Manual*, Section 8B2.1, (2) (B), <http://www.ussc.gov/2004guid/CHAP8.htm>

<sup>12</sup> For more information on the ECOA, please go to their website: [www.theecoa.org](http://www.theecoa.org). For more information on the latest signatories to the OECD Anti-bribery Convention, go to the OECD website at [www.oecd.org](http://www.oecd.org). For further resources on anti-corruption go to: Transparency International at [www.ti.org](http://www.ti.org); the World Economic Forum Partnering Against Corruption Initiative (PACI) at [www.weforum.org/en/initiatives/paci](http://www.weforum.org/en/initiatives/paci); and the United Nations Global Compact at [www.unglobalcompact.org](http://www.unglobalcompact.org)

<sup>13</sup> For example, in the United States, the Office of the Inspector General of the United States Department of Health and Human Services issued the *Office of the Inspector General Compliance Program Guidance for the Pharmaceutical Industry* in 2003, suggesting, among other requirements, that the board of directors of pharmaceutical manufacturers exercise proactive oversight over their company's compliance program.

## The Role of the Board Regarding Ethics & Compliance Infrastructure

So what is the role of the board in making sure the integrity infrastructure of a company is properly in place? Table 1 (page 12) shows a summary of critical integrity infrastructure components and specifies what the board's role should be regarding such components. Inspired by several decades of experience and the work of the United States Sentencing Commission, these include:

- **Code of conduct and appropriate policies** A company needs to develop a company-appropriate, customized code of conduct, employee handbook, and related policies addressing its common issues (e.g., harassment) and its particular issues (e.g., in the media business, proper subscriber/royalty accounting).
- **Governance oversight and E&C resources** A company must have a dedicated senior-level executive in charge of E&C issues to whom sufficient and appropriate resources are allocated and who has the ability to report directly to the governance body.
- **Periodic E&C risk management** A company needs to maintain a periodic risk assessment and management of its ethics and compliance exposures whether criminal, civil, or reputational.
- **Delegation of approval authority and leadership vetting, and due diligence** A company must have an internal system of accounting and delegation of approval controls as well as a background check system for employees.
- **Targeted training and communications** A company must maintain an ongoing communications and education program in which ethics and compliance topics are regularly discussed.
- **Monitoring, investigating, and auditing of E&C program** A company must have a sound and confidential system to investigate and resolve ethics and compliance issues.
- **Anonymous reporting and help lines** A company must provide employees with a system to voice concerns, report problems, and get answers either anonymously or otherwise without fear of retaliation.
- **Continual review and improvement of E&C program** A company must continually benchmark, compare, and improve its processes.

