A global compliance career

an interview with Sally March
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See page 14

27 Facebook and privacy: The courts weigh in
Angela Preston

31 Global trends in financial supervision: The “Twin Peaks” model
Ruthann Granito

37 The high cost of whistleblower retaliation: Why institutions should prevent it
Amy Block Joy

43 The LIBOR Scandal: Teachable moments for the compliance practitioner
Thomas Fox
Many companies considering merging with or acquiring other businesses proceed through a minefield of risks, only to find they have bought a bomb. The risk mitigation approach required by most boards of directors and private equity firms involves intense due diligence reviews in a variety of areas, including previous and pending litigation, multiple years’ financial results, independent audit opinions, background checks on executives and principals, scrutiny of government excluded parties lists, and verification of assets and property records.

Nevertheless, efforts taken to protect investors, employees, customers, and other stakeholders can prove insufficient to prevent costly buying mistakes. Why? Important information about the target company is not captured in most financial statements, nor is it evident from outward appearances. Six months, a year, or even several years after the buyer takes on the personnel—and problems—of another firm, the buyer may be surprised, or even “burned” by revelations about smoldering problems in the acquired organization. Serious issues may be uncovered involving employee morale and turnover, poor leadership, ethical challenges, and indiscriminate ways of doing business inconsistent with industry standards and regulations. Investors and buyers are left to wonder how a thorough due diligence process can fail to reveal such problems.

Hewlett Packard’s 2011 purchase of a company called Autonomy headquartered in Cambridge, England, has been in the news and widely cited as an example of poor due diligence. Although there were discrepancies in the numbers, other issues within the company compounded its problems: bad morale, a sales culture described as dog-eat-dog, and an environment in which staff were afraid to speak out for fear of retaliation by management.1

Could such problems have been discovered? In general, merger and acquisition
(M&A) due diligence efforts do not adequately assess the ethical make-up, morale, and integrity of target companies (and their employees). In fact, the M&A process itself has been known to create and expose ethical problems in companies whose employees strive to make the acquisition look more attractive through “shortcuts.” Unlike the “objective” financial data sliced and diced a thousand ways for financial and legal consideration, ethical culture is viewed as an amorphous concept not easily measured or analyzed. It may be dismissed as a “soft” science best left to human resources professionals, not factored into the rough and tumble financial and legal negotiations of the M&A process.

This flawed assertion places companies in an unnecessary position of risk. Corporate fraud and misconduct are growing problems plaguing both large and small organizations. The Department of Justice and the Securities and Exchange Commission have adopted an increasingly aggressive posture in prosecuting cases under statutes such as the False Claims Act, the Foreign Corrupt Practices Act, and the Sherman Antitrust Act. Other federal regulatory agencies, as well as suspension and debarment officials, are looking not just at regulatory compliance, but at the culture in those companies where violations are found. A company’s program for preventing and detecting misconduct reflects its ethical culture.

The strength of a company’s ethical culture is an important factor in how it is treated by the government agencies, law enforcement, and regulators who oversee it. The Federal Sentencing Guidelines for Organizations (FSGO), which were established in 1991 and amended in 2010, recognize that an organization’s ethical culture can either positively or negatively affect fraud risk. The Guidelines reward organizations that create strong ethics and compliance programs—and punish those that do not—by establishing penalties commensurate with their degree of ethical due diligence. Likewise, the U.S. Attorneys’ Manual, produced by the Department of Justice (DOJ), requires federal prosecutors to consider nine different charging factors before proceeding with a prosecution. Among the compliance-related factors are (1) the pervasiveness of corporate wrongdoing; (2) the existence and effectiveness of a company’s pre-existing ethics and compliance program; and (3) the company’s remedial action in response to wrongdoing. At a policy summit hosted by the Ethics Resource Center (ERC) in February 2013, representatives from the DOJ, federal regulatory agencies, as well as other federal law enforcement officials confirmed that company adherence to the Ethics and Compliance Program principles contained in the FSGO often results in quicker and more favorable settlements of matters involving corporate misconduct.

