

Governance, Ethics and Compliance
In The
New Global Economy

Introduction

On November 18, 2009 the Los Angeles Times reported that the Obama administration had “*announced a renewed crackdown on financial crimes, establishing a task force of top federal officials to work with state and local authorities to prosecute cases stemming from the crash of the housing market and the Wall Street meltdown.*” Since the financial crisis swept the globe, governments around the world have initiated hundreds of actions all essentially focused on two issues:

- Gaining more oversight and control over the financial and corporate business sectors in order to ensure that no such financial crisis can happen again; and
- Instituting - or more rigorously enforcing - punishment on those financial investment firms, corporations, and individuals which violate laws, regulations, codes and ethical standards of conduct.

While it may take some years yet for the full legal and regulatory response to the current international financial crisis to be formulated and enacted, no one should doubt that stricter requirements and stricter enforcement of those requirements will ultimately have a major influence on corporate business practices globally.

How we got here.

“It’s only when the tide goes out that you learn who’s been swimming naked.”

Warren Buffet

It is not as if every corporation in the world was “swimming naked” during the current global financial crisis; but enough of the largest and most influential corporations were exposed to essentially continue the erosion of private investor and the public trust in corporations that began with the Enron collapse. Governments, in response to intense pressure from private investors and the public at large, have had very little choice but to respond by enacting legislation and regulations which appear to be aimed squarely at forcing – and enforcing - what they define as ethical behavior on every corporation, regardless of how well clad those corporations may or may not have been when the financial tide went out.

That government response began in 2002 with the passage of the original Sarbanes-Oxley Act which was intended to “*protect **investors** by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.*”¹ In essence the Sarbanes-Oxley Act, and similar legislation initiated by

¹ Sarbanes-Oxley Act of 2002, One Hundred-Seventh Congress of the United States of America, January 23, 2002

governments globally, was a reaction to the fact that the public, private investors and governments had been rocked by a series of corporate financial incidents which seemed to peak with the Enron collapse. With such incidents the “trust” of the public and private investors in corporate America was seriously eroded, to the point where neither the public at large or private investment community aligned themselves with corporate America to resist the imposition of legislation specifically aimed at improving financial accounting and reporting and, for the first time, holding specific corporate and board of directors individually responsible for the actions and reports of the corporation. The result was Sarbanes-Oxley.

In this latest financial crisis it was actually the financial arm (investment banking and other loan institutions) of the investment community itself that lost the trust of the public, private investors and governments. It is surprising in retrospect to realize the extent to which the world’s corporations and financial institutions operated and were dependent on private investor and public trust. Unfortunately, once trust is broken it is extremely difficult to regain. In the last 10 years, two of the critical elements of the general business model – corporations and the financial community – have shaken the financial structure of the globe to the point where governments, urged on by their respective public and private investors, are no longer willing to work on trust and are taking actions to regulate and control business at increasingly pervasive and rigid levels.