Table 1

**Integrity infrastructure requirements: the role of the board**

Procedural best practice/infrastructure requirement	The board of directors needs to ensure that...
A. Code of conduct & appropriate policies	<ul style="list-style-type: none"> <li>• There is a code of conduct for all employees, the board, senior management, and third parties</li> <li>• High risk-specific policies are in place</li> <li>• Policies address systemic and industry-specific risks</li> <li>• There is periodic education of board on company code of conduct</li> </ul>
B. Governance, executive oversight, E&C resources	<ul style="list-style-type: none"> <li>• A CECE or equivalent has been appointed</li> <li>• CECE has sufficient personnel and resources commensurate with company needs</li> <li>• CECE is sufficiently integrated with company's executive team</li> <li>• CECE has ability to report directly to board or board committee formally or informally</li> </ul>
C. Delegation of approval authority and background diligence	<ul style="list-style-type: none"> <li>• Senior management has rules and procedures in place regarding hiring and promotions that take into account integrity issues</li> <li>• Procurement and third party on-boarding process is transparent, systematic, and compliant with applicable laws</li> <li>• Proper background checks are conducted on senior and mid-level management</li> <li>• Overall internal controls and other public company or applicable regulatory processes and practices are in place and reviewed periodically through audit committee and full board</li> </ul>
D. Targeted training and communications	<ul style="list-style-type: none"> <li>• The conduct of periodic training and education for all employees, management, and critical third parties takes place</li> <li>• Training and code certification process is tracked and that further inquiries take place when issues come up</li> <li>• Company issues regular communications to all employees on E&amp;C topics including from the CEO and senior management</li> <li>• Board receives appropriate code of conduct and other relevant integrity education periodically</li> </ul>
E. Monitoring, investigating, and auditing of E&C program	<ul style="list-style-type: none"> <li>• Periodic monitoring and auditing of the E&amp;C program takes place; board should demand reports</li> <li>• Routine internal audits take place</li> <li>• Key compliance indicators (e.g., fines, penalties, warnings, violations) are reviewed</li> <li>• An investigations protocol is in place and is followed; reports are received on overall results of this process each year</li> <li>• Exit interviews take place</li> </ul>
F. Anonymous reporting and help lines	<ul style="list-style-type: none"> <li>• A system is in place for employees and others to report and discuss concerns without fear of retaliation</li> <li>• Concerns are addressed and resolved</li> <li>• Periodic (quarterly or annual) reporting of statistics about hotline and other reported issues, including trend lines, comparisons to peer companies, and overall business statistics are provided</li> </ul>
G. Continual review and improvement of E&C program	<ul style="list-style-type: none"> <li>• Lessons are learned from mistakes; board should seek examples from senior management</li> <li>• Accountability on improvements from senior management are demanded</li> <li>• Proof of implementation of improvements is provided</li> <li>• E&amp;C considerations are factored into performance evaluations</li> <li>• There is wholehearted support and encouragement of the CECE becoming a member of relevant peer associations to enable him/her to access and benefit from materials, benchmarking, etc. (e.g., The Conference Board, Ethics &amp; Compliance Officer Association, the Ethics Resource Center, the Institute on Business Ethics, and others)</li> </ul>
H. Periodic E&C risk management	<ul style="list-style-type: none"> <li>• There is full understanding of the company's risk profile</li> <li>• E&amp;C risk assessment is done periodically</li> <li>• Risk assessments and management target specifically high-risk areas for the business</li> <li>• Senior management be accountable for risk management</li> <li>• A relationship exists between E&amp;C risk assessments and enterprise risk management</li> </ul>



## The Substantive Touch Points: E&C – A to Z

Once an in-depth risk assessment is conducted, the organization will have an understanding of its risk profile. The board should then request selected briefings on multiple ethics and compliance topics based upon the organization's risk profile. The board should be well informed through educational sessions and periodic updates by the CECO and other relevant officers (CRO, CFO) of the substantive issues that rise to the top of the company's risk profile.

The well-informed board will have a good understanding of how ethics and compliance issues intersect and affect the business. Table 2 summarizes some of the hot button issues that most businesses must tackle. Beyond this list, each specific business will have industry, geographic, and regulatory-specific risks for which it needs to design and implement appropriate risk assessments, policies, and safeguards.

Table 2

### Integrity substantive requirements: the role of the board

Integrity issue	The board of directors needs to ensure that...
Antitrust	Policies and procedures are in place to avoid collusion and other anti-competitive practices that could lead to possible criminal and/or civil penalties and fines
Child labor	Policies and programs are in place so that no child labor is used at the company or any third party provider
Corruption, bribery	The company has a tight anti-corruption (private and public) program in place that is closely followed and promoted
Data privacy	Policies and programs are in place so that employee and client data are protected internationally
Discrimination	Policies and programs are in place so that there is a fair and productive workplace devoid of discrimination
Environmental protection	Policies and programs are in place so that there is compliance with environmental laws and the provisions for an environmentally safe workplace
Fraud, theft	The company has sound internal controls, anti-fraud policies, and procedures in place to avoid internal theft, misappropriation, and a culture of cheating
Harassment, bullying, and mobbing	Policies and programs are in place so that there is a fair and productive workplace devoid of harassment, bullying, or mobbing
Health and safety	Policies and programs are in place so that there is a safe and healthy workplace for employees and third parties
Slave labor	Policies and programs are in place so that no slave labor is used at the company or any third party provider
Supply chain management	There are protocols in place for due diligence and vetting of all third parties on an initial and periodic basis to avoid civil, criminal, or reputational damage
Conflicts of interest	A process is in place for a conflict's awareness, disclosure, and resolution and that all employees know when to discuss these with supervisors and management