In May 2012, the RAND Corporation brought together a group of public company directors and executives, chief ethics and compliance officers (CECOs), as well as representatives of government, academia, and nonprofit organizations to discuss organizational culture. Topics included the progress of compliance initiatives; the barriers to achieving a strong ethical culture; and the current thinking about corporate boards, executives, and policymakers on what can be
done to strengthen ethical culture in corporate America. Some of the key findings of this symposium were:

- Organizations are unlikely to have successful compliance programs without a solid ethical culture, and successful compliance programs are critical to fostering an ethical culture among corporate leadership and employees;
- Corporate boards, top executives, and CECOs all have a central role to play in building a stronger ethical culture;
- Culture is the “missing link” that drives internal whistleblowers either to come forward or to stay silent;
- The only way to effectively reduce risk is to ensure that compliance and ethics programs are prioritized throughout the organization; some measures to achieve this goal include empowering the CECO, offering performance incentives, and committing to periodic corporate self-assessment; and
- Policymakers can play a role by punishing ethical deficiencies while rewarding companies that implement effective compliance and ethics programs.

Assessment strategy
M&A decision-making that incorporates these factors will be more comprehensive than that based solely on numbers. A broader approach would take into consideration the ethical posture and practices of a company, how it addresses regulatory challenges, and how its management and employees rank business integrity among their other priorities. This assessment strategy provides insight into the adequacy of, and risks associated with, the target company’s regulatory and compliance programs, potentially revealing large-dollar liabilities with government agencies that would not otherwise be apparent. It might, in short, alert a buyer to hidden acquisition costs. Although the Federal Sentencing Guidelines for Organizations set out a template for creating the kind of ethics and compliance programs that are positively viewed and often rewarded by federal agencies, regulators, and law enforcement, companies need more than the template to assess the underlying culture and make such programs effective. A worthwhile ethics assessment should focus on key themes derived from the best practices of companies which have successfully strengthened their ethical culture and managed their fraud risk. These themes are presented as questions to ask when assessing the entity under consideration for merger or acquisition.

1. What is the real “tone at the top” of the organization?
The words of corporate leaders undoubtedly impact company behavior, but their actions speak equally loudly to staff. Said another way, leaders lead by example. Staff looks to company leadership, particularly the CEO, to be personally invested in and to live out the company’s ethical commitment, and to communicate the company’s ethical priorities regularly. Mistrust, cynicism, or indifference at the leadership level will erode loyalty to the organization and drive ethical leaders and employees out the door. Proactive, visible engagement of senior leadership and the board on ethics matters is a critical element in building and maintaining a strong ethical culture.

2. How does the “mood in the middle” and the “buzz at the bottom” impact the organization?
The tone at the top of an organization is critically important, but it is not the only indicator of a company’s ethical culture. For employees in large enterprises, for example, local leaders often have more influence on day-to-day
decisions and therefore on the practical implementation of ethical principles, than a remotely located CEO. To determine how, and how well, the corporate ethics policies are affected, it is essential to gain the honest perspectives of employees at all levels of the organization.

3. What is the relationship between ethics and other performance metrics in the company?
It is frequently noted in management that “What gets measured gets done.” Often, however, corporate ethics objectives compete with financial, operational, and other business metrics. If an employee’s or manager’s compensation, bonus, and promotion opportunities are measured solely on financial objectives, without mention of how the business gets done, the message conveyed—intentionally or not—is that ethics are of secondary importance in the corporate culture.

The 2011 National Business Ethics Survey (NBES), conducted by the Ethics Resource Center, reported that the percentage of employees who perceived pressure to compromise company standards in order to do their jobs reached 13%, just shy of the all-time high of 14% reported in 2000. Such pressure is often described as evident in (what employees perceive as) unrealistic goals and performance metrics that are not properly calibrated with the company’s stated ethical values.

4. Is the company’s required ethics training more than a check-the-box exercise introducing the code of conduct?
Ethics training is a key component of corporate ethics and compliance programs. However, the quality of the training and employee retention of the information conveyed is widely variable. Many companies view ethics training as a mass undertaking where the goal is documented completion, rather than substantive learning. In these cases, ethics training can be merely a rehash of the compliance and ethics manual, offering little insight into the real ethical decisions faced by staff in the course of doing business. A close look at a company’s ethics training program and materials can indicate whether its corporate ethics and compliance efforts are truly impacting the culture of the organization.

