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CONFERENCE PROCEEDINGS

Directors as Guardians of Compliance and Ethics Within the Corporate Citadel

What the Policy Community Should Know

Michael D. Greenberg



Center for Corporate Ethics and Governance

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SUMMARY

Advancing corporate ethics, compliance, and governance has been a significant policy priority for the U.S. government for at least 20 years, going back to the 1991 promulgation of the Federal Sentencing Guidelines for Organizations (FSG). This concern has achieved new prominence in the wake of the financial collapse of 2008, and policymakers have once again become focused on corporate compliance and ethics (C&E) programs and on the oversight role of corporate boards as potential avenues for preventing excesses and scandals in the private sector. In principle, the institutional mechanisms of boards and C&E programs should have helped to protect firms from excessive risk-taking and opportunistic misconduct. But in practice, at least in some financial services firms in the lead-up to the collapse, they did not. It remains to be seen whether history will view the Great Recession as accruing, in significant part, to lapses in corporate ethics and governance practices. But in the wake of the financial collapse, policymakers and business leaders alike have been galvanized to reconsider the responsibility of boards for C&E oversight and the notion that ethics, compliance, and risk management may be fundamental to the role of corporate directors. Basic notions about the fiduciary duty of directors, and about the protection of shareholder and societal interests, are consequently evolving rapidly.

It is in this context that RAND convened a May 12, 2010, symposium titled “Directors as the Guardians of Ethics and Compliance Within the Corporate Citadel: What the Policy Community Needs to Know.” The purpose of the symposium was to stimulate a broad conversation about the role of directors in providing C&E oversight in U.S. corporations. The symposium brought together more than two dozen persons, some with distinguished service as directors on leading public company boards, and others with long experience serving as ethics and compliance officers within firms. Participants also included stakeholders and thought leaders with backgrounds in the non-profit sector and in government. Discussions at the conference focused on (1) challenges and opportunities for boards in performing a C&E oversight role and (2) resources and policy that might assist directors in strengthening the C&E function and in more effectively carrying out oversight responsibility.

Several major themes emerged from the symposium discussions. The first was that corporate directors do have basic responsibilities for monitoring ethics and compliance in their firms and infusing related values into their decisionmaking, but that these responsibilities are broadly hampered by a lack of training and awareness on the part of many outside directors. More robust, targeted efforts to educate directors on this aspect of board responsibility, and on ways to carry out the responsibility effectively, are needed. A second major theme was that a primary responsibility of directors involves gathering the information they need to really understand their firms, as well as related risks, strategies, and operational concerns. This data-gathering obligation takes many different forms, but with regard to C&E, it means that directors need to gather information both about their firms’ “ethical culture” and, more concretely, about

C&E processes, initiatives, gaps, challenges, and performance. A third theme discussed at length in the symposium was that directors are not operating in a vacuum when it comes to carrying out their responsibility for C&E oversight. They have an agent in the person who carries day-to-day responsibility for overseeing a firm's C&E program: the chief ethics and compliance officer, or CECO. The CECO provides a major conduit of information on C&E matters back to the board. When properly positioned and empowered, the CECO can become a key resource for the board in fulfilling its own mandates to monitor and ensure the effectiveness of C&E practice within the firm.

INVITED REMARKS FROM THREE PANELISTS

The initial session of the symposium was dedicated to invited remarks from three panelists, all with expertise in the governance obligations of boards and the C&E function within firms. The first panelist discussed directors' evolving role and liability in C&E oversight, and the reality that directors face significant civil liability risk in connection with state law fiduciary duty and shifting stakeholder and regulatory expectations. The second panelist focused on the in-house counsel perspective and the need for a compliance-savvy board. He suggested that many corporate C&E programs are vulnerable to being treated as "check-the-box" exercises rather than as fundamental commitments to accountability and ethical leadership within their organizations. In this regard, he suggested that the board has a central role to play and must become knowledgeable about C&E matters if it is to adequately discharge its responsibilities. The third panelist discussed how the CECO occupies a pivotal position in empowering the board, driving an effective C&E program, and making ethical culture into a reality within the firm. He suggested that the expansion of board C&E responsibilities has only made the CECO role more important as a resource, that board involvement is simultaneously crucial to empowering the CECO, and that the CECO's function is likewise crucial to empowering and informing the board.