# WHEN: Getting E&C Issues on the Agenda

As part of its oversight responsibilities, the board or a specified board committee must make certain that it receives routine briefings on the status of the company’s ethics and compliance program. Boards typically meet on a periodic basis, with very full agendas. Until recently, integrity issues and the status of the company’s ethics and compliance program had not been given the prominence that is warranted. Notable exceptions have taken place at companies that have experienced integrity lapses or reputational damage—in such companies the effectiveness of the company’s ethics and compliance program is established and monitored via government agreement and continuing oversight (e.g., corporate integrity agreements, consent decrees, and deferred prosecution agreements). Unfortunately, it is only a minority of companies that have voluntarily established sound and integrated ethics and compliance programs. Companies need to learn that an ounce of voluntary prevention is worth a ton of forced remediation.

In setting the tone at the top, boards would be wise to establish an ethics and compliance timeline, including regular and periodic business integrity program updates and a thorough review of the program elements described in Table 1 (page 12). The most effective way to demonstrate the proper tone is to establish, as an ongoing agenda item, an ethics and compliance status report.

Routine board briefings can take place at or during:

- The establishment of the company
- Annual briefings
- Quarterly briefings
- Periodic disclosure reports
- M&A integration
- Corporate citizenship/responsibility reports
- Compliance and ethics reports
- Extraordinary situations
- When the CECO has a material concern

Table 3  
Ethics & compliance program status report

When	Substance: what	Action: who
At establishment of company	<ul style="list-style-type: none"> <li>• Creation of code of conduct</li> <li>• Consideration of ethical issues in connection with bylaws and charter</li> <li>• Formation of board and committees</li> <li>• Consideration of where ethics and compliance fits into organizational and board structure</li> <li>• Hiring of CECO</li> </ul>	<ul style="list-style-type: none"> <li>• Shareholders</li> <li>• Board</li> <li>• Executive management</li> </ul>
Annually	<ul style="list-style-type: none"> <li>• Annual report</li> <li>• Corporate citizenship report</li> <li>• Annual ethics and compliance report</li> </ul>	<ul style="list-style-type: none"> <li>• Senior management</li> <li>• Committee or officer</li> <li>• CECO/general counsel</li> <li>• Audit committee (or other board committee)</li> </ul>
Quarterly	<ul style="list-style-type: none"> <li>• Ethics and compliance update</li> <li>• Ethics and compliance review</li> </ul>	<ul style="list-style-type: none"> <li>• CECO/GC</li> <li>• Audit committee</li> <li>• Committee chair</li> <li>• Compensation committee</li> </ul>
Upon occurrence of material events	<ul style="list-style-type: none"> <li>• Material ethics and compliance issue</li> <li>• Material audit issue</li> <li>• Material corporate responsibility issue</li> </ul>	<ul style="list-style-type: none"> <li>• CECO/GC</li> <li>• Chief auditor</li> <li>• Audit committee</li> <li>• Committee chair, officer</li> </ul>
Merger & acquisition	<ul style="list-style-type: none"> <li>• Due diligence activities relating to M&amp;A, joint venture, and similar activities</li> </ul>	<ul style="list-style-type: none"> <li>• Transition team</li> <li>• CECO/GC</li> </ul>

# HOW: Board Critical Thinking and Proactive Oversight on Integrity in a Troubled Time

At a time when critical, strategic thinking by governing bodies of both public and private organizations is an absolute necessity, boards of business organizations must reevaluate and implement fresh and practical thinking on the issue of conducting business with integrity. Recent times have unequivocally proven that business integrity issues are just as important as issues of financial planning and business strategy. Indeed they may be arguably even more important during troubled economic times when fraud, malfeasance, and other corner-cutting activities significantly rise.<sup>14</sup> Boards must think of business integrity as indelibly and irreversibly intertwined with business finance and strategy, and have an obligation to take action to accomplish this essential objective.

