RETHINKING ETHICS:
COMPLIANCE, CULTURE AND MANAGING RISK

"SUCCEED WITH INQUIRY: INSIGHTS, KNOWLEDGE, ACTION"
13TH ANNUAL FORUM OF THE IN2:INTHINKING NETWORK
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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

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WHAT IS BUSINESS ETHICS?

➢ A system of right conduct principles in the workplace
➢ Applying society's ethical norms to business dealings
➢ Determined by:
    ➢ A Code of conduct
    ➢ A Code of ethics
    ➢ Policies and procedures

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ETHICS VS. COMPLIANCE

➢ Ethics developments in industry are largely rules-based.

  ➢ There is less emphasis on values than on statutory requirements.

  ➢ Ethics officer / compliance officer titles are interchangeable.

  ➢ Training is focused on legal obligations versus ethical decision making.

➢ Many companies choose not to go beyond the minimal requirements of SOX code of ethics provisions.

➢ Individuals at the heart of the 2008 economic meltdown often obeyed the letter of the rules, not the spirit.

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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

ETHICS VS. COMPLIANCE

➢ Compliance operating philosophy:

  ➢ "As long as it's legal, it's ethical."

  ➢ "As long as it's not illegal, it's okay."

➢ Peter Drucker – World's shortest class on Business Ethics:

  "If you can't look yourself in the mirror for something you're about to do, don't do it."

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
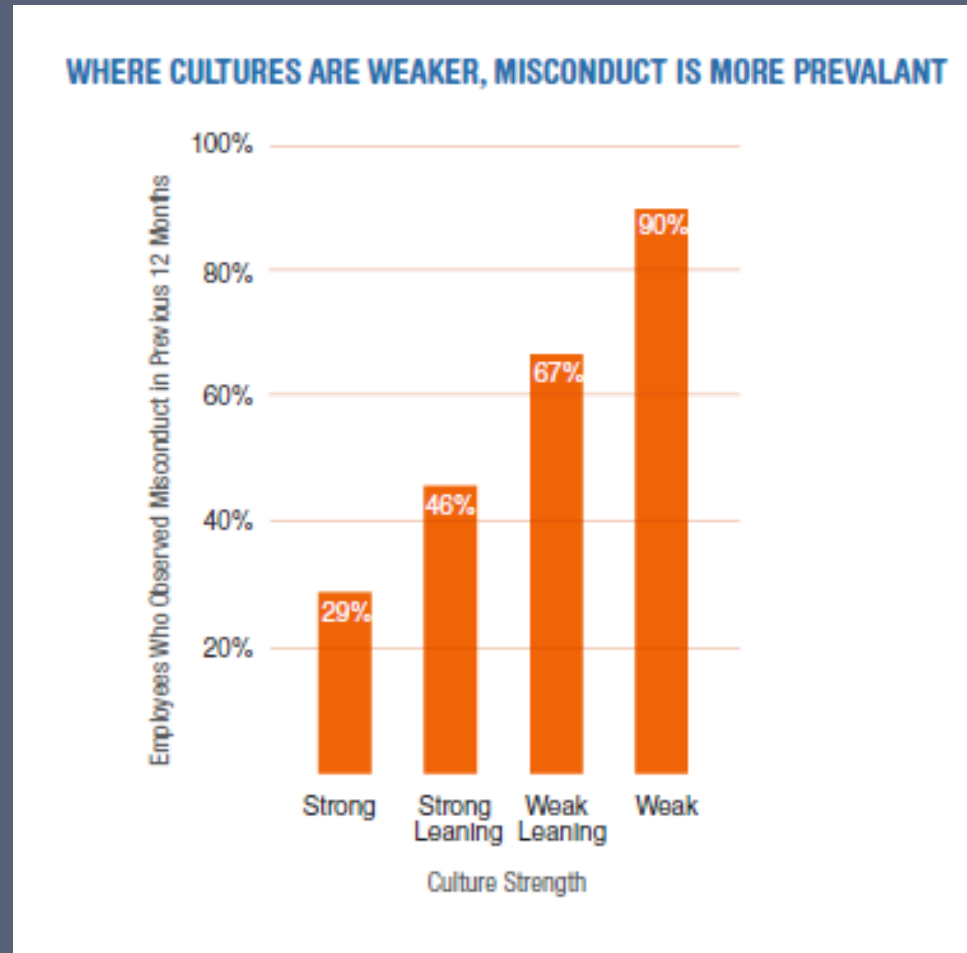
WHAT IS ETHICAL CULTURE?

