

THE EFFECTIVE PRACTITIONER ETHICS AND COMPLIANCE: BIRTH OF A PROFESSION

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This Journal is grounded in the promotion of effective, ethical decision-making. Business and commerce have had to grapple with this challenge ever since the first barter exchange took place between two strangers many millennia ago. Greed and self-interest have conflicted with trust and mutual interest ever since. Yet, there has, until recently not been any perceived need for dedicated, internal functions to manage these conflicts. Adam Smith first provided a comprehensive understanding of the efficiency of capitalism and its moral workings in his groundbreaking works, the *Theory of Moral Sentiments* (1759) and *The Wealth of Nations* (1776), when he provided a scientific blueprint and moral defense of the market exchange system. As a professor of Moral Philosophy, he saw our current system of free enterprise rooted in moral and ethical foundations. Where has this moral rectitude, if ever it existed, disappeared to? From whence came the impetus for the establishment of more regulations to make up for the failings of individuals moved by the invisible hand? In the face of a skeptical audience, self-assured in their own ethical values and performance and questioning as to the value and need for compliance, Keith Darcy provides an important reminder of the story behind the emergence of a new profession, in a world demanding both greater wealth, and higher moral standards where the ends do not justify the means.

■ Despite the roots of capitalism being grounded on Adam Smith's moral imperatives of mutual long-term self-interest, from the dawn of the industrial revolution to today, corporate scandals and the neglect of the so-called

“Commons¹”, have been unsettling parts of the history of capitalism. Businesses have repeatedly failed the ethical test, failed to self-regulate, leaving markets to react negatively and governments to provide quick remedies.

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1 Land or resources belonging to or affecting the whole of a community.

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Thus;

- In the 1830's when public attention focused on child labor and unsafe work conditions, governments passed labor laws to protect the workers.
- When the "robber barons" in the U.S. exploited competition through trusts, resulting in enormous economic concentration in the hands of few, the government passed the Sherman Anti-Trust Act in 1890.
- In 1906, Upton Sinclair wrote "The Jungle" about the filthy work conditions in the Chicago meat markets, and gave rise to the Pure Food and Drug Act.
- In 1914, Woodrow Wilson established the Federal Trade Commission to combat unfair business practices.
- In 1933, the Securities and Exchange Commission was established to protect investors against market manipulations.

Failure to self-regulate unfortunately leads to an unwelcome result – more regulation.

Integrity:

Out of sight; out of mind

Fast forward, following a 1975 investigation of a major U.S. aerospace manufacturer² who paid bribes to high-ranking government officials in Japan, more than 400 U.S. companies admitted making questionable payments abroad under an amnesty program. Congress criminalized these actions through the passage of the Foreign Corrupt Practices Act (FCPA) in 1977, thereby setting down legal standards for internal controls. At the same time in Paris, the International Chamber of Commerce (ICC) adopted the Shawcross Report and issued ICC's "Rules of Conduct to Combat Extortion and Bribery." Already, an increased emphasis on internal controls and legal liability laid the seeds for a new profession; that of compliance.

And the scandals continued. In November 1986, the illegal stock manipulation and insider trading investigations of Ivan Boesky led to a settlement of \$100 million and 22 months in jail. With Boesky's cooperation, the junk bond king, Michael Milken, would

2 <http://www.time.com/time/magazine/article/0,9171,917751,00.html>

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later be fined \$600 million and he, too, spent time in jail.

Also in 1986, following allegations of waste and fraud among US defense contractors, with the help of Senator Howard Baker, the defense industry formed a self-regulatory body called The Defense Industry Initiative (DII)³. Working together with the government, DII developed a model for internal ethics and compliance programs to detect and prevent waste, fraud and other wrongdoings. With the definition of the requirement for ongoing internal programs related to behaviour and decision taking, the compliance function started to shoot from its seed and sink its roots into the organisation.