There are five key practical steps that boards must champion and oversee to achieve the seamless integration of integrity with finance and strategy. By providing encouragement and proper incentives to senior and mid-level management, boards will contribute to the establishment and long-term maintenance of integrity within their company and in business generally.<sup>15</sup> While it is often said that the tone is set at the top, meaning senior management, it can be argued that tone should be set at the very top—at the governance or board level. Without such board-driven clear and unequivocal oversight and focus on issues of business integrity, senior management may ignore or circumvent issues of ethics and compliance.

## Action Item #1: It Begins With the Board – Director Selection and Performance

Boards must think about ethics at the inception—i.e., when boards are formed and when new members are recruited. Following are a few components to consider.

### Board member selection

There are a few key criteria that boards and their chairpersons should follow in the selection of new board members. These include:

**Independence** Board candidates should be selected based upon pre-determined objective criteria, and cronyism (for the sake of cronyism) should be avoided at all costs. As discussed earlier in this report, board members should be selected because of the substantive contribution they will make to the overall welfare and development of the company and their expertise and experience that is relevant and useful to the company, not exclusively because they may be a friend or political ally of the CEO or other board members.

**Knowledge and analytical capabilities** Board candidates should be selected on the basis of their analytical and substantive ability and should be encouraged to avoid “rubber-stamping” recommendations from senior management.

**Business integrity experience** Board candidates should be selected for their knowledge of and experience with ethical challenges and decision making in their current or past roles. A substantive background in governance, risk management, compliance, or corporate responsibility should be part of the selection criteria for any candidate.

**Integrity & conflicts review** If they haven’t already done so, boards have a duty to ensure that all existing and new members of the board pass certain set standards of integrity themselves. In other words, prospective board members must undergo prior scrutiny through due diligence, background checks, and a thorough vetting and interview process.

<sup>14</sup> See: Luke Johnson, “Watch Out for an Epidemic of Petty Fraud,” *Financial Times*, June 2, 2009; and Megan Murphy, “Tolerance of Fraud in Business Rises,” *Financial Times*, May 20, 2009.

<sup>15</sup> Several good books have been written on various aspects of the historical turning points in the early 21st century. Among them: Dove Seidman, *How: Why HOW We Do Anything Means Everything in Life and in Business* (Hoboken, NJ: John Wiley & Sons, 2007); Thomas Friedman, *Hot, Flat & Crowded* (New York, NY: Farrar, Straus and Giroux, 2008); James Surowiecki, *The Wisdom of Crowds* (New York, NY: Doubleday, 2004); and Malcolm Gladwell, *Blink* (New York, NY: Little Brown and Company, 2005).

**Board member preparation** Among some of the key elements of board member preparation is providing the new (and existing) board members with education. Board candidates should be given an ethics and compliance overview so that they fully understand the company's expectations upon joining the board.<sup>16</sup> Additionally, board members should fully understand the parameters of key integrity documents and practices, such as:

- The company's code of conduct
- SOX escalation procedures
- The audit committee's role
- CECO reporting on material concerns

#### Ongoing ethics activities

In addition to initial vetting and due diligence, ongoing activities to ensure the independence and transparency of the board itself must follow. Among the tools to assist in this regard:

- **Code of conduct** The organization should have a code of conduct applicable to the board—either its general code or a specific one for the board and/or senior management.
- **Certifications** Annual or periodic code of conduct certifications and conflicts checks should be conducted.
- **Education** Annual or periodic training and education of the board should take place.
- **Reporting** Periodic ethics and compliance reports should be given to the board.

## Special role of the compensation and benefits committee

Recent public outrage has focused specifically on what has been interpreted as excessive executive compensation, seemingly without metrics related to the business. In this environment, the C&B committee needs to take special care to make certain that company executives receive pay for performance.

#### Special role of the audit committee

The board itself or a specific board committee (e.g., audit committee) should meet periodically with the CECO to receive a regular briefing about the effectiveness of the company's ethics and compliance program. The board, or a board committee, should have an established mechanism for being advised expeditiously in the event of a material event. Alternatively, the audit committee should make it clear that the CECO may approach it at any time for any purpose.