The Path Ahead

*“We are unfit for any trust
'Til we can and do obey.”*

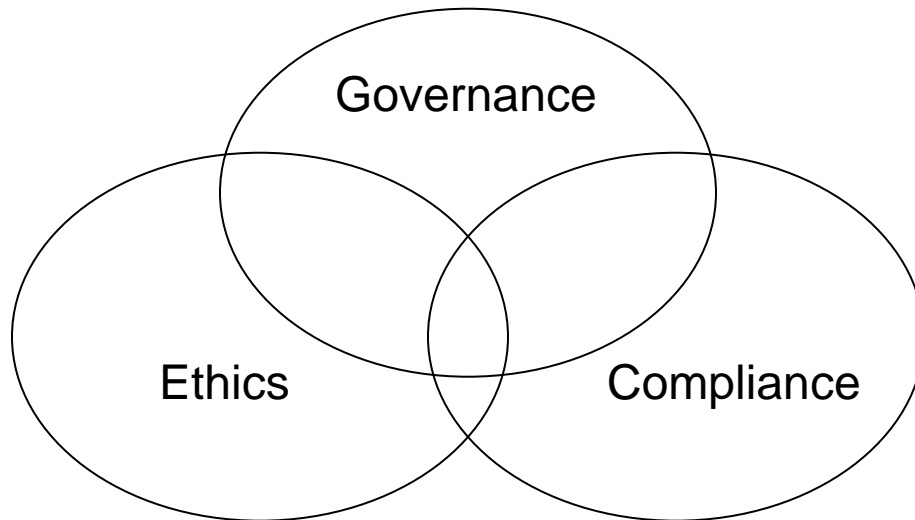
Willie’s Question
George Macdonald

There are political battles being fought globally on a daily basis relative to the final forms that this increased regulation and control will ultimately take; however, what is inevitable is that there will be additional regulation and control over both the corporate and financial communities. It is also becoming increasingly clear that that regulation and control will not simply concern corporate and financial entities; individuals within those entities will be held personally responsible for the acts of those entities.

Recently a conference of “Corporate Compliance Officers” from the oil and gas industry was held in Houston, Texas.² At that conference representatives from some of the largest and most recognizable oil and gas corporations in the world gathered for only one reason: to discuss the impacts that the recent changes in the world’s business and financial environment have had – or would have – on their corporate governance, ethics and compliance actions. Although the conference was specifically to address one industry – oil and gas – the topics discussed and the information exchanged during those three days would be valuable to any large corporation attempting to keep abreast of global trends in business and financial regulatory controls.

² The Energy Corporate Governance, Ethics & Compliance Conference by Marcus Evens Conferences, November 3 – 5, 2009

The conference focused on the three elements of corporate operations:



Frankly, the information exchanged during the conference was sobering for anyone tasked with proving to the public or a government that its operations have been adequately **governed**, were **ethical** and that the corporation and its board actively enforced **compliance** with laws, regulations and internal corporate policies.

By **governance** the conference focused most on the *ethical leadership* demonstrated by the corporation's board of directors and key senior positions. Without exception conference attendees and presenters stressed the critical importance of the "tone at the top" setting the environment within which a corporation would operate.

Interestingly, **ethics** was not simply defined as a voluntary code of conduct such as the "knight's code of chivalry". Ethics from the point of view of the conference attendees and presenters is comprised of the following elements:

- Standards of conduct promulgated internally within the corporation as policies and procedures;
- Standards of conduct generally in practice within the oil and gas industry;
- Standards of conduct as established by custom, laws, regulations and codes specific to area(s) of the world where a corporation is working; and
- Standards of conduct as established by custom, laws, regulations and codes within the home country of the corporation.

Note that those four standards are not numbered or presented in a definitive order: according to most attendees and presenters at the conference, none of those four standards were considered optional. The primary difference among them is that the last

two bulleted standards increasingly carry with them specific legal penalties for failure to abide by those standards of conduct.

Compliance is simply enforcement of those ethical standards of conduct within a corporation. The major difference going forward for corporations will be that failure to impose compliance will, in and of itself, be a major violation of the standards of conduct. In short, a corporation may be found guilty and punished for its inability to demonstrate that it enforced compliance of those standards of conduct promulgated within, or outside of, the corporation.

Each of those three elements is discussed briefly below.

Governance – The Tone at the Top

“...leadership emphasizes defining a vision and taking actions to increase the chances that your vision will become reality.”

Stanley E. Portny
Project Management for Dummies

During the Conference presenters cited “tone at the top” as perhaps the most critical element to successfully establishing and meeting the standards of care identified above. Tone at the top involves *leadership* starting at the board of directors and moving through the Corporate Level senior management. Simplistically summarized: if top corporate management won’t set the standards and won’t abide by the standards, then those below the board and senior management will not believe that those standards carry any meaning or weight for them as individuals.

The lack of governance - tone at the top – by a corporation is a leading cause of the current global financial crisis. Sarbanes-Oxley had in part attempted to address tone at the top by forcing greater uniformity and transparency on corporations, and in particular at the board and senior management levels of corporations. While that forced uniformity and transparency did expose issues, it does not appear to the public (or government) that that the increased uniformity or transparency led to any fundamental change in the corporate tone. What they expected was that corporations would, because of the increased visibility into corporate operations, take action to set and enforce ethical standards throughout *every level* of the corporation.

Rightly or wrongly, the current financial crisis has convinced a large segment of the population and their elected government that corporations cannot be trusted to do what is right simply because it is the right thing to do. And the finger is pointed directly at the highest levels of the corporation. Therefore, the response has been that if corporations won’t voluntarily adopt and meet industry and national ethical standards, then we the public, through our government, will set those standards and, to ensure those standards are met, will punish those who continue to ignore those standards.

