The Code of Conduct – Laying a Cornerstone for Effective Governance

Executives often talk of change being the one constant of today's business environment. Adaptive cultures are most likely to sustain superior performance over time because they are best prepared to anticipate and adjust effectively to change. Organizations with adaptive cultures are proactive, entrepreneurial, creative and willing to take prudent risks. However, if there is one other constant for success in a rapidly changing global marketplace, it is the immutable bedrock of an unwavering commitment to ethical and responsible business behavior.

Business ethics go beyond the moral code most are taught from childhood that differentiates between what is good and what is bad. Business ethics are the principles of conduct governing an organization and the individuals within it. These principles are defined through the day-to-day behaviors of managers and employees, creating a culture in which everyone is able to observe management's actions and reactions in response to events. These observations lead, in turn, to an understanding of how individuals throughout the organization are expected to behave in similar situations.

A formal, written code of conduct transforms ethical behavior into something more tangible and real in an organization. Such a code, while a best practice among many companies, is now a requirement mandated by the Sarbanes-Oxley Act, as interpreted by rules proposed by the U.S. Securities and Exchange Commission (SEC), and by the listing requirements of major stock exchanges.

Following are important steps for boards and management to consider in designing and implementing an effective code of conduct.

Set the tone

Corporate governance is not just about rules and regulations. Fundamentally, it is about corporate culture and the way a company conducts its business in an ethical, responsible way. “Tone at the top” is an often-used term because it captures the essence of where a commitment to responsible business behavior begins. It also refers to the manner in which the executive management team behaves with respect to employees, customers, suppliers, investors, creditors, insurers, regulators, competitors, auditors and other stakeholders—behavior observed by many individuals both within and outside the organization. The process by which C-level executives make decisions and the manner in which they communicate and implement those decisions can have just as significant an impact on the organization’s behavior as the decisions themselves.

Key Questions to Ask

Key questions for board members:

• Are you satisfied that the CEO and management team emulate and practice the company’s code of conduct?
• Does the board oversee management’s communication, monitoring, reinforcement and enforcement of the company’s code of conduct? Does the board have its eye on the warning signs?
• Is there a corporate governance code for the board setting forth its mission, roles and responsibilities, charter, committees, rights of shareholders, and other relevant matters?
• Has the board considered its policies and procedures for evaluating requests for management by waivers of the code of conduct?
• Does the company operate in environments that might increase the exposure to ethical violations and issues, e.g., foreign operations or an industry that is struggling?

Key questions for management:

• Are you satisfied with the tone at the top? Are the right messages being sent? Do employees see clear evidence that management “walks the talk” with respect to the company’s code of conduct? How do you know?
• Does the company have a written code of conduct? Has it been updated recently? If there is no written code, does management intend to write up a code to address applicable Sarbanes-Oxley and exchange listing requirements?
• If the code has not been updated recently, has management considered the requirements of the proposed rules relating to Section 406 of Sarbanes-Oxley that were recently released by the SEC?
• Is there an effective compliance infrastructure in place to enforce and receive the code of conduct as well as ensure satisfactory follow-up on code violations?

The board's role: Watch the warning signs

Over the long term, the credibility of the organization and the integrity of its people ultimately define its success or failure. The board has three responsibilities with respect to the code. First, determine that the code is consistent with values that most stakeholders will hold in the highest esteem. Second, comply with the code. Third, provide the appropriate oversight to ensure management is operating the business in a manner consistent with the code.

With respect to oversight, directors should keep an eye on key vital signs (see sidebar on cover). If a combination of one of these or other “red flags” are noted, the board should investigate them to determine whether there are integrity issues requiring attention at the highest levels of the organization.

Ultimately, the best test of the effectiveness of a code of conduct is whether it is practiced. When management’s preferences, value judgments and operating styles are consistent with the highest standards of ethical behavior, the organization is better positioned to sustain a quality reputation that attracts and retains the customers, talent and capital required to grow the business and create enterprise value. In every industry, strong corporate ethics breed positive business results.

Ethics Warning Signs Directors Should Look For

1. The extent to which the code of conduct is emphasized and reinforced by management in operating the company
2. The manner in which management engages the board
3. The existence of circumstances within the organization or aspects of its culture that could lead to unethical behavior
4. The existence of direct or anecdotal evidence that the CEO and senior management lack credibility with employees
5. The existence of direct or anecdotal evidence that certain business activities might be on the verge of running out of control
6. The identification of problem areas or process failures that may be a symptom of a potential ethics issue
7. Requests to waive conflicts of interests or other significant ethics requirements
8. The effectiveness of management’s follow-up on instances of code violations and noncompliance issues reported by “whistleblowers” and third parties

NOTE: For an expanded discussion of these warning signs, visit www.protiviti.com and go to the section highlighting Issue 5 of The Bulletin.
Define a good code of conduct

For years, corporations in industries such as health care, government contracting, regulated utilities and financial services have implemented programs of corporate compli-
cance. These programs are generally based upon a published code of conduct and follow the infrastructure outlined under Federal Sentencing Guidelines for Organizations. Most organizations have found there is no single “off the shelf” approach to implement a business ethics program. To be effective, the program’s underlying elements should reflect the unique aspects of the organization’s culture and man-
gagement’s operating style. Organizations implementing these programs to comply with recent regulatory require-
ments should consider the tone, style and level of authority necessary to make them part of any employee’s daily decision making.