## Action Item #2: Boards Should Demand Cross-Functional Collaboration on Business Risks

In the face of many years of multiple and repeated ethical lapses, and in the context of increased regulatory and governmental oversight and enforcement activity, it is important that boards insist that their organization assess and manage their risk profile across the enterprise. A solid enterprise risk management program (ERM) will take into consideration not only financial, strategic, and operational risk, but also ethics, compliance, and reputational risk. To ensure effective ERM, boards should encourage and even demand a high level of cross-functional collaboration on issues of business integrity.<sup>17</sup>

<sup>16</sup> An excellent overview of the required elements of a sound ethics and compliance program can be found in *The Ethics & Compliance Handbook*.

<sup>17</sup> See the following article on how to integrate ethics and compliance issues into ERM: Andrea Bonime-Blanc, "Building Ethics & Compliance Risks into ERM," *ComplianceWeek*, October 31, 2006.



Following are the types of functional areas that require collaboration on ethics issues and which need to be reflected in a company's ERM system:

- Human resources
- Ethics and compliance
- Employee communications
- Labor and employment matters
- Media and communications policies
- Finance and internal controls
- Security
- Environment, health, and safety
- Governance
- Corporate responsibility

### Action Item #3: Board Oversight of Executive Management – Putting Teeth into Performance with Integrity

Boards must seriously reevaluate compensation packages and performance appraisal systems to ensure they are aligned with long-term ethical performance.<sup>18</sup> Many companies have developed sophisticated performance appraisal processes that take into consideration a “leadership” rating with an ethics component. Whatever system the company elects to follow, the board will be held responsible, both in letter and in spirit, for establishing a compensation and benefits policy that is not only designed to retain executives and encourage their efforts on behalf of the company, but also one that permits the board to carry out its responsibilities to further the company's commitment to ethics and integrity. This may be a radical approach in light of recent developments; however, the board will need the courage to deny excessive compensation in the face of ethical lapses.

### Action Item #4: Board Oversight of the Ethics & Compliance Function – Ten Questions the Board Should Ask

The role of the CECO merits further debate and discussion. Several articles have reviewed the role of the CECO with some suggesting the elevation of the role to executive management.<sup>19</sup> Boards should ask the CECO certain key questions on a periodic basis regarding their own and senior management's oversight and accountability on issues of integrity and compliance, including:

- 1 Are we identifying and prioritizing the company's ethics and compliance risks?
- 2 Are the company's standards, policies, and procedures (e.g., code of conduct) linked to the prioritized ethics and compliance risks?
- 3 Do we audit compliance risk areas?
- 4 How are we communicating to our employees their job-related compliance risks, and the importance of ethics and compliance, generally?
- 5 Do we have an effective issue escalation policy/procedure/guideline?
- 6 Are we responding appropriately to compliance allegations, issues, and concerns?
- 7 Can we demonstrate that employees are appropriately vetted upon hiring and promotion into certain positions of substantial authority?
- 8 Do we have the right systems and controls (e.g., a help line) to ensure that ethics and compliance-related issues and concerns are brought to the attention of the appropriate people within the company?
- 9 Are senior management and the board receiving the information that they need to provide appropriate oversight of the ethics and compliance program?
- 10 How do we use performance management processes and tools to ensure that all employees are held accountable for creating an ethical, values-based culture?

<sup>18</sup> Ben W. Heineman, *High Performance with High Integrity* (Boston, MA: Harvard University Press, 2008).

<sup>19</sup> See: Andrea Bonime-Blanc, “Governance, Risk, Ethics & Compliance: Time for a Seat at the Executive Table,” *Ethics Today*, February 18, 2009; and Patricia Harned and others, *Leading Corporate Integrity: Defining the Role of the Chief Ethics & Compliance Officer* (Washington D.C.: Ethics Resource Center, 2007).