➢ 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."

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INQUIRY:
How Strong is My Ethical Culture?

➢ Most companies assume ethics efforts are impactful without verification

➢ C-Suite far removed from realities on the ground

➢ Survey/interview efforts necessary to get to ground truth

➢ Independent assessments critical to strengthen programs
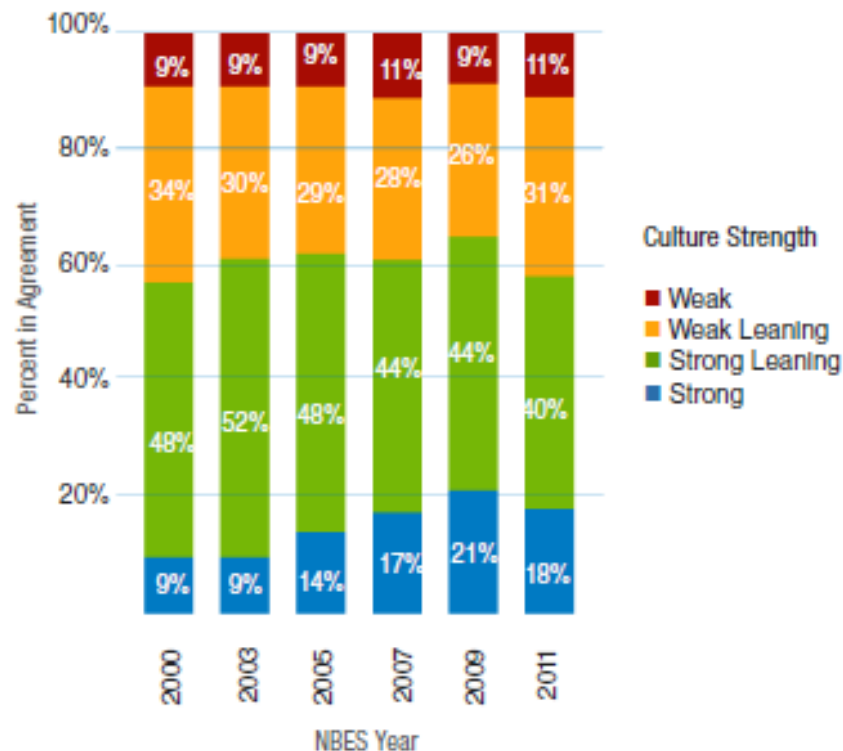
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IMPACT OF CULTURE ON MISCONDUCT

2011 National Business Ethics Survey®: Workplace Ethics in Transition, p. 20. Ethics Resource Center. www.ethics.org/nbes.

DECLINING STRENGTH OF ETHICAL CULTURES

2011 National Business Ethics Survey®: Workplace Ethics in Transition, p. 19. Ethics Resource Center. www.ethics.org/nbes.

WHAT IS AN ETHICS AND COMPLIANCE PROGRAM?

➢ It is not an exotic legal structure invented by the big accounting and law firms.

➢ It is not just a set of detailed legal rules the government wants companies to follow.

➢ It is simply:

  ➢ A management commitment to do the right thing

  ➢ Effective management steps to make that happen

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"

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

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

    ➢ 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 7 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