CHALLENGES AND OPPORTUNITIES FOR BOARDS IN PERFORMING THE C&E OVERSIGHT ROLE

The second session of the symposium involved a moderated discussion on challenges, issues, and opportunities for directors in connection with C&E monitoring and oversight. Participants addressed a broad range of related concerns. The session opened with reflections on the need for directors to balance C&E as an important issue on their radar, but as only one among the many specific demands now being placed on directors' time. It was observed that directors have oversight obligations in many areas — legal, information technology (IT), risk, audit, strategy, Sarbanes-Oxley Act of 2002 (SOX) Section 404 compliance, and obligations under new Securities and Exchange Commission (SEC) disclosure rules — all of which represent competing demands, in addition to their more basic responsibilities concerning review of company performance and protection of shareholder rights. For independent

directors who are unlikely to spend more than several weeks a year carrying out their duties, the simple press of time was identified as a significant challenge with regard to both C&E and these various other aspects of oversight. Efficiency and effectiveness were therefore stressed as important aims for directors in husbanding their time and making the strongest possible contribution on C&E.

In a different vein, the opening remarks for the session underlined that in carrying out their responsibilities, directors help to set the ethical “tone at the top” of their organizations. This basic aspect of what directors do in contributing to organizational culture was identified as pivotal to their role.

Some of the discussions touched on defining the essence of the C&E oversight role for directors, on the ways that directors can better inform themselves about C&E matters within the firm, and on the appropriateness and effectiveness of outside legal mandates for board involvement in C&E. The reality that the problems of corporate misbehavior and ethically dubious conduct remain abundant in the United States despite widespread awareness of their existence among directors was a major theme of conversation, with a serial focus on several potential root causes. Session participants generally agreed on several points:

- The first C&E commandment for directors is “Know Thy Company.”
- Ensuring ethical culture is a top responsibility for directors and feeds into other aspects of the director role.
- Because the ability of directors to see into C&E matters within the firm is limited, appropriate management mechanisms must be put into place.
- Although applying ethics to business strategy decisions can sometimes be ambiguous, there are concrete steps that boards can take to improve C&E performance in firms.
- It can be difficult to mandate ethical behavior through the law, but the FSG nevertheless offer critical guidance to boards.

EMPOWERMENT, RESOURCES, AND POLICY — HOW DO WE SET DIRECTORS UP TO SUCCEED IN C&E OVERSIGHT?

Participants in the final session of the symposium focused more deeply on the topics of board empowerment and policy, and on ways to help and encourage directors to play a stronger and more meaningful independent C&E oversight role, as opposed to simply “rubber-stamping” management reports. One part of the discussion touched on government enforcement authority and liability risk pertaining to C&E matters, and the incentives these policies create for persons serving as directors. The reality was underscored that boards face heightened civil liability on C&E, resulting from a combination of recent legal and regulatory developments. It was also observed that there is serious interest in the regulatory community in facilitating board engagement in C&E oversight, as well as concern that some boards and directors are not adequately scrutinizing these issues. The question was raised, How can the policy community help in promoting stronger recognition of C&E issues in the director

community, and better related performance by boards and by management? Some pragmatic steps along these lines, such as director certifications in C&E or bringing people with C&E backgrounds onto boards as outside directors, were discussed. Another topic of discussion involved specific steps that managers and CECOs can take in building stronger C&E programs within firms. It was noted that although these kinds of programmatic steps are somewhat removed from the immediate role of directors, more robust, targeted education for directors, together with a basic familiarity with the elements of a strong C&E program, can help directors to ask the right questions of their CECOs and to confirm that appropriate controls and institutional mechanisms are put in place.

Several of the major points of discussion and agreement during the session included the following:

- The FSG have created more oversight responsibility and liability risk for directors, so there is a need for more robust, targeted board education on C&E.
- Fiduciary duty calls for a robust decisionmaking process on C&E.
- Empowering the CECO is a path to empowering the board.
- Boards should seek out multiple sources of information and reporting on C&E.
- More specific feedback from regulators, citing cases in which companies benefited from specific, strong C&E program steps, would drive more-effective corporate programs.
- The “conversation” between directors and the CECO is a key asset for the board.