In addition, boards should require the following from executive leaders regarding the ethics and compliance function and issues:

- Ensure selection of an appropriate CECO for the organization
- Allow the CECO the ability to independently report to the board when necessary
- Ensure appropriate compensation and performance management of the CECO
- Ensure that the CECO has appropriate resources
- Require executive leadership proof of action regarding CECO and the E&C program
- Hold executive leaders accountable for integrity up to, and including, termination
- Require timely delivery of audit committee and other reports on critical integrity issues
- Help executive leaders integrate integrity into the organization’s mission, vision, and values
- Require integrity metrics (not just business metrics) be integrated into strategy and business plan

Table 4

**Questions the board should ask the chief ethics & compliance officer**

Board oversight questions	Related topic	Example
Do we have the right model to oversee, manage, and implement the company’s ethics and compliance program?	Status of office of CECO	<ul style="list-style-type: none"> <li>• Overview of compliance infrastructure</li> <li>• Report on resources, budget, personnel, external costs incurred</li> <li>• Report on projected needs</li> </ul>
How do we assess adherence to company standards?	Compliance metrics	Compliance assessment tool
How do we ensure the visibility of high-risk matters arising in the business units?	Escalated matters	<ul style="list-style-type: none"> <li>• Escalation procedures</li> <li>• Types of high-risk categories</li> <li>• Specific high-risk matters for review by the board</li> </ul>
Are we identifying and prioritizing the company’s compliance risk?	<ul style="list-style-type: none"> <li>• Risk management and risk assessment process</li> <li>• Risk management update</li> </ul>	<ul style="list-style-type: none"> <li>• Outline of how risk assessments conducted</li> <li>• Report of E&amp;C risk</li> <li>• Report on ERM integration</li> <li>• Risk brainstorming session results</li> </ul>
Are we auditing for priority compliance risks?	Results of specific audits and assessments	<ul style="list-style-type: none"> <li>• FCPA audit, report from outside auditor</li> <li>• Sample of integration of E&amp;C risks into ERM</li> <li>• E&amp;C issues escalated to audit committee from CECO</li> </ul>
Do we have the right systems in place to: <ul style="list-style-type: none"> <li>- ensure observed misconduct is reported?</li> <li>- ensure employees are comfortable raising issues?</li> </ul>	Multiple means for employees to obtain assistance and report issues	<ul style="list-style-type: none"> <li>• Hotline; help line</li> <li>• Ethics office</li> <li>• Ombudsman program</li> <li>• Non-retaliation policy</li> </ul>
How do we measure program effectiveness?	<ul style="list-style-type: none"> <li>• Organizational ethics and compliance assessment (OEA)</li> <li>• Active case intervention and investigation process</li> <li>• Hotline/help line report</li> </ul>	<ul style="list-style-type: none"> <li>• OEA focus groups; ethics survey</li> <li>• Anonymous vs. named allegations</li> <li>• Rated of substantiation</li> <li>• Remediation actions (i.e., enhanced controls)</li> <li>• Disciplinary actions</li> </ul>
<ul style="list-style-type: none"> <li>• How do we train our employees?</li> <li>• How do we raise employee awareness of the company’s ethics and compliance program?</li> </ul>	<ul style="list-style-type: none"> <li>• Specify mandatory training modules</li> <li>• Explain how training is tracked</li> <li>• Describe how employee communications are disseminated</li> </ul>	<ul style="list-style-type: none"> <li>• FCPA training:                             <ul style="list-style-type: none"> <li>- Who gets trained?</li> <li>- How often?</li> </ul> </li> <li>• Posters advertising the hotline/help line</li> </ul>

## Action Item #5: Boards Should Listen to, and Learn from, Integrity Experts

So, whom is a board to turn to for ethical and integrity advice?

**Company CECO** Boards should turn to their internal CECO, if the role is in place, for their candid, even behind-closed-doors advice if and when necessary.

**Senior company leader** If a company does not have a CECO, the board should find the next best member of senior management who might have an overview of the topic of integrity within the company for a report on the status of integrity issues.

**Outside expert** If no one within the company has expertise, the board should consider retaining an outside expert to provide the board and senior management with an overview or risk assessment of the integrity exposure of the business.

