“IT’S NOT JUST TONE AT THE TOP”: HOW COMPANIES CAN BUILD A CORPORATE ETHICAL CULTURE AND PREVENT FRAUD

SOCIETY FOR CORPORATE COMPLIANCE AND ETHICS
ETHICS AND COMPLIANCE INSTITUTE
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BACKGROUND

Retired from CIA in April 2011 with 32 years of federal service

- Government Accountability Office
- Department of Defense
- CIA/National Reconnaissance Office IG
- Senior Advisor for Procurement Integrity

Different perspectives on business ethics:
- senior agency official, law enforcement, corporate consultant, independent monitor

WHAT IS BUSINESS ETHICS?
A system of proper conduct principles in the workplace that applies society’s ethical norms to business dealings determined by:

- Code of Conduct
- Code of Ethics
- Policies and Procedures

**ETHICS vs COMPLIANCE**

- Largely rule-based
- “SOX” Code of Conduct
- 2008 Economic Meltdown
ETHICS VS. COMPLIANCE

“Some companies have given up entirely on trying to figure out what’s ethical and are instead using what’s legal as their standard for decision-making…the result is moral bankruptcy.”

–Kevin Rollins, president
Dell Computer Corporation

Ruling Philosophies:

→ “As long as it’s legal, it’s ethical.”
→ “As long as it’s not illegal, it’s okay.”

“If you can’t look yourself in the mirror for something you’re about to do, don’t do it.”

–Peter Drucker

CULTURE OF COMPLIANCE

“Our rules alone won’t be enough. Our rules never have been enough, are not enough today, and never will be enough. What’s really needed is a change of mindset—one that fosters not only a ‘culture of compliance’ but also a company-wide environment that fosters ethical behavior and decision-making.”

–William Donaldson
Former chair, SEC
It's how things are "really done around here."

- Donaldson says it is instilling "a company-wide commitment to do the right thing this time, and every time."
- Ethical behavior must become "the core of the company’s essential DNA," shared by every employee.
- A firm's leaders must have the courage and commitment to question whether a practice is truly ethical or truly in the best interest of clients and customers.
- Donaldson: "Customers must always come before the balance sheet and not the other way around."
Corporate code of conduct
Business ethics
Corporate compliance
Anti-fraud programs
Anti-corruption programs
Enterprise risk management
Corporate risk assessments
Fraud risk assessment

Process of assessing risks and vulnerabilities and the adequacy of controls in place to manage those risks.
**FEDERAL SENTENCING GUIDELINES**

- **Goal:** “Promote an organizational culture that encourages ethical conduct and a commitment to compliance.”
- Deter and punish corporate crime via sentencing.
- Reduce fraud and other misconduct through strong ethics and compliance programs.
- Seven steps: “The Gold Standard.”

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**FEDERAL SENTENCING GUIDELINES**

1. **Written Compliance Standards and Procedures**
   - Code of conduct
   - Anti-fraud/corruption program
   - Non-retaliation policy

2. **Accountability and Oversight at the Top**
   - Board of directors
   - CEO/leadership team

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**FEDERAL SENTENCING GUIDELINES**

3. **Due Diligence in Selecting Staff**
   - Ethics and compliance team
   - Individuals with discretionary authority

4. **Adequate Training and Communication**
   - Management expectations
   - Training in relevant requirements

5. **Robust Monitoring and Auditing**
   - Anonymous reporting mechanism
   - Continual program assessment
**FEDERAL SENTENCING GUIDELINES**

6. Effective Incentives and Discipline
   - Carrot and stick
   - Alignment of ethics/integrity and financial objectives
   - Incentives for good ethical decision-making
   - Consistent enforcement actions

7. Prompt and Reasonable Response to Criminal Conduct
   - Full internal investigation
   - Government notifications
   - Internal remediation/self-improvement

