

**The
Corporate
Ethics
Officer
Redux:**

Strengthening Organizational Governance

After a decade of business scandals and economic crises, the boards of public companies have come under increasing scrutiny, while their roles and responsibilities have been enlarged considerably – not just by the Sarbanes-Oxley Act (SOX) but also by various Securities and Exchange Commission (SEC) stock exchange listing requirements, and the Federal Sentencing Guidelines for Organizations (FSGO). These legislative responses were all based in some measure on the conclusions of Congress and others that inadequate ethical oversight of senior management by boards has been a significant or even dominant cause of corporate misdeeds. Although the causes for the recent Global Financial Crisis from which we are only starting to emerge are complex

and varied, there is a broad consensus that significant factors in bringing about this crisis were failures in governance, ethics and culture.

One factor behind these corporate governance failures that has received little attention is the fact that the ethics and compliance function in corporations has not performed as expected. More specifically, the ethics officer (EO)¹ has not engaged the board of directors in sufficiently meaningful ways to ensure the ethical oversight necessary for truly effective corporate governance. As we see it, there are at least three reasons for this: First, ethics officers are typically answerable primarily to senior management, and only incidentally to the board of directors. This creates an inherent conflict of interest since the EO may

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need to call to account the very people who can make or break his or her career. Secondly, in many – if not most – cases, ethics officers do not have the power, status and authority in their corporations that they need to do their job effectively. Thirdly, as presently structured, the nature of the relationship between ethics officers and their boards does not provide the degree of mutual support or the leverage necessary for ethics and compliance programs, and the governance process as a whole, to reach their full potential.

Despite the significant governance reforms, none have addressed the aforementioned three issues underlying the failure of ethics and compliance programs to operate with full force and effect. As an important step to remedy this situation, we propose to make the EO an agent of the board of directors. Under this new model the EO would be appointed by the board, report directly and be accountable to the board, and have his or her compensation set by the board. Furthermore, only the board would be authorized to fire the EO. This is a relationship that far exceeds the giving of periodic reports to the board about what is going on in the ethics and compliance program. The FSGO now recommends at least one such appearance before the board annually.² This doesn't go far enough. It may give the ethics officer limited "access" to the board, but it does not give the EO independence or significant board access.

Let's look in more detail at what we have identified as the three sources of "ethical governance dysfunction" in corporations.

An inherent conflict of interest in current EO reporting structures

The EO is the person with primary responsibility for ensuring a company's ethical performance, and the success of that mission depends on creating a universal expectation that no one in the company, no matter how senior, is above the law or the requirement to behave ethically. Given the huge influence of senior management on a company's business performance and culture as well as the frequency of senior executives in corporate fraud and abuses, one of the EO's most important responsibilities is to monitor and critique senior management's decision-making and conduct. However, when the company's reporting structure dictates that the EO is appointed by, reports to, and is accountable to management — the situation found in almost all companies with ethics officers — this creates a conflict of interest in which the EO is likely to be influenced, consciously or subconsciously, by the self-preservation instinct. When that happens, the EO's objectivity and independence cannot fail to be compromised.

Besides the internal credibility of its ethics and compliance program, a company must also be acutely sensitive to the perception of regulators, prosecutors and sentencing judges, especially given that the EO's independence and objectivity are relevant in assessing program effectiveness within the terms of both the FSGO and the Department of Justice's "McNulty Memo." By having the EO's report to the board, this conflict of interest is essentially removed. The EO can operate indepen-

dently of management with the direct authority of the board and all the protection that affords.

Ethics officers do not have sufficient power, status and authority

While there is no doubt that an ethics officer profession has become well established over the last two decades,⁴ we believe there has been a worrying trend toward declining EO importance in the corporate hierarchy. This view is shared by other commentators, including Richard J. Bednar, former Coordinator of the Defense Industry Initiative on Business Ethics and Conduct (DII). Bednar noted several symptoms that mark this trend, including:

- EOs are not regularly invited to CEO meetings with direct reports;
- EOs are asked to take on assignments unrelated to their core mission;
- Senior management frequently calls the general counsel instead of talking to the EO.

The proposal that the EO be an agent of the board has the important virtue of elevating the EO in the corporate hierarchy. It would also give the EO the very real authority that comes with any board appointment, and would signal to management and all employees, more than any board resolution, that the ethics and compliance program was endorsed and supported by the highest authority in the corporation.

Boards need to enhance their ethical oversight capabilities

It is not enough for directors to be diligent and vigilant; they need access, on demand, to high quality information

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about management proposals and activities, and about the company's operations in general. Ideally, the board will acquire such information in the ordinary course of an open and collaborative relationship with senior management. However, the recent history of corporate scandals demonstrates that boards cannot depend on management disclosure and must take a proactive approach to information gathering and processing.

By changing the nature of the EO's relationship with the board of directors, not only will the EO become more effective, but he or she can also significantly assist the board in performing its ethical oversight responsibilities, such as in the following ways:

- Advising the board on acquiring, analyzing, and acting upon information pertinent to its ethical oversight responsibilities;
- Assuring the board of high quality ethics information;
- Engaging the board in a more comprehensive process of continuous ethics education to fully satisfy FSGO requirements;⁶
- Guiding the board on suitable opportunities for demonstrating ethical leadership and positively influencing the corporate culture as envisioned by the FSGO.⁷

Developments supporting an EO-board of directors reporting relationship

The FSGO requires that "individual(s) with operational responsibility [for the ethics and compliance program] shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the ... program." We believe that the reporting by EOs to the board, as it is currently structured, is inadequate and will not be adequate until there is a direct reporting relationship of the kind we are proposing.