**Board members** Consider whether a member of the board should be a resident board expert on these issues. First, if an existing board member has expertise in this area, ensure they participate actively in oversight of the company's ethics and compliance program. When a vacancy arises on the board or, more proactively, if deemed prudent, the board should consider bringing on a new board member with specific expertise in the area of business integrity—a retired CECO or other luminary with practical experience in the area who can add value to the company.

# Conclusion

## The Board as Ethical Role Model and Guardian of Integrity

Among the key roles boards must play in the emerging and as yet unclear form of capitalism rising in the early 21st century will be those of guardians of their own organization's integrity and ethical role models to their company's executive management. The uppermost governing bodies of business institutions need to become at once

more self-reflective and more proactive in charting a more effective course where integrity is more deeply embedded into business strategy. Boards should simultaneously attend to cleaning up their own house (insofar as there are issues of independence, conflicts, or other governance challenges) and encouraging executive management changes to allow for the seamless integration of business integrity into business strategy.

Table 5

### Elevating ethics: a summary of what a board can (and should) do

- Recruit board members with a strong ethics and compliance background<sup>a</sup>
- Recruit board members with non-traditional, diverse backgrounds<sup>b</sup>
- Recruit board members with actual relevant expertise for the business in question
- Thoroughly background check all directors at outset and periodically thereafter
- Hold existing directors to the highest standards by:
  - requiring periodic conflicts of interest questionnaires and other ongoing disclosures from director
  - removing directors when conflicts of interest are not waivable
  - removing directors when conflicts or other issues have not been properly disclosed
- Separate the role of chairperson of the board and CEO
- Name independent directors to chair the audit and compensation committees
- Elevate CEO role to executive leadership team and require concomitant credentials and visibility from CEO<sup>c</sup>
- Require CEO reporting not only to executive leadership but also to board or board committees<sup>d</sup>
- Make integrity an integral part of every agenda
- Hold senior management accountable for integrity issues at every meeting
- Take advantage of "teachable moments" using ethical lapses to understand risk
- Engage willingly in periodic (at least annual) substantive integrity education
- Engage in a risk brainstorming session with members of executive management
- Maintain appropriate relationship between executive compensation and company performance
- Promote long-term reputational goals vs. short-term "Wall Street" targets

<sup>a</sup> Boards should consider recruiting board members who are experts in risk management, governance, ethics, and compliance from among the increasing pool of seasoned and experienced CEOs, many of whom began work in the 1980s and 1990s when the profession began.

<sup>b</sup> A number of countries, other than the United States, are making breakthroughs concerning the composition of their boards. The following articles report on how boards in Spain and Norway are recruiting diverse and non-traditional directors such as women and experts in risk management to help with the increasingly complex and multi-faceted running of global organizations: Peter Thal Larsen, "Spain Shows the Way in Better Handling of Risk Management," *Financial Times*, May 4, 2009; and Richard Milne, "Skirting the Boards," *Financial Times*, June 15, 2009.

<sup>c</sup> See: Patricia Harned and others, *Leading Corporate Integrity: Defining the Role of the Chief Ethics & Compliance Officer* (Washington D.C.: Ethics Resource Center, 2007).

<sup>d</sup> See: Gael O'Brien, *A Place at the Table: Should the Ethics Function Report to a Company's Highest Authority*, The Conference Board Executive Action Series, No. 254, January 2008. Also see: Andrea Bonime-Blanc, "Governance, Risk, Ethics & Compliance: Time for a Seat at the Executive Table," *Ethics Today*, February 18, 2009.



## About This Report

This report is authored by Andrea Bonime-Blanc and Jacqueline E. Brevard, both of whom are members of The Conference Board Global Council on Business Conduct. Through pursuit of an agenda set by its members, the council provides an exclusive network for a candid exchange of views on the key ethics and business practice issues that corporations confront in home and host countries. As a forum for representatives of companies from diverse regions, the council seeks to build a global perspective in discussion of common concerns such as articulation of core principles, developing effective compliance systems, and balancing stakeholder interests. The views expressed in this article are based on the authors' experience and expertise.

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