**BENEFITS OF THE SEVEN STEPS**

- Sentencing reduction: 3–5 points
- Leniency in prosecution decisions
  - U.S. Attorney’s Manual re: charging factors
  - Quicker and more favorable settlements
- Avoid suspension or debarment
- Strengthen ethical culture
- Better manage fraud risk

**“WE’RE ALREADY AN ETHICAL COMPANY”**

- What is the culture like outside of the C Suite?
- Risk of bad actors
- Regulatory complexity
- Aggressive enforcement
  - DOJ
  - SEC
  - Suspension and debarment
  - Health care
- Foreign Corrupt Practices Act (FCPA)
  - Global economy
  - Enforcement
  - Materiality
**SENTENCING GUIDELINE UPDATES (THRU 2014)**

- Response to criminal conduct
  - Reasonable steps to remedy harm
  - Restitution
  - Self-reporting
  - Cooperation
  - Modifications to program (outside advisors)
- High-level misconduct “okay”
  - CECO reporting relationships
  - Self-detection
  - Prompt reporting
  - Ethics officials not involved

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**Sentencing of Organizations**

“These guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-policing its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.”


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**Sentencing Guideline Updates (THRU 2014) Ethics and Compliance at High Level**

“Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility 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 compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.”

Sentencing Guideline Updates (THRU 2014)

"As Appropriate" = At Least Annually

“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 for the program 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.”


Sentencing Guideline Updates (THRU 2014)

Organizational Carrots

“The organization’s compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.”


Sentencing Guideline Updates (THRU 2014)

Evaluate Effectiveness

“The organization shall take reasonable steps—

... to evaluate periodically the effectiveness of the organization’s compliance and ethics program...”

“The organization shall take reasonable steps—
... to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization’s employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.”


Large organizations—A large organization generally shall devote more formal operations and greater resources in meeting the requirements of this guideline than shall a small organization. As appropriate, a large organization should encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective compliance and ethics programs.


ETHICAL CULTURE DRIVES COMPLIANCE RISK

- May 2014 RAND Symposium-Transforming Compliance
  - Compliance without ethics doesn’t work. Period.
  - Ethical norms shape the compliance risk.
  - Tone at the top is a prerequisite for ethical culture.
  - Boards need to be engaged; CECOs need to be empowered.
  - Effective compliance reflects transparency/confidentiality balance.

- 2013 NBES
  - Ethics culture drives employee conduct.
  - In the weakest cultures, 82% of misdeeds happened repeatedly.
WHAT FACTORS INFLUENCE CULTURE?

- AMA/HRI 2005 Survey
  - The top-ranking process for sustaining a strong business culture is “leaders supporting and modeling ethical behavior.”
- Deloitte LLP 2009 Survey
  - Seventy-seven percent of employees cited behavior of managers or direct supervisor as the top factor influencing workplace conduct.
- NBES 2013 Ethics Culture includes:
  - Ethical leadership – tone at the top
  - Supervisor reinforcement of ethical behavior
  - Peer commitment – supporting one another in doing right

TEN QUESTIONS TO ASK WHEN TRYING TO STRENGTHEN A CORPORATE ETHICAL CULTURE

1. What is the relationship between ethics and other performance metrics in the company?
   - The leading factor in unethical behavior is pressure from management or the board to meet unrealistic business objectives.
   - Alignment of ethics and performance objectives is critical in compensation, bonus, and promotion decisions.
2. Is our required ethics training more than a check-the-box exercise?
   - Cascading training
   - Scenario-based

TEN QUESTIONS TO ASK WHEN TRYING TO STRENGTHEN A CORPORATE ETHICAL CULTURE

3. Have we exercised due diligence in our hiring, promotions, and mergers/acquisitions?
   - Due diligence in hiring
   - Promotion screening
   - Performance assessment elements
4. Have we conducted a risk assessment to identify weaknesses? What is our potential Enron?
   - Perverse incentives
   - Unintended consequences of goals and expectations
   - Do WE have a “paper program”?
TEN QUESTIONS TO ASK WHEN TRYING TO STRENGTHEN A CORPORATE ETHICAL CULTURE

5. What is the tone at the top?
   - Communicating the ethics message
   - Proactive engagement
   - CECO independence, authority, resources

6. What is the mood in the middle and the buzz at the bottom?
   - Immediate supervisors have greatest impact.
   - Leadership skill represents a key asset/vulnerability.
   - Leadership accountability or “executive protection program”?