2010 SENTENCING GUIDELINE UPDATES

➢ 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
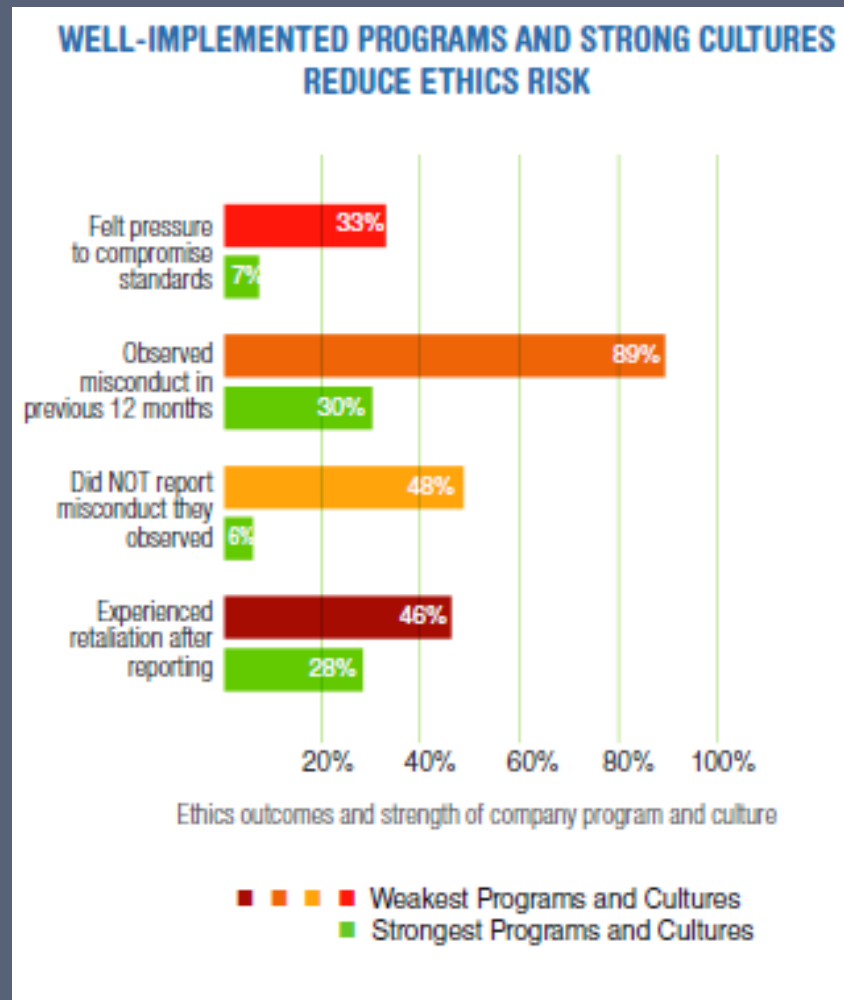
The Guidelines and Ethical Culture

➢ May 2012 RAND Symposium

    ➢ Organizations are unlikely to have successful compliance programs without a solid ethical culture.

    ➢ Culture is the missing link that drives whistle-blowers either to come forward or stay silent.

    ➢ Risk reduction is linked to strong CECO, performance incentives, and periodic assessments.

➢ 2011 NBES

    ➢ Employees in companies with effective ethics program are more likely to perceive a strong ethical culture.

    ➢ Well-implemented programs and strong cultures reduce ethics risks.

Strength of Ethics Programs Impacts Fraud Risk

WELL-IMPLEMENTED PROGRAMS AND STRONG CULTURES REDUCE ETHICS RISK

Felt pressure to compromise standards: 33% / 7%

Observed misconduct in previous 12 months: 89% / 30%

Did NOT report misconduct they observed: 48% / 6%

Experienced retaliation after reporting: 46% / 28%

Ethics outcomes and strength of company program and culture

Weakest Programs and Cultures
Strongest Programs and Cultures

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 their direct supervisor as the top factor influencing workplace conduct.

- NBES 2011 Culture Metrics

  - Management trustworthiness

  - Supervisory reinforcement

  - Peer commitment

INSIGHTS:
How Do I Know If Its Working?

1. What is the relationship between ethics and other performance metrics in the company?

   ➢ Pressure from management or the Board to meet unrealistic business objectives is the leading factor in unethical behavior.

   ➢ 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

INSIGHTS:
How Do I Know If Its Working?