Those at the conference generally felt that for the near future, interests outside the corporate structure – primarily governmental bodies - will act in an effort to impose the

tone at the top. Corporate leadership's choice now is to be an active participant in the setting and enforcing that tone or suffer the consequences of that tone being set and enforced totally by those outside of the corporation.

Ethics – Sun Tzu vs. the Golden Rule

“Draw them in with the prospect of gain, take them by confusion.”

The Art of War
Sun Tzu

“Do unto others as you would have them do unto you.”

The Golden Rule

Business has always existed to make a profit. Business has always had a naturalistic “survival of the fittest” view of its operating environment. And while business would push the ethical envelope in its relationship with the public (including its own customers) and governments, it has historically tended to respect that there were some limits to what was acceptable behavior (with some rare but notable exceptions such as the robber barons of the 19th century). But in the second half of the twentieth century business as an environment began to take the concept of laissez faire to the extreme by equating business with war, and equating corporations with warlords. The corporate world discovered a 2,000 year old Chinese text on war by Sun Tzu and adapted it to corporate business ethics and strategy. Unfortunately while Sun Tzu focused on strategy as a means to achieve an end, some of those adaptations of his work were more focused on attack and destruction than ever was advocated by Sun Tzu. For example:³

Sun Tzu:

“Superb command of spatial relationships during a conflict, sensing where moves may be made or avoided to best advantage.”

Was converted by one author to:

“The conviction that you are right, always, and a vicious need to eradicate all who oppose you, publically, if possible.”

Business adherents of Sun Tzu unfortunately spawned an entire genre of business courses and texts that lowered corporate ethics and strategies to the level of one of the most violent and destructive of all human endeavors, war. If the tone at the top is based upon “... *the conviction you are right, always, and a vicious need to eradicate all who oppose you ...*” then it is not difficult to imagine that someone would develop and run a ponzi scheme, never once considering the consequences of that scheme. If a

³ *Sun Tzu was a Sissy*, Stanley Bing, Harper Business, 2004, page 57

corporation sees rules, standards, regulations or codes of conduct – its ethics - as something which they are entitled to ignore or violate if those ethics stand between the corporation and its ultimate goals, then it is not difficult to imagine lower management personnel believing that bribery and false financial reporting are accepted business practices within the corporation.

Ultimately war exacts a huge price on both those who wage it and those who are simply identified as collateral damage. This time those who lost their retirement or even their livelihood - those who were collateral damage - decided to fight back and the weapon they are using is their government. Since the public perceives that corporations will not act and operate ethically, their response is to attempt to impose ethical standards on those corporations, using the power of their government to enact laws and regulations on the operations of the corporations. Ultimately, government control and enforcement is pictured by the public as the only viable option open to it.

At the conference presentations were given by representatives of both the US Department of Justice and the US Securities and Exchange Commission, the two branches of the US government primarily charged with enforcement of the “ethical business standards” currently in place - and those standards soon to be in place. Those speakers were very direct and the picture they painted of the near future was not one which corporations will find comforting or reassuring. The new thrust can be summed up very simply: break the rules and you will be found and punished. *Enhancing* the business environment, for so long the focus of global governments, has been replaced for at least the near term with a focus on *Enforcing* the expanded (and still expanding) code of ethics. This gets us to the main theme of the Conference, and the focus of those attending the Conference, compliance.

Compliance – Enforcement with teeth

*“Let him be punished, sovereign, lest example
Breed, by his sufferance, more of such a kind”.*

The Life of King Henry V
Act 1, Scene 2
William Shakespeare

The most sobering presentations were from the US Department of Justice and the US Securities and Exchange Commission. The tone of those presentations was very much reflective of the Los Angeles Times article quoted in the introduction; according to those presenters, both agencies have received a “*clear mandate*” from both Congress and the Obama Administration to “*quickly and strongly go after*” corporations and individuals that fail to adhere to the laws and regulations of the United States. In short, swift and certain punishment of those breaking the required ethical standards will not simply end that ethical breach, but punishment will serve as an example to every other corporation.