The Ethics Profession Is Born

In the early 1990's, a number of companies in other industries began to draw on the experience of defense contractors gained through DII. Through the efforts of the Center for Business Ethics at Bentley College, executives from a number of non-defense companies started exploring the prospects of creating a non-profit,

multi-industry membership association where they could come together and share best practices.

Concurrently, on November 1, 1991, the United States issued Chapter 8 of the Federal Sentencing Guidelines⁴ pertaining to crimes in the workplace. This landmark pronouncement raised two new risks:

- a personal threat, and
- a corporate threat.

The personal risk meant that executives could become subject to civil and/or criminal charges when an employee of theirs commits a crime in the workplace. Willful ignorance and willful blindness are not defensible. In addition, the corporate threat resulted from the fact that companies could be subject to mandatory fines of up to \$290 million. The Commission, however, intentionally and creatively offered a carrot with the stick, i.e. incentives to those organizations that take meaningful steps to develop

3 <http://www.dii.org>

4 www.ussc.gov/Guidelines/index.cfm

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effective ethics and compliance programs that can mitigate those risks. A carrot, whose value can only be measured against the anticipated, potential pain of the stick.

While many business people were wary of these new risks, the implication of new developments was not lost on the executives who were meeting at Bentley College. It was time to allow the early shoots of compliance to blossom. In 1991 the Ethics and Compliance Officer Association was formed in the USA with nineteen ethics officers as charter members. Through this act of mutual recognition and collaboration, the ethics profession in the USA was born.

Subsequent Experience

During the 1990's, following de-regulation of the energy, utility, telecomm and financial services industries, the economy soared⁵, business scandals such as BCCI and Barings came and went, yet none of them affected the unstoppable rise in the stock market. Wealth creation it seems, trumped any serious concerns on

integrity and ethics.

Then, as GDP growth slowed and sagged in 2000/2001, Enron took center stage as the largest bankruptcy in the history of capitalism (\$63 billion). Enron, the seventh largest company in the U.S., became the poster child for corporate fraud. The 20,600 employees of Enron lost 62% of their pension assets, which were tied up in Enron stock held in their pension plans.

Unfortunately, Enron was not the only scandal. Entering 2002, a litany of other scandal-plagued companies paraded across newspaper headlines: ImClone; Tyco; Adelphia; Rite-Aid; Xerox; Aurora Foods; and Arthur Andersen. The Dow Jones Industrial Index plummeted to 7,700, and NASDAQ had fallen over 75% from its peak. In contrast to the 90's experience, the markets were nearing a freefall as investors, concerned that the markets lacked integrity, fled to safer investments.

By late spring, leaders in Washington began negotiating the passage of a bill proposed by Senator Paul Sarbanes and

5 NASDAQ rose from 453 in 1991 to its peak in March 2000 at 5,132. Dow Jones Industrials rose from 2,883 to its peak in January 2000 at 11,750.

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Congressman Mike Oxley to restore investor confidence. Unfortunately, the chances for passage dimmed as memories of Enron faded from the front page and congressional attention was focused on the Homeland Security Act. In June, the U.S. senator Jon Corzine was heard to say, “It will take another Enron to get (Sarbanes-Oxley) approved”. Shortly thereafter WorldCom obliged and imploded, resulting in a \$107.5 billion bankruptcy, eclipsing Enron’s bankruptcy within six months by a factor of 1.8 times. On July 8, 2002, President Bush called for a “new ethic of responsibility,” and subsequently, SOX (as it quickly became known) was swiftly passed into law by a vote of 423-3 in the Congress, and 99-0 in the Senate.