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

INSIGHTS:
How Do I Know If Its Working?
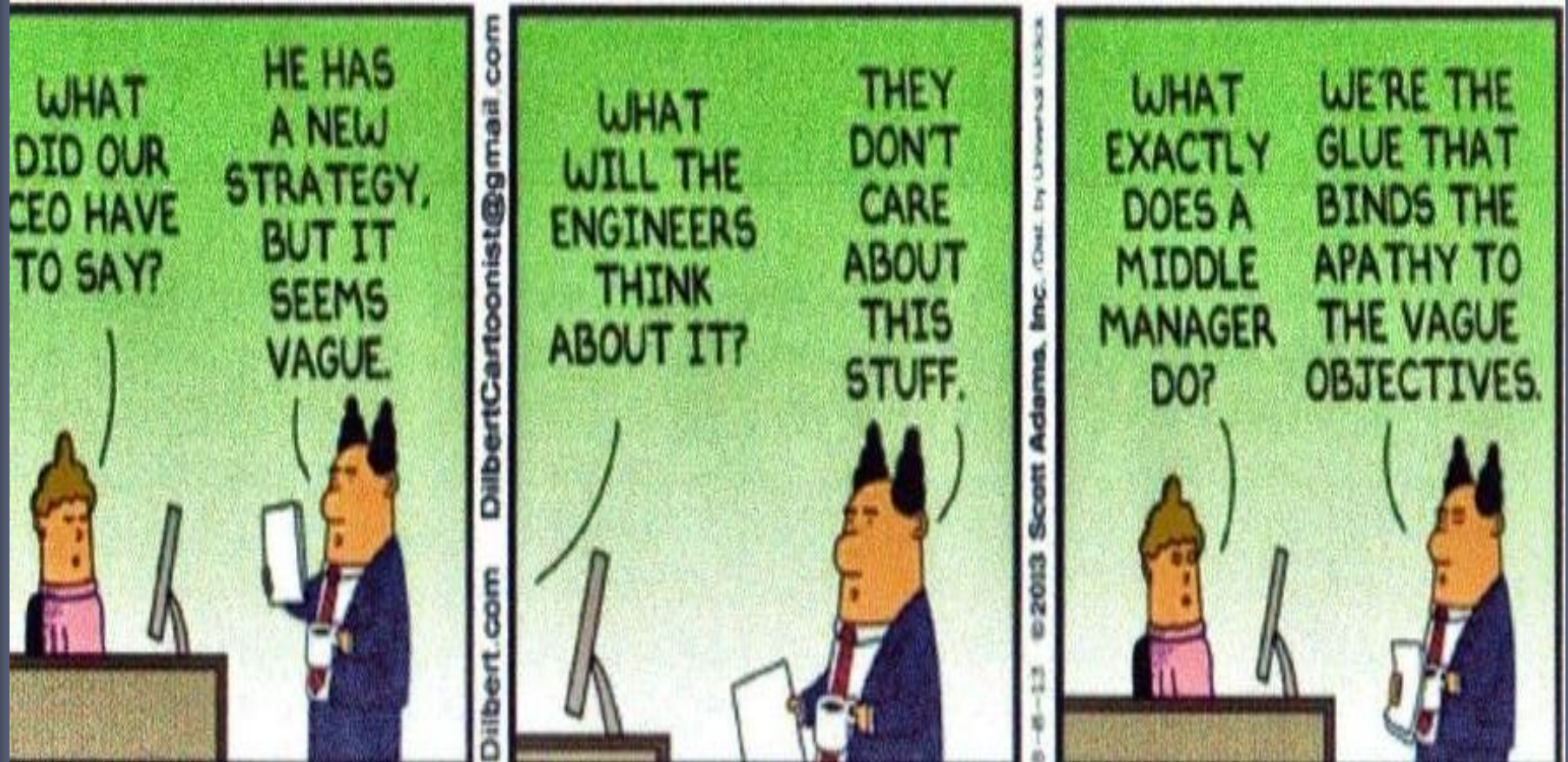
5. What is the "tone at the top"?

> 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

Role of the Middle Manager

INSIGHTS:
How Do I Know If Its Working?

7. Who is responsible for paying attention to the ethical culture?

   ➤ Senior leadership intentions don't always reflect reality.

   ➤ How is ethics incorporated into day-to-day business decisions?

   ➤ Ask the employees!

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?

INSIGHTS:
How Do I Know If Its Working?

9. Are our employees familiar with and comfortable using reporting mechanisms?

   ➢ Is there a fear of retaliation?

   ➢ Is the hotline 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 necessary

   ➢ Often the weakest area in ethics assessments.

STEVEN 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."

KNOWLEDGE:
ETHICAL CULTURE AND FRAUD PREVENTION

➢ Cost of fraud is staggering

  ➢ *ACFE Report to the Nations*: 5 percent loss

  ➢ Record False Claims Act 2012 settlements: $5 billion

  ➢ Record number of SEC / DoJ FCPA actions

  ➢ Record number of suspensions / debarments

➢ ROI of anti-fraud programs

  ➢ Duration and value of losses reduced

  ➢ Reporting hotlines, training, code of conduct, and reporting incentives all decrease fraud

The Fraud Triangle

Opportunity

Rationalization

Pressure / Motivation

Fraud Triangle and Ethical Culture

Opportunity

➢ Greatest when an employee perceives bad behavior is an accepted way of doing business

➢ Fear of retaliation prevents reporting

Rationalization

➢ Sense of entitlement high in cultures with low morale

➢ Perception of unfair treatment

➢ Incentives / rewards favor ethically challenged and promote the wrong behaviors

Pressure

➢ Unrealistic business objectives

➢ Ethics divorced from financial metrics

What Percentage of Employees Would Commit Fraud?