Senior Level Managers Should Be Setting the Tone

Large Portion of Misconduct Committed by Managers
7. Who is responsible for paying attention to the ethical culture?
   - Senior leadership intentions don’t always reflect reality.
   - How are ethics incorporated into day-to-day business decisions?
   - Active ethics messaging is a must.

8. Is our Code of Conduct more than shelfware?
   - Is it referenced beyond new-employee orientation?
   - Is it customized to our business?
   - Has it been updated?

9. Are our employees familiar with and comfortable using reporting mechanisms?
   - Is there a fear of retaliation?
   - Is the Hotline or Helpline used regularly?
   - Are reporting trends analyzed and used to strengthen the program?

10. Are we paying adequate attention to the ethical posture of third-parties?
    - Third-party risks are high; due diligence is necessary.
    - This is often the weakest area in ethics assessments.

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**STEWART COVEY:**

**THE ETHICS OF TOTAL INTEGRITY**

“When everybody accepts personal responsibility to behave in ethical ways, you then hardly even have to think about it, because ethical behavior is your nature, not some artificial department… When leaders are open and exact in their observance of ethical codes, they inspire others to do the same.”
Opportunity
- Greatest when an employee perceives bad behavior is an accepted way of doing business: culture
- Fear of retaliation prevents reporting

Rationalization
- Sense of entitlement high in cultures with low morale
- Perception of unfair treatment
- Incentives/rewards favoring ethically challenged and promote the wrong behaviors
- Doing the “wrong” thing for the “right” reasons

Pressure
- Unrealistic business objectives
- Ethics divorced from financial metrics
**Organizational Stress Increases Misconduct**

**MERGER, ACQUISITION, RESTRUCTURING ELEVATE ETHICS RISK**

An average 21.5% increase in the amount of misconduct observed.

<table>
<thead>
<tr>
<th>Year</th>
<th>No Merger, Acquisitions, Restructuring</th>
<th>Yes Merger, Acquisitions, Restructuring</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>61%</td>
<td>53%</td>
</tr>
<tr>
<td>2009</td>
<td>59%</td>
<td>51%</td>
</tr>
<tr>
<td>2011</td>
<td>52%</td>
<td>41%</td>
</tr>
<tr>
<td>2013</td>
<td>51%</td>
<td>67%</td>
</tr>
</tbody>
</table>

(Data from the NEEC study)

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**WHAT PERCENTAGE OF EMPLOYEES WOULD COMMIT FRAUD?**

A. 10%
B. 25%
C. 50%
D. 75%
E. Depends on the circumstances

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**THE 10-80-10 RULE**

According to fraud experts:

- 10–20% of employees would never commit a fraud, regardless of the situation.
- 60–80% of employees could become perpetrators if the situation was right.
- 10–20% of employees are basically dishonest and would steal if they got a chance.
**WHERE DO YOUR EMPLOYEES FALL?**

- 10–20%
- 60–80%
- 10–20%

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**ETHICAL CULTURE AND FRAUD PREVENTION**

- Cost of fraud is staggering
  - ACFE Report to the Nations: 5% loss
  - Record False Claims Act 2014 settlements: $5 billion
  - Record number of SEC/DOJ FCPA actions
  - Record number of suspensions/debarments
  - Loss of reputational capital

- ROI of anti-fraud programs
  - Duration and value of losses are reduced
  - Reporting hotlines, training, code of conduct, and reporting incentives all decrease fraud

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**THE ROI OF ANTI-FRAUD PROGRAMS**

What is an anti-fraud program?