The language of SOX is very clear. It aims to get beyond the rules based approach of legal compliance and speaks directly to governing bodies (boards), top executives and public accounting firms. Like the so-called Principles Based Regulation being increasingly emphasized by the UK Financial Services Authority through the first half of the decade, the objective was to place management at the center of responsibility when it comes to ensuring that decision taking

and organisational culture would focus on ethical outcomes as opposed to legal compliance. Its major provisions include among other, the evaluation and certification of internal controls, certification of financial statements by CEOs and CFOs, new governance standards, a ban on personal loans and accelerated reporting of insider trading. Failure to comply with these rigorous new standards would be met by enhanced civil and criminal penalties. Interestingly, while Section 404 of SOX received the widest attention, in large part due to the significant cost to businesses, it merely required *certification* of internal controls that have been obligatory since 1977 and the passage of the Foreign Corrupt Practices Act (FCPA). Increasingly, management was called upon to do more than merely passively assume all is well in the “State of Denmark”, but instead to actively verify and confirm that it is truly so.

SOX provisions required greater efforts at “self-policing” (i.e. self-regulation) and extended its impact well beyond the borders of the U.S. to encompass any company boasting a U.S. securities listing. In addition, the Commission required that organizations “otherwise promote

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an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” There was clear recognition that effective programs must be embedded, not only in the law, but also in promoting ethics standards and a corporate culture that embraces them. As law prescribed the dictum “if it ain’t broke, don’t fix it” obsolete, the need for dedicated resources to inspect and repair was growing.

Fallout from SOX era

During this time we experienced a number of high profile trials, leading to the convictions of Bernie Ebbers (WorldCom), Dennis Koslowski (Tyco) and fifteen members from the executive ranks of Enron, including former CEO Jeff Skilling. Arthur Andersen & Co. lost its license to practice accounting, and 88,000 employees lost their jobs. The CEO and CFO of Rite-Aid went to jail, as did John Rigas (Adelphia) and his sons.

In addition, the outrage experienced from these scandals awakened regulators and State Attorney Generals resulting in new and sweeping investigations. The sectors deeply affected include Wall Street firms (analysts’ scandal), the mutual fund

industry (market timing and late trading), the insurance industry (price fixing), brokerage firms and pharmaceuticals. Massive fines and settlements have littered the headlines in the aftermath of this scandal-ridden era.

Sarbanes-Oxley was passed at a time when the US investing and consuming public concluded that there was a serious erosion of ethical norms, where “gaming the system” and “winning at any cost” was the norm, and only the “insiders” could win. Critics have argued that implementation of Section 404 was excessive, with some estimates as high as \$20 billion. Against that, advocates for SOX cited the annihilation of \$63 billion and \$107.5 billion in market capitalization from Enron and WorldCom alone as justification.

Of course, malfeasance in this era was not limited to U.S. corporations. Names like Royal Dutch Shell, Vivendi, ELF, France Telecom, Mannesmann, ABB, ABN-Ambro, Volkswagen, Royal Ahold, Heidelberg Cement, Parmalat and others produced stunning headlines in Europe, leading to ever greater pressure from legislators and regulators for an increasing presence of the so-called, second line

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of defense – the compliance oversight functions. In Asia, Hyundai, Livemore, Samsung, Nikko Cordial and Bank of China found their way into the news as well.

The Great Recession

Following the tech bubble of the 1990's came the real estate bubble of the early new millennium. The economic paralysis that resulted from terrorist attacks on September 11, 2001 drove the Federal Reserve Bank to reduce interest rates to 1% as a means to stimulate economic activity. At the same time, the banking community completely abandoned its underwriting standards by offering “teaser rates”, no documentation loans commonly referred to as “Liar’s Loans” and “NINJA Loans (“no income, no job, no assets”). Sold globally as “Aaa” rated securities, the markets were flooded with junk, creating an extraordinary moral hazard. When teaser rates began to expire in 2007, the deck of cards came tumbling down, exposing massive fraud and malfeasance, such as:

- In the U.S. over 150 ponzi schemes were prosecuted, including the

unthinkable Bernard Madoff (\$65 billion, without trading a security for 13 years). Another 100 ponzi schemes were prosecuted outside the U.S.