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

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.**
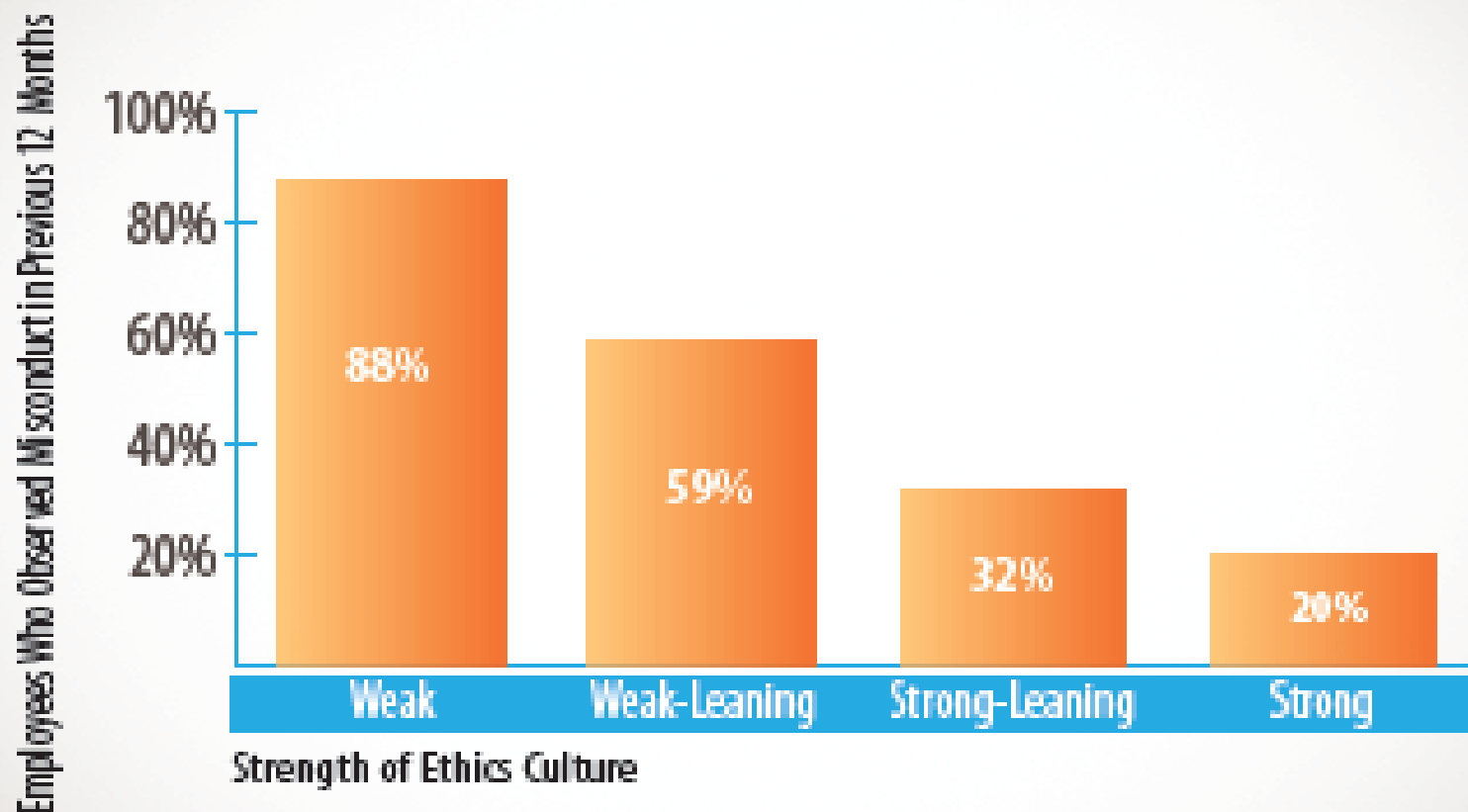
Where Do Your Employees Fall?