A non-binding footnote to the SEC

final rule applying to Section 406 of SOX provides that the "appropriate person" to whom violations of the code of ethics should be reported — typically the EO — "should have sufficient status within the company to engender respect for the code and the authority to adequately deal with the persons subject to the code regardless of their stature in the company."⁸

We are proposing that the board of directors be directly responsible for the appointment, compensation and oversight of the EO on the basis that independence and an absence of conflicts of interest are just as essential to the successful performance of the ethics and compliance function as to the external audit function.

Perhaps the most relevant model is that of compliance officers in the mutual fund industry. The SEC's Rule 38a-1 requires each mutual fund to appoint a chief compliance officer (CCO) who must report directly to the fund's board of directors. The rule contains several provisions expressly designed to promote the independence of the CCO from the management of the fund. For example, only the fund board can hire or fire the CCO; and the fund board (including a majority of independent directors) must approve the designation of the CCO and must approve his or her compensation or changes in compensation.

Anticipated objections and rebuttals

We are aware that our proposal does not enjoy universal support among business leaders or EOs; popularity, however, is not necessarily a gauge of merit. For example, some critics have said our proposal would have no value at their organizations because their senior management is highly ethical. This position is at best optimistic, perhaps naïve, and possibly even complacent; it takes no account of the fact that even managers with a longstanding reputation for integrity can, and sometimes do, buckle under pressure, allowing their

ethical judgment to be compromised. And, of course, management teams come and go.

Others contend it is impractical for the EO to report directly to the board of directors because the board comprises outsiders who meet infrequently, and, therefore, are out of touch with the company's operations. This argument reflects a limited view of how boards ought to work and do, in fact, often work. Throughout the year, directors are frequently engaged in company business outside of full board meetings, both as individuals and in board committees. In any event, the EO's access to the board should not be limited to formal meetings — many EOs report to directors on an ongoing basis.

Some people with whom we spoke believe that if the EO were an agent of the board, management would be less inclined to share information. This position assumes that under the current reporting model, management does, as a rule, share information with the EO, which is not the case. As an agent of the board, we contend that such information sharing with the EO would increase as the EO's stature in the organization would have increased.

Some fear that our proposal would preclude a collaborative relationship between the EO and management. However, this arrangement would enable the EO to serve as an important conduit between management and the board; and if management is operating in the right way for the right reasons, there would be nothing to hide from the board.

Others claim that the inherent conflict of interest to which we referred applies not only to EOs but also to internal auditors, lawyers and accountants, and yet, no one is advocating that they report to the board. However, the functional responsibilities of professionals in such areas are not primarily dedicated to the assurance of the ethical integrity of the organization. This is precisely the primary mission of the EO, which makes

it especially important that it be insulated from undue pressure.

Finally, others have argued that boards have been culpable themselves, and having the EO report to the board will not necessarily change that. This is true. However, if the EO is reporting directly to the board, there is every prospect of raising the board's level of ethical awareness and preparedness to perform its oversight duties properly. This is at the heart of our proposal: having the EO report directly to the board would energize its commitment to ethics, compliance, and sound governance in general.

Conclusion

We entered the new millennium amid a series of major corporate scandals followed by the worst global financial crisis since the 1930s. Behind all of these problems we see fundamental failures of

governance. In spite of considerable reforms, we believe that the disconnect-ness of the ethics and compliance function from the board of directors constitutes a significant problem, which has prevented both from working as they should.

If the EO is appointed as an agent of the board, this will create conditions that will provide additional leverage for corporate governance reform, thereby furthering our society's pursuit of increasingly ethical corporate cultures. Business will consequently benefit and so too will our economy and society generally. <<

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REFERENCES

¹ We use the term "Ethics Officer" to include the variety of job titles, including Compliance Officer, Business Conduct Officer, Business Practices Officer, etc., that apply to individuals who are responsible for their organization's ethics, compliance, and business conduct programs.

² The "Application Notes" for §8B2.1(b)(2) of the FSGO state: "If the specific individual(s) assigned overall responsibility for the compliance and ethics program does not have day-to-day operational responsibility for the program, then the individual(s) with day-to-day operational responsibility typically should, no less than annually, give the governing authority or an appropriate subgroup thereof information on the implementation and effectiveness of the compliance and ethics program."

³ Memorandum, dated December 12, 2006, from Deputy Attorney General of the United States, Paul McNulty, to United States Attorneys, giving updated guidelines for prosecuting corporations. It includes nine factors to consider when weighing whether to charge or negotiate a plea in corporate criminal cases. The McNulty Memorandum replaced the Thompson Memorandum of 2003. For more information see: http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf

⁴ This is evidenced by the growth in membership of the two leading professional associations for ethics and compliance practitioners: the Ethics and Compliance Officer Association and the Society of Corporate Compliance and Ethics.

⁵ For a fuller discussion of Bednar's observations and concerns, see Sherwood, E. L., "The Evolving Position of Ethics Officer," *Ethikos and Corporate Conduct Quarterly*, Vol. 20, No. 1 (2006): 10-19. (When the general counsel is also the chief ethics and compliance officer, which is true in many corporations, this situation greatly exacerbates the conflict of interest issue mentioned earlier.)

⁶ Since the amendment of the FSGO in November 2004, directors have been required to be educated about their company's standards and procedures through "effective training" and the dissemination of information appropriate to their roles and responsibilities [United States Sentencing Guidelines Manual § 8B2.1(b)(4)].

⁷ United States Sentencing Guidelines Manual § 8B2.1(a)(2).

⁸ Federal Register, Volume 68, No. 21, (January 31, 2003), page 5118, footnote 45.



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