- Satyam Computer, India’s outsourcing pride and joy, revealed that its CEO, Ramalinga Raju, had created 10,000 fake employees and over 400 fake companies, to siphon almost \$1 billion from the company.
- Halliburton, BAE, Daimler and Siemens became the face of corruption.
- Galleon CEO, Raj Rajaratnum, has been sentenced to 11½ years in jail for insider trading, taking down Rajat Gupta, the highly respected former McKinsey CEO, with him.
- Goldman Sachs settled with the Securities and Exchange Commission for \$550 million on charges related to the Abacus Fund.
- Headlines concerning bribery and corruption appeared almost daily, including Avon Products, Wal-Mart, Rio Tinto, Mabey & Johnson, Johnson & Johnson, etc.

Despite, or perhaps because of, the economic and moral devastation, there are some signs of progress emerging.

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Addressing corruption, the collective efforts of UNCAC, OECD, UNGC, MESICIC, the G-20, combined with ramped up prosecutions of FCPA violations and the emergence of the UK Bribery Bill suggest resolve and the likelihood of progress in the years ahead. OECD's "Good Practice Guidance" promoting corporate ethics initiatives and cultures of integrity by its 44 nation signatories is yet another sign of likely progress down the road. In addition, the whistleblower bounty program promulgated in the Dodd-Frank Act has already yielded 3,000 referrals in the first year (from less than 50 in the previous year). Lastly, the proliferation of social networks and smart phone communication systems has made the world perfectly transparent. There's no place to hide, and no secrets anymore. All matters of business conduct are subject to a new standard – the light of day.

Looking Ahead

As we look ahead, the option to do nothing, is no longer an option and we are faced with many new challenges, including:

- The risks of social media, and the vastly expanded potential for legal discovery of texts, tweets, You Tube and social media postings.
- Cyber-threats from external and internal sources.
- Corporate espionage.
- Hacking and threats to privacy.

The "twitter revolution" that took down the Mubarak government in 17 days can similarly destroy personal and corporate reputations in a nanosecond. Indeed, reputation risk today is at least as great as strategic, operating and financial risk. We need to develop a generation of integrity sensitive leaders who can help build and fortify responsible organizations.

Twenty-one years ago, the ethics workers in the USA took the first steps to become a profession by creating the ECOA. Today these professionals are the moral agents of our organizations. Looking back, we know much progress has been made through the efforts of the ethics and compliance community.

As we look ahead, however, the true measure of success for our efforts must be seen not just in terms of operational and legal compliance or limiting the

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liability to our organizations, but also in how our initiatives contribute to the success of the enterprise and its place in society. The proper positioning of the compliance function relative to the internal control framework including first line business responsibility, operational risk, legal and audit amongst other, is a necessary reflection in the face of these new expectations and imperative success factors.

Enduring, great companies are built upon a foundation of ethics and integrity-based cultures. This is the next step in the evolution of our profession. Compliance programs destined to promulgate adherence to policy and procedure infrastructure need to be expanded in scope to incorporate promotion of the ethical organisation. Within the firm, there has to be an active dialogue between the stakeholders in the ethical organisation such as compliance, operational risk management, human resources, branding, legal, audit; and not least management to define a common strategic approach to take control of organisational culture - a force that has for too long been taken as a given. Outside the firm, progress can only be sustained through the collective

actions and practical partnerships of committed businesses working together with governments and civil society organizations.

Together, we have the capacity to reform capitalism and restore it to its moral and ethical foundations as envisaged by Adam Smith himself. ■

“How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it. Of this kind is pity or compassion, the emotion we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrows of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous or the humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it”.

– ADAM SMITH 1759

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Next Steps in the furtherance of the Ethical Organisation

- The proper positioning of the compliance function relative to other internal control functions including first line business responsibility, operational risk, legal and audit, amongst other.
- Establishing an active dialogue between all stakeholders in the ethical organisation such as the internal control functions, human resources, branding; and not least management to define a common strategic approach to an ethics programme.

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