10-20%   **60-80%**   **10-20%**
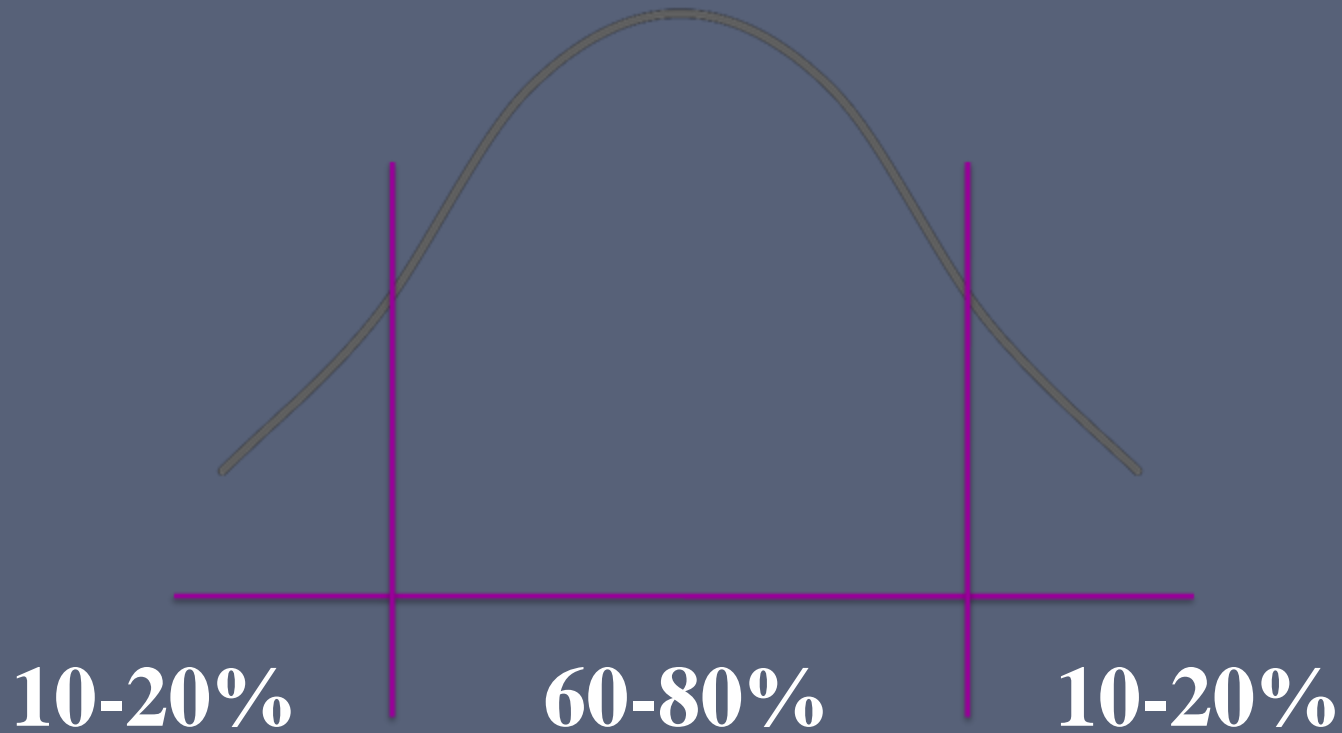
Action:
The ROI of Anti Fraud Programs

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

Impact of Culture on Misconduct

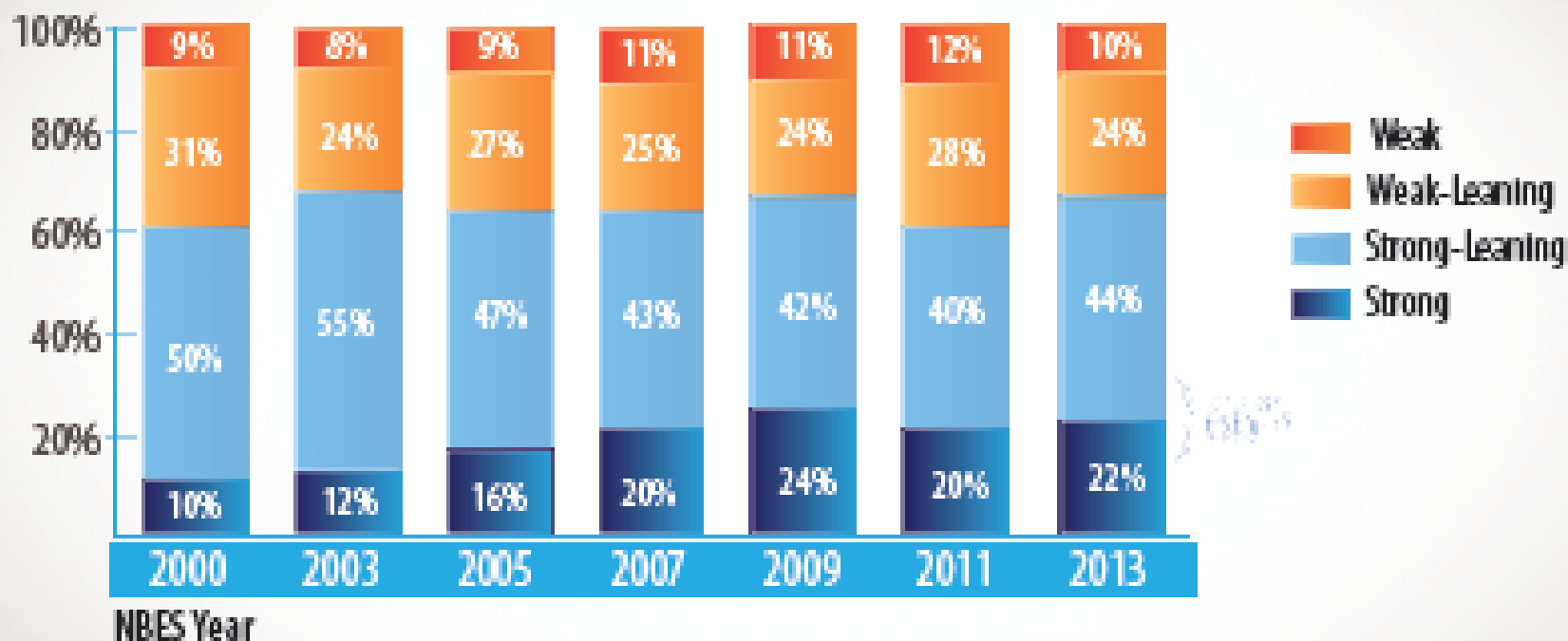Misconduct Declines As Ethics Culture Improves