5. Has the company exercised due diligence in its hiring, promotions, and mergers and acquisitions?
Corporate ethical culture is not static. Staff attrition, new hires, new business lines, and the corporate acquisition of other staffs often create significant cultural shifts within a company. Analyzing a company’s hiring practices can reveal whether sufficient attention is paid to ethics and integrity in the selection process. Likewise, the standards included in performance appraisals and the criteria used for promotions reveal where the company places its greatest emphasis and exactly where on the priority list ethical conduct falls.

6. Has the company conducted a risk assessment to determine where its most likely ethical weaknesses are?
Every company faces ethical challenges specific to its industry, market, and workforce. Determining what those challenges are and how they are being addressed can help establish the actual value of a company targeted for merger or acquisition. Are there pernicious incentives impacting corporate ethical behavior, such as compensation based 100% on financial goals? Likewise, are there identifiable but unintended consequences of policies, procedures or expectations that could motivate employees to make the wrong ethical decisions for what they believe are the right reasons (such as winning a contract unethically in order to save the jobs of colleagues)?
7. Who, if anyone, is responsible for paying attention to the ethical culture of the company?
Many executives operate on the dubious assumption that statements made in the code of conduct about the ethical intentions of the company represent the reality of how the company and the culture actually operate. This premise is rarely tested, although doing so does not have to be either time-consuming or difficult. To be effective, M&A due diligence should include mechanisms to develop an understanding of the realities of ethics at all levels of the organization.

8. Is the company code of conduct more than glossy shelfware?
Can due diligence determine if a company’s code of conduct is real or an eye-catching trophy? A code of conduct should be a useful, up-to-date document that is broadly applied and regularly referenced; it should clearly spell out responsibilities of both the company and its employees. Simply looking at a company’s code of conduct in the due diligence process does nothing more than confirm its existence. A better strategy is to test employee familiarity with the code and understanding of its real-world application.

9. Are employees comfortable raising issues and encouraged to do so?
Issues and problems arise in every business, but whether staff feels comfortable raising questions or concerns can be telling. Although many organizations have reporting hotlines for employees to confidentially or anonymously report observed misconduct, the 2011 NBES found that retaliation against employee whistleblowers continues to be a problem. More than one in five employees (22%) who reported misconduct say they experienced some form of retaliation in return. That compares to 12% who experienced retaliation in 2007 and 15% in 2009. Employees identified their fear of retaliation, and expected unresponsiveness by management to their reports, as the main reasons for not reporting misconduct. That is, many employees fear that no action will be taken to address the underlying problem, but they will suffer for having raised an unwelcome issue. Although more employees report having observed misconduct than in previous years, 35% of those in the 2011 NBES who said they observed misconduct did not report it to their companies.

10. Is the company paying adequate attention to the ethical posture of its subcontractors, vendors, and suppliers?
Employee fear of retaliation and hesitance to speak up or use reporting hotlines can limit a company’s opportunities to identify problems, strengthen controls, and mitigate risks. In assessing a company’s ethical culture, it is helpful to know what kind of reporting mechanisms are in place, how they are promoted, how often they are used, and what types of issues they bring to light. In addition, is there evidence the company has made changes based on reports? If the only changes made involve dismissal of reporting staff members, then there may be employment liability issues to consider, as well.
vendors, and suppliers. Failure to scrutinize the performance record of third parties, including whether they have faced their own ethical challenges, can put a company at risk both with customers and with government regulators. This risk has become particularly troublesome for companies hiring third parties to facilitate the conduct of business abroad, an area increasingly scrutinized by the Department of Justice and the Securities and Exchange Commission as part of their heightened Foreign Corrupt Practices Act enforcement efforts. Knowledge about a company’s third-party due diligence process can provide insight into potential ethics and compliance risks that could surface down the road.

Conclusion

Consideration of the ethical culture and assessment of the ethics and compliance program as part of a comprehensive M&A due diligence process can help identify ethics risks that, if not carefully considered, can lead to buyer’s remorse. Although the information garnered from this more comprehensive effort may not necessarily make or break a deal, it may affect the valuation of the target company or lead to additional deal contingencies. In addition, understanding of the ethical culture can help smooth the organizational transition and foster proactive improvement efforts to reduce risk. The ounce of prevention provided by undertaking broader due diligence assessments may be priceless.

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6. RAND findings, see note 5, above.
8. Ibid

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