

Effective Board Governance

by Dov L. Seidman

Corporate compliance requirements, mandates and guidelines have become the panacea for regulators and rule makers seeking to reform corporate America—adding compliance oversight responsibility to the board’s heavy job description. How can a working board hope to do all the jobs now demanded of it? By focusing on the tasks that really matter, setting the right tone and focusing on assessing and improving their organization’s ethical health, says Dov Seidman.

Corporate board members may have prepared for board meetings in the past by reviewing a slim binder of financial statements on the flight to a quarterly meeting. Today they face email and in-boxes jammed with hundreds (if not thousands) of pages of briefing materials.

Despite the ensuing regulatory response from recent corporate scandals that requires greater board oversight, directors are not looking for *everything*. In fact, providing *everything* may actually increase the risk to companies that something important will be lost in the flood of information. Now more than ever boards need relevant, focused information and knowledge to discharge their duties of governance and oversight.

This responsibility is not simply about meeting the regulatory requirements. Regulations are by their nature over and under-inclusive and cannot address every conceivable situation. A close examination of new regulations reveals their focus on principles and standards rather than obedience to rules and laws. Proof of this can be found in a review of key questions that regulators ask about a board’s ability to govern effectively include:

- Is the board “knowledgeable” and exercising reasonable oversight?
- Has the board “ensured” the effectiveness of management efforts to promote an ethical corporate culture?

- Is there a high-level person with “direct, overall responsibility” to report to management and the board on ethics and compliance issues?

- Are there “adequate resources, appropriate authority and direct access” to the board?

Operating in the less certain arena of standards, board members have a difficult task at hand. The key to effective governance is to pay attention to the *right* things and ensure that management is equally focused on them.

Without clear, universally accepted metrics and guideposts that can definitively determine that an organization is ethical and healthy, however, board members must measure and assess ethical health and corporate culture indirectly. Here are five ways for board members to foster a strong ethical corporate culture to help their own organizations succeed and win.

- Invest sufficient time in the right areas.
- Find out what is going on for yourself.
- Help the company enlist the right people.
- Examine, ask and assess essential questions.
- Align motivations, incentives and inspiration.

It is important not to confuse boardroom effort with efficacy. Just because directors are working harder does not mean they are getting more done.

- *Invest sufficient time in the right areas.* Board members have numerous competing demands across all areas. Investing time in assuring the overall ethical health of the company is an annuity that continues to bear dividends long into the future. The first step in investing sufficient time is to assure that the board makes ethics and culture a priority. The new regula-

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tions that have ratcheted up the pressure on boards offer some instructive insights.

In 2004, the United States Sentencing Commission examined why the dramatic increase in formal corporate compliance programs made little difference in improving actual compliance. In a significant departure from its previous approaches, the commission concluded that no longer is it sufficient to design and implement programs that allow executives to report that the company is complying with all applicable laws and regulations. What is now required is an “organizational *culture* that encourages *ethical conduct* and a commitment to compliance with the law” [emphasis added]. Moreover, the “governing authority” (i.e., board) must oversee this requirement and be trained in its ethical responsibilities.

Last October, the Federal Deposit Insurance Corporation placed responsibility for creating a culture of ethics and compliance at banks squarely on the board. It noted that the “board of directors should convey the message that integrity and ethical values of the highest standard should be maintained” by establishing “clear expectations” and ensure “that bank management is cognizant of all applicable laws and regulations.”

With broad powers but limited resources, regulators depend heavily on corporate institutions policing their own conduct. Enforcement alone does not work. Only a commitment to ethics and culture has consistently enabled corporations to self-regulate based on commonly shared values.

The language of standards and principles is now common throughout many company codes of conduct. The Exxon Mobil Corporation’s code mandates, for example, “Even where the law is permissive, the corporation chooses the course of highest integrity. The corporation cares how results are obtained, not just that they are obtained.”

Some companies have taken the next logical step and implemented codes of conduct and ethics specifically for members of the board as well. Ford Motor Company, for example, has created a code intended “to focus the board and each director on areas of ethical risk, provide guidance to directors to help them recognize and deal with ethical issues, provide

mechanisms to report unethical conduct, and help foster a culture of honesty and accountability.”

Following is a list of key questions directors should ask of their own ability to invest sufficient time in the right areas.

- Codes alone are not sufficient to inspire ethical, winning corporate cultures. Does your board invest structured time in assuring that the right policies are in place? How does the board assess your company’s adherence to your code?

- Is your code of conduct worded to ensure fidelity to standards and principles as well as obeying the law and bright line rules? Does management apply its policies and standards consistently?

- Do you have an effective ethics and compliance education and certification program in place? Is an entry-level clerk in the mailroom treated the same as the company’s top salesperson?