- Core values
- Code of conduct
- Independent CECO
- Ethics messaging
- Ethics training
- Rewards and incentives (aligned with values)
- Anonymous reporting hotline
- Investigative process
- Disciplinary process
THE ROI OF ANTI-FRAUD PROGRAMS

Figure 29: Median Losses Based on Presence of Anti-Fraud Controls

<table>
<thead>
<tr>
<th>Internal Controls</th>
<th>Median Losses ($)</th>
<th>Percentage of Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Support Programs</td>
<td>$75,000</td>
<td>57.1%</td>
</tr>
<tr>
<td>Management Review</td>
<td>$125,000</td>
<td>25.1%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>$100,000</td>
<td>17.0%</td>
</tr>
<tr>
<td>External Audit of CSSR</td>
<td>$94,000</td>
<td>15.8%</td>
</tr>
<tr>
<td>External Audit of Controller</td>
<td>$70,000</td>
<td>12.3%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>$50,000</td>
<td>8.8%</td>
</tr>
<tr>
<td>Policies</td>
<td>$35,000</td>
<td>6.2%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>$25,000</td>
<td>4.4%</td>
</tr>
<tr>
<td>Management Certification of CSSR</td>
<td>$20,000</td>
<td>3.4%</td>
</tr>
<tr>
<td>Management Certification of Controller</td>
<td>$20,000</td>
<td>3.4%</td>
</tr>
<tr>
<td>Employee Education/Training</td>
<td>$10,000</td>
<td>1.7%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>$50,000</td>
<td>8.8%</td>
</tr>
</tbody>
</table>

THE ROI OF ANTI-FRAUD PROGRAMS

Figure 30: Median Duration of Fraud Based on Presence of Anti-Fraud Controls

<table>
<thead>
<tr>
<th>Internal Controls</th>
<th>Median Duration of Fraud</th>
<th>Percentage of Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employee Support Programs</td>
<td>2 months</td>
<td>57.1%</td>
</tr>
<tr>
<td>Management Review</td>
<td>3 months</td>
<td>25.1%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>2 months</td>
<td>17.0%</td>
</tr>
<tr>
<td>External Audit of CSSR</td>
<td>1 month</td>
<td>15.8%</td>
</tr>
<tr>
<td>External Audit of Controller</td>
<td>1 month</td>
<td>12.3%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Executives</td>
<td>2 months</td>
<td>8.8%</td>
</tr>
<tr>
<td>Policies</td>
<td>1 month</td>
<td>6.2%</td>
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<td>Anti-Fraud Policy</td>
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<tr>
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<td>1 month</td>
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<tr>
<td>Employee Education/Training</td>
<td>2 months</td>
<td>1.7%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>2 months</td>
<td>8.8%</td>
</tr>
</tbody>
</table>

Companies with Strong Ethics Culture Are Less Likely to Have Ongoing Misconduct

- Single Incident
- Multiple Incidents
- Ongoing Pattern

WHO’S WATCHING?

- Government Agency Customers
- Agency Inspectors General
- Defense Contract Audit Agency (DCAA)
- Federal Regulatory Agencies
- Department of Justice

EXPANDED USE OF SUSPENSION AND DEBARMENT

Increased Government Scrutiny

- False Claims
- Procurement Integrity Act Violations
- FAR Violations
- Mandatory Disclosures
- Regulatory Violations
- Quality Control

*Ethical culture is a key element considered in Suspension and Debarment Actions.*

Ethical Culture Can Soften the Blow of Enforcement Actions

- Morgan Stanley’s strong, well-documented compliance program and clear compliance directives from their managers protected the company from prosecution.

- Johnson & Johnson avoided prosecution by abiding by a long list of Ethics and Compliance program requirements.

- Fokker Services DPA was rejected by a court because it lacked a requirement of independent monitoring or regular reporting on the impact of its Ethics and Compliance program.