Employees Who Observed Misconduct in Previous 12 Months

- Weak: 88%
- Weak-Leaning: 59%
- Strong-Leaning: 32%
- Strong: 20%

Strength of Ethics Culture

Positive Ethical Cultures

Two in Three Companies Now Have Positive Ethics Cultures

NBES Year	2000	2003	2005	2007	2009	2011	2013
Weak	9%	8%	9%	11%	11%	12%	10%
Weak-Leaning	31%	24%	27%	25%	24%	28%	24%
Strong-Leaning	50%	55%	47%	43%	42%	40%	44%
Strong	10%	12%	16%	20%	24%	20%	22%

2011 National Business Ethics Survey®: Workplace Ethics in Transition, p. 19. Ethics Resource Center. www.ethics.org/nbes

Action:
Where Should We Focus Our Energy?

➤ Hiring Due Diligence

    ➤ Attract the Ethical

    ➤ Keep out the bad apples

➤ Ethical Culture

    ➤ Supporting environment for the 80 percent

    ➤ Training

    ➤ Accountability

    ➤ Messaging

Our Future Starts Here...

State of Ethics Today: Reasons for Concern

"Lie, Cheat and Steal: High School Ethics Surveyed"*

- 78% of high school students surveyed reported cheating.
- 64% of students cheated on a test in the past year and 38% did so two or more times, up from 60% and 35% in 2006.
- 60 years ago, only 20% of college students admitted to having cheated while in high school; today, only 22% report they did NOT cheat.
- Serious implications for the workforce (both government and industry)
  - Ethical values can't be assumed
  - Entry-level training requirements
  - Different approaches for Gen X and Gen Y

*Source: Josephson Institute 2008 Study

State of Ethics Today: Reasons for Concern

"Did you *Cheat* to Get Into Graduate School?"*

YES!!

Liberal Arts	43%
Education	52%
Law/Medicine	63%
Business	**75%**

*Source: Rutgers University Survey of Students

State of Ethics Today: Reasons for Concern

Graduate School Cheating

MBA	**56%**
Engineering	54%
Education	48%
Law	45%

*Source: Rutgers University Survey of Students

State of Ethics Today: Reasons for Concern

Why Do They Cheat?

- **Students in the Rutgers Study rationalized their cheating:**
    - Too many pressures.
    - Desire to please parents and professors.
    - Intense competition for jobs.
    - Everyone is doing it.
    - Disinterested in required classes.
    - Professors don't care about students.

It's the 'way of the world;' getting others to do my work is a skill I will need in business.

State of Ethics Today: Reasons for Concern

Graduating MBAs

- 76% were willing to understate expenses that cut into their companies' profits.

- Convicts in 11 minimum security prisons had higher scores on an ethical dilemma exam than MBAs.