- How effective is the program in aligning employee behavior to your corporate values?

- Do you regularly see evidence of ethics and compliance at work in the form of reporting, evaluation and discussion? Does your organization value a commitment to transparency and openness in its dealings?

Directors should not fail to question their conduct just because the rules allow it. Do not ask, “can I do it,” but instead “should I.”

- *Find out what is going on for yourself.* An article in the May 2005 issue of *Credit Union World* noted, “Effective boards perform five critical tasks continuously: governance; performance; management development and accountability; strategy and ethics; and financial integrity.” Juggling these five tasks is never easy under the best of circumstances, particularly for outside directors who are a step removed from the operations of the corporations they govern.

Board members review materials that are prepared for them by management. In the area of culture and ethics, however, working with the larger organization can make board members more effective in setting

the company's ethical compass. Sometimes the most telling aspects of ethical health and culture come from impromptu interactions and exchanges.

A study released last year by the Conference Board found 78 percent of board members in the United States reviewed their company's efforts to ensure ethics. Done right, this oversight goes beyond the much-discussed "tone at the top." Yes, boards must model appropriate conduct and insist on the same for senior management, but they can also do more. Evidence suggests that boards are taking this responsibility seriously.

Some companies follow the regulatory lead and become explicit about the requirement of the board for "reasonable oversight" of compliance and ethics. The corporate governance guidelines of Sanmina-SCI Corporation, for instance, begin, "It is the paramount duty of the board of directors to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis."

Regulations such as the Federal Sentencing Guidelines require that the head of compliance have adequate influence and direct access to the board. Extending this access to other stakeholders provides yet another opportunity for unvarnished raw data to reach the board.

Following is a list of key questions directors should ask of their own ability to gather objective information.

- How does your board evaluate the number of ethics and compliance issues flagged for board attention?
- If few incidents are brought to the board, is it a sign of overall ethical and cultural health? Or sign that the information is not available or known?
- Should your board be encouraged about the effectiveness of the channel or concerned about fears by the rank-and-file about management retribution?
- Are directors encouraged to question conduct and practices that may be legal, but close to the legal line?
- Does your board ask not only ask "can we do it," but "should we" when it comes to business strategy and decisions? Does the decision making

process consider ethical and reputation outcomes in addition to financial?

Boards enjoy the dual vantage point of assessing both management and each other. Directors have the ability to assess and uncover their own strengths and weaknesses.

□ *Help the company enlist the right people.* The corporate scandals of the modern era were not largely perpetrated by run-of-the-mill grifters. Rather, these were tremendously gifted people who used their abilities (in some cases even their genius) to pursue the wrong ends. As a board member, it is important not only to set the "tone at the top" through personal conduct beyond reproach, and insisting that executives meet the same standard. You must also insist that the corporation values character as well as skill. Talent without a commitment to ethics can expose your organization to extreme risks.

Although the board does not usually do the hiring, it can ask the right questions about who is being hired and assure that ethics and character are criteria in reward and advancement after hiring. The board can gain greater assurance that the corporate workforce is not being misdirected in pursuit of a short-term, narrow financial goal at the price of long-term investment.

Enlisting the right people applies not only to the company's employees, but to the board itself. Board members enjoy the dual vantage point of assessing both management and each other. Directors have the ability to assess and uncover their own collective strengths and weaknesses.

Following is a list of key questions directors should ask of their own ability to help the company enlist the right people.

- Does management integrate ethics into its recruitment programs? Are these practices reinforced through reward and recognition programs?
- Does the organization publicly recognize ethical role models? Does the company recognize the value of "doing things right"?
- Is management receptive to board participation

in key hires? Has management determined and communicated those high risk job functions that require board participation?

- Are there mechanisms in place to reward ethical behavior “when no one is looking”?
- Does the company apply its standards fairly and uniformly?

The board needs to learn of “bad news” sooner rather than later. The ethical health of a company can be assessed through unimpeded access to employees.

□ *Examine and assess the unspoken, but essential questions.* Directors bring expertise, intelligence and ethical compass to the job of governance. Volunteering to ask the respectful, but potentially uncomfortable questions minimizes the chance for surprises in the future.

U.S. Supreme Court Justice Brandeis once commented, “Sunlight is said to be the best of disinfectants.” One measure of the overall ethical and cultural health of companies is how they bring “bad news” to the attention of management and the board. Management and the board need to learn of bad news sooner rather than later. The board can drive needed changes to assure that appropriate mechanisms and cultural alignment are in place to provide management and the board with the information they need.

The board can begin by assessing the ethical health of the company from the people who choose to work there. Some industries lend themselves more easily than others to this type of interaction. Nothing illuminates how a company really works better than unscripted, unimpeded access to employees outside of the earshot of the executives. This “raw material” goes far to reveal how far ethics and a common corporate culture have spread throughout the company and uncover a corporate culture that is in need of redirection and renewal.

