The Compliance Conundrum

Compliance programs are now ubiquitous, with more checks and balances than ever before, so why has the wave of corporate scandals not abated?

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The development of the compliance and ethics field has been nothing short of phenomenal. Spurred on by popular opinion, regulatory and judicial fiat, and good common sense, the vast majority of large-scale US public companies have created a professional ethics and compliance mechanism that was virtually unheard of as little as a decade ago.

The rise of the Chief Compliance and Ethics Officer as a vital part of every company’s senior management team and the creation of a plethora of concomitant professional organizations and publications (including Ethisphere) dedicated to the area are a testament to the growing significance of this subject.

But all is not well in the compliance house. While the establishment of a compliance infrastructure is critically important to ensuring an ethical organization, our present approach to assuring compliance may, oddly enough, be working against maintaining the kind of ethical organization that all of us desire and the investing public demands.

The history of the formal ethics and compliance program dates to the 1970s and the passage of the Foreign Corrupt Practices Act by Congress in 1977. In response to the Act’s requirements, a
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number of corporations, mainly in the defense industry, which was the situs of the bribery scandal that sparked the
Act's implementation, created the first
general ethics and compliance programs
to prevent violations of the Act, or at
least reduce the governmental penalties
involved where they occurred.

In the early 1990s, the federal courts, through the Federal Organizational Sentencing Guidelines, adopted the same approach and expanded compliance requirements beyond bribery to include any kind of illegal act; consequently, compliance programs
multiplied dramatically in nature, scope, and
industry.

Then, in 1996, the Delaware Court of Chancery in the now legendary Caremark ruling effectively mandated that all
public companies establish some sort of
compliance program so that directors
may meet their 'duty of good faith'.

Thereafter, all companies were effectively
required to establish compliance and
ethics programs. This was the final
governmental push that created what
has now become a substantial compliance
function throughout corporate America.

Ostensibly, this should have been a good
thing. And, in many respects, it has been
successful in raising public and corporate
consciousness of the importance of
ethical business practices. But, as the
cavalcade of corporate scandals seems to
continue unabated, we have to ask, why
hasn't our compliance culture done much
to change this?

The answer is quite simple. Our focus
on compliance is heavily form-based
and responsive to the mandated legal
compliance obligations created by the
courts. Companies and their boards act
to meet a legal standard to avoid liability
for themselves rather than simply because
good ethics make good sense. This is
classic form-over-substance and has led
to the creation of large-scale compliance
bureaucracies that meet legal muster and
protect directors. All would be well,
however, if a vast compliance program
alone would prevent misconduct. But,
as we have painfully learned from the
many corporate scandals post-Caremark
(including Enron), complex compliance
structures don't necessarily prevent
unethical conduct.

It really is all about culture. Companies
with historically strong ethical cultures
rarely find themselves in an ethics-based
scandal. In such organizations, a pervasive
ethical tone at the top, starting with the
board and chief executive, permeates the
ranks. Those who act problematically are
not tolerated. Ethical direction does not
emanate from the bottom of a culture and
percolate up. It must start at the top and
cascade downward. If the top is rank, the
rest of the organization will be too. If the
top is ethical, the rest will follow and those
who don't rarely stay.

One of us, as a director, has witnessed this
on numerous occasions. While we believe
that compliance structures are important,
it is the tone of the organization directed
by its leadership that ultimately saves the
day. Even the best compliance structure
cannot work if those at the top lack
values. They subvert or simply ignore the
warnings their compliance mechanisms
send and ultimately they and the
organizations fail. This is true at both for
and not-for-profit entities. Culture and
tone matter.

How, then, should the board and investors
approach this problem? Clearly an
appropriate compliance structure must
be in place. But the inspiration must be
organizational, not legal. A compliant and
ethical culture creates more motivated
employees, better relations with
customers and suppliers, and ultimately,
greater shareholder value. Any formal
structure that encourages such a culture
is worthwhile, but the key is the insistence
by the board and shareholders that ethics
and integrity are key attributes of the
organization's leadership. They must insist
that the CEO communicate continuously
the values of an ethical culture throughout
the organization, not only by personal
example, but in management style as well.

Those who show a lack of fundamental
integrity must not remain with the
organization regardless of how 'valuable'
they may seem. As the late Judge Elbert
Buttel once wrote, "...for what is a share
of a man worth? if he does not contain
the quality of Integrity, he is worthless. If
he does, he is priceless. The value is either
nothing or it is infinite."

Additionally, the board must promote
an ownership culture within the
organization through broad-based equity
ownership. If all have a stake in the
company's success, which an ethical gap
threatens, the sort of employee vigilance
that leads to a compliant culture will be
fostered.

Finally, the board must be independent of
management both in form and substance,
and this independence must be highly
visible to the entire organization. This
makes it much more likely that, should a
problem occur, a vigilant employee will
feel the comfort level necessary to
come to the board rather than silently
allowing a managerial ethical lapse within
the organization to become a cancer
enveloping the entire corporation.

The past decade has been an amazing
and exhilarating period for those of us
involved in the ethics and compliance
arena. But, to reach the ultimate goal of
a more compliant and ethical business
organization, we must look beyond the
procedural and focus instead on the
internal integrity and ethics are qualities
that cannot be externally imposed, but
must be an integral part of who we—and
our organizations—are from within.

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