*Source: Rutgers University Survey of Students

The Epidemic of College Football Scandals

- University of Miami facing the NCAA "death penalty."
- 2002-2010: Illegal gifts from Nevin Shapiro, convicted Ponzi schemer and Miami booster.
- Sex parties on yacht, expensive jewelry, etc.
- Ohio State, Auburn, NC, Oregon, Tennessee, LSU: recruiting violations, cars, women.
- Winning seen as bottom line; tied to enormous revenue for the schools.

If You're Skeptical: Other Studies of Note

➢ **U.S. News and World Report:**

- 80% of "high achieving high school students admitted to cheating; 51% did not believe cheating was "wrong"

- 75% of college students admitted to cheating, and 90% didn't believe cheaters would be caught

- 85% of college students said cheating was necessary to get ahead

➢ **Center for Academic Integrity:**

- 44% of college faculty were aware of student cheating in their course, but never reported a student to campus authorities

- Serious test cheating on campuses with honor codes is typically 1/3 to 1/2 lower than the level on campuses without honor codes

CASE STUDIES – DOD MONITORING

COMPANY: Federal construction contractor

GOVERNMENT AGENCY: DOD

ISSUE: Possible debarment for violating the Buy American Act

ETHICS ASSESSMENT RESULTS:

➢ Strong ethical culture

➢ Absence of training and formal program

➢ Incentives for independence and self-reliance created organizational risk

CASE STUDIES – DOD MONITORING

COMPANY: Federal consulting contractor

GOVERNMENT AGENCY: DOD

ISSUE: Suspension for violating the Procurement Integrity Act

RESOLUTION: Ethics evaluation and monitoring, suspension lifted, administrative agreement

ETHICS ASSESSMENT RESULTS:

➢ Leadership's ethical intentions not fully executed

➢ Ineffective ethics messaging

➢ Over-reliance on computer-based training without reinforcement

➢ Financial and business metrics sent mixed messages

CASE STUDIES – CIVILIAN AGENCY

COMPANY: Federal services contractor

GOVERNMENT AGENCY: Civilian agency

ISSUE: Breach of Contract / False Claims

RESOLUTION: Independent integrity officer, ethics evaluation, follow up reviews

Ethics Assessment Results:

➢ Absence of formalized program

➢ Leadership tone at the top compromised

➢ Corporate profitability trumped all other values and metrics

➢ Constant turnover / low morale

CASE STUDIES – PHARMACEUTICAL

COMPANY: Pharmaceutical manufacturer

GOVERNMENT AGENCY: State Licensing Board

ISSUE: Fraud, guilty plea by owner, licensing issues

RESOLUTION: Compliance program, monitoring, hotline, random drug analysis, debarment of owner

ETHICS ASSESSMENT RESULTS:

➢ Absence of compliance program

➢ Leadership tone at the top compromised

➢ Lack of training / understanding of complex regulations

➢ Absence of transparency

CASE STUDIES – PATRIOT ACT

COMPANY: International precious metals refiner

GOVERNMENT AGENCY: US Bureau of Immigration and Customs Enforcement

ISSUE: Money laundering

RESOLUTION: Fines, anti-money laundering program, independent monitoring

ETHICS ASSESSMENT RESULTS:

➢ Ineffective third-party due diligence

➢ Weak ethics and compliance function

➢ Poor ethics messaging

CASE STUDIES – HEALTHCARE FRAUD

COMPANY: Pain management specialist clinic

GOVERNMENT AGENCY: US Dept. of Health and Human Services

ISSUE: Medicare fraud

RESOLUTION: Fines, compliance program, periodic audits, and reporting hotline

ETHICS ASSESSMENT RESULTS:

➢ Absence of compliance program

➢ Ineffective training

➢ No reporting hotline / fear of retaliation

CASE STUDIES – FEDERAL HIGHWAY

COMPANY: Multi-state construction company

GOVERNMENT AGENCY: Federal Highway, IG

ISSUE: Requisition / time and materials fraud, false claims

RESOLUTION: Compliance program and independent monitor in lieu of debarment

ETHICS ASSESSMENT RESULTS:

➤ No formal ethics and compliance program

➤ Poor controls, no risk assessments

➤ Ethics message not effectively communicated

SOME TAKE AWAYS

➤ Increased governmental focus on corporate ethics and compliance reflected in law enforcement decisions and court actions

➤ "Paper Program" not enough to receive favorable treatment and mitigate risk; it's all about the culture

➤ Companies must take a proactive role to gain insight and knowledge about their culture, and take positive actions

➤ Ethics and Compliance programs and corporate ethical culture should be viewed as good business decisions that reduce fraud exposure and create better companies

Questions

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