A crucial step in maintaining objectivity is to assure that outside directors periodically meet without the inside directors. GE requires its directors to meet a minimum of eight times a year; at least three of

these meetings must take place without management present. This allows for candid assessment and conversation with less likelihood that fraternal sentiments will overcome skepticism. These meetings also serve as a tangible reminder that the inside and outside directors have a common goal of governance, with complementary yet equally important roles.

GE directors, for instance, are expected to visit two GE businesses a year without management present “so they can interact freely and directly” with GE employees. Home Depot requires its board members to visit at least 12 stores a year.

Following is a list of key questions directors should ask of their own ability to ask the essential questions.

- Do you have direct access and opportunity to engage with employees and employee groups?
- How does the management of your company deal with breaches and “bad news”?
- Do you have systems, people and processes in place that help to track and report potential problems? Can you analyze the trends in these metrics?
- Do you have systems, people and processes in place that help to define the significance of the problem? The impact on “the messenger”?
- What steps are in place to prevent this from occurring in the future? Do you have a means to assess the effectiveness of the process itself?

Directors should assess their company’s performance, management and compensation plans to assure that ethical behavior is rewarded.

□ *Align motivations, incentives and inspiration.* Some boards define their responsibility narrowly as primarily representing and serving the interests of shareholders. Serving investors is and always has been important. What was often lost with this focus on investors were the interests of other stakeholders—employees, partners, community members—who in many cases had a greater commitment than short-term investors in creating institutions of enduring significance and value.

At the same time, what are the risks that these stakeholders pose on the institution? A recent study by the Economist Intelligence Unit identified regulatory risk and reputation risk as the top two threats to global businesses. The regulatory and reputation risks companies face differ by industry, company and job function, however, they can be categorized as “ethics and compliance risk.” Common regulatory risk areas for multinational companies include the Foreign Corrupt Practices Act and anti-trust, harassment, insider trading, conflict of interest and fair competition laws. The most common ethical risk area for multinational companies is non-compliance with a company’s code of business conduct. Each depends on the behaviors and actions of employees.

Directors are well-qualified to assess their company’s performance, management and compensation plans to assure that ethical behavior is rewarded—even when it is inconvenient, unpopular, or unprofitable in the short-term. Explicit communications to employees about the board’s commitment to a culture of ethics and compliance provide critical reinforcement of this priority.

Global leaders are increasingly deploying hybrid pay for their directors, such as a 60/40 stock-to-cash compensation mix, with the stock paid out only upon a board member’s departure from the board.

Boards should periodically review the activities and interactions involved in the work of employees to determine likely ethics risks. By this means, boards can help ensure that the company has matched its ethics and compliance education curriculum, including the orientation and education of board members, to focus on potential trouble spots.

Following is a list of key questions directors should ask of their own ability to align motivation, incentives and inspiration.

- Are the interests of board members aligned with various stakeholders, or only shareholders?
- Do directors have “skin in the game” in terms of personal investment in the company? Are they required to maintain a minimum level of commitment? How are committee members compensated for their additional responsibilities? Are their incentives aligned with those of responsible governance?

- Does your risk management processes also include key ethical and compliance risk areas? Do you understand the greatest global risk areas to your company’s reputation?

- Are there processes in place to manage ethics and compliance risk areas on a global basis?

- Are processes and policies designed for global risk assessment, management and evaluation?

Responsible board service is based on true oversight, not reliance on rules and laws. Boards can bring real value to stakeholders by fostering ethical corporate cultures.

The new evaluative criteria for responsible board service are based on standards of true oversight, not passive reliance on rules and laws. There is no panacea for effective self-governance. However, investing in the ethics and culture at the board level increases the odds that ethics and compliance failures will be anomalies. The focus of the board has to extend beyond oversight of senior management and deep into the employee base to determine the corporate culture’s health, especially ethical health.

Forward thinking companies are training their workers in the principles that animate the corporate code of conduct, and employees no longer enter a dangerous ethical gray area without a guide. They are measuring the feedback they are getting through anonymous help lines to determine where their risks are. They are infusing discussions of ethics into business communications to correlate the principles they espouse with the business that they practice.

Finally, they are driving home the message that ethics is additive to the business, not a cost. Studies have shown that good ethical reputations are linked to an ability to attract and retain customers, suppliers and employees. Companies that effectively manage governance can expect percent-point gains in their market valuations. Ultimately, however, insisting on the fostering and strengthening of ethical corporate cultures is how board members can bring real value to the stakeholders they represent and protect and strengthen their company’s reputation. ■