Some of the more crucial points made included the following:

- Action will not be simply taken against corporate entities; the mandate is to bring action against any individual found to have been involved in failure to meet the laws and regulations, including those who failed to govern the corporation and those who failed to manage the corporation so that such a failure could not have occurred.
- The government is significantly increasing its investigative resources and its prosecution resources devoted to corporate fraud.
- Failure of a corporation or its directors and officers to report instances of fraud is as punishable as the actual fraud itself. If a corporation voluntarily reports a violation – quickly and completely – the government may “defer prosecution” of the corporation and individuals pending observation of the corporation’s subsequent actions. However, if a corporation knew of a violation and does not report it and it is subsequently discovered by government investigators, prosecution will be automatic both against the corporation and those individuals which knew of but failed to report the violations.
- Failure of a corporation to act swiftly within the policies and procedures to respond to the fraud (i.e. fully investigating and acting to end the fraud and act against those perpetrating the fraud) is also punishable.
- The first question to be asked in a federal investigation is “*does the corporation have clear, specific policies and procedures relative to this issue*”. The second question will be “*did you follow that procedure*”. If the answer to those questions is yes, the last demand will be for the corporation to prove the existence of the policy and prove that the procedure for addressing the issue was followed.
- Part of the test of the effectiveness of a policy will be an examination of the “tone set at the top” by directors and senior management.
- Corporations will be responsible for the actions of its third party contractors and must demonstrate that it: (1) required those contractors to adhere to the corporations ethical standards; (2) conducted a deep due diligence to ensure the contractor had no record of ethical violation had been conducted; and, (3) monitored and oversaw the actions of the contractor in an effort to identify and prevent any illegal actions (whether that violation occurred at home or abroad).
- There is a significantly elevated sensitivity to corporations working internationally and this will result in increased surveillance of those corporations. For the first time 65 governments around the world have executed mutual assistance agreements and begun cooperating to investigate and prosecute corporations that violate national laws and regulations. There will be an increase in multi-jurisdictional prosecutions, with cooperating governments sharing both investigative results and prosecutorial results.

Those are just a few of the points raised by the government presenters, but the most important point was left in the tone of those presentations. These are individuals that have been given a specific mission, with increased staff and legislative and regulatory tools to execute that mission. The tone is conveyed by the fact that during the question and answer period many of the Compliance Officers stated that they felt to be now “*personally at risk for prosecution*” if they discovered an ethical breach, reported it up the management chain but the management chain subsequently did not report that breach to the government.

Because of the extremely high public visibility of the corporations represented at the conference, because those companies were global and worked internationally and because the public already scrutinizes those corporations closer than almost any other industry sector (from environmental issues to social disruption issues), each had internal ethical standards of care, each of them recognized the existence of an industry standard of care, and each of them already operated under a multitude of global and regional laws, regulations and codes. Yet even with all that experience it was clear that the expanded government focus on compliance and punishment was unsettling for many attending the conference.

Where do we go from here

"I don't know where we're going but there's no sense being late."

Mathew Quigley
Quigley Down Under

We think we know governance, and ethics, and compliance because they have become part of the core corporate environment within which we exist. We think we know uniformity and transparency because they have become the watchwords of corporate governance from both within the corporation and by governments regulating those corporations. We like to think we have comprehensive, cohesive and complete ethical standards in place. We also think we actively adhere to and enforce those ethical standards. And prior to the current global economic crisis we thought we knew the consequences if we failed to adhere to those ethical standards. But what we know and what we thought we knew is changing and we are not the ones in control of the depth of those changes or the pace of those changes. But it is clear from what has been published and presented by the governments of the world over the past 8 months that insofar as compliance is concerned, we better not be late in responding affirmatively and effectively to the ethical standards which are set.

One action which is not dependent on the passage of legislation or regulation is to engage an independent third party to undertake a full governance audit of the corporation. This audit should not be limited to an audit of the corporation's compliance with formal governmental regulations and laws, but should encompass those governance practices which are recognized globally as best practices. To regain the public and governments trust, corporations should act ahead of the tsunami of regulations and laws likely to be enacted over the next two years. Waiting to act until the government acts will give the appearance that the corporation and its board would not adopt sound governance practices until forced to do so by law or regulation, and the threat of punishment; that is not the way to begin rebuilding the public's trust.