Typically, a code of conduct includes the following:

• A statement by the CEO that the organization is committed to conducting its business with integrity in accordance with the highest ethical standards and in compliance with all applicable laws, rules and regulations. Additional wording may emphasize the proper handling of conflicts of interest between personal and professional relationships. This may include the principles that define the organization’s values when doing business – for example, an engineering services firm may state it will only accept those contracts for which it has the requisite experience and competence to service. A statement may also include a statement specifying certain activities, such as deceptive advertising, illegal pricing practices, discrimination, etc.

• Practical examples of situations that an individual might encounter and that provide guidance to help clarify how the code should be applied in such situations.

• A discussion of the role the organization’s policies, structure, risk management and internal controls play in ensuring the above objectives are met, including the role of personal accountability. For multinational organiza-
tions, this discussion may address relevant international considerations.

• Recognition of the company’s responsibilities to share-
holders, customers and other stakeholders, e.g., management and the board have a responsibility to recognize the importance of sustainability to its stake-
holders before taking on huge risks that could take the company down if they make the wrong bet.

• Prohibitions on and/or required disclosures related to con-
flicts of interest, e.g., borrowing from the organization accepting gifts from customers or vendors, related party transac-
tions, political contributions, etc. Material transac-
tions or relationships that could reasonably be expected to create a conflict should be reported to a designated person (or persons) for approval.

• Prohibitions of and restrictions on the use of confidential and proprietary information as well as respect for the intel-
lectual property rights of others.

• Various corporate guidelines, including expense policies, asset usage policies, vacation policies (where the absence from a job is viewed as a control mechanism), insider trad-
ning, filing of personal tax returns, etc.

• Accountability for adherence to the code, with require-
ments for prompt internal reporting of violations to a designated person (or persons). The code should specify the consequences for breach of policy and unethical conduct and include provisions for reporting a summary of code violations to the board.

A written code of conduct ordinarily applies to everyone. Some organizations even extend the applicability of their code to outsiders as a condition for doing business. There may also be more detailed codes required for executives in certain positions, such as job qualifications and specific responsibilities. For example, the following points would almost always apply to senior executives involved with public reports:

• Responsibility, transparency, and internal and external auditors, including prohibiting actions to limit the scope of the auditors’ work or restrict their access.

• Responsibility for the design and implementation of policies and processes to promote, as articulated by the SEC, “full, fair, accurate, timely and understandable disclosure” in public reports, including effective disclosure controls and procedures.

• Responsibility to report to management and the audit committee any disagreements between the senior financial officer and the auditors with respect to accounting princi-

ples or estimates, whether or not subsequently resolved.

• Employment prohibitions, e.g., the senior financial officer should be barred from resigning to join the external auditor until after an appropriate “cooling off” period. Similarly, the company should not recruit a senior financial officer directly from the external auditor.

• Receipt, retention and treatment of accounting-related issues reported by “whistleblowers” consistent with procedures approved by the audit committee.

• In writing their codes of conduct, companies should differ-
entially treat any wrongdoing by a high-level officer (e.g., an executive or the CEO) vs. any wrongdoing by a lower-level officer (e.g., a mid-level manager).

Communicate and disclose the code

Disclosure of the code of conduct has not been a consistent practice by all companies. Following are suggestions based on today’s leading best practices:

• Write the code in a way that all employees can read and understand. This includes publishing it in several lan-
guages, if necessary, and considering the education and experience level of line employees.

• Circulate the code internally to all employees on a regular basis (annually at a minimum), and require everyone to acknowledge that he or she has read the code, understands his or her responsibility to comply with it, and has reported through appropriate channels any violations he or she has observed.

• Circulate the code externally to institutional investors and other constituents.

• Publish the code on the company’s website – many companies elect to place the code within their investor relations pages.

• Publish the code in the company’s annual report (or refer readers to the company website where the code is posted).

• Post the code in break rooms, in employee manuals, etc.

• Conduct regular employee training on the code (e.g., annual reinforcement, new employee orientation, etc.).

• Conduct periodic “audits” of the workforce’s understand-
ing of key elements of the code, including scenario-based “ethical dilemma” tests. Use the results of these audits to evaluate the effectiveness of internal communications and training.

• Require periodic compliance self-assessments of selected employees using appropriate code provisions.

Broaden the focus of the code

A code of conduct may be expanded into a broader code of corporate governance. Alternatively, the code of conduct and the code of corporate governance may be two separate documents. The broader code would include the topics reviewed above but would also address areas such as the board of directors, the roles and responsibilities of the board and its committees, the rights of shareholders, the compa-
ny’s philosophy regarding executive compensation, and the roles and responsibilities of senior executives, including the role of and interaction with auditors. (For more information on these topics, please see our addendum to this issue of The Bulletin – “Broaden the Focus of the Code” – located at www.protiviti.com.)

Reinforce the code

A written code of conduct articulates both expected and unacceptable standards of behavior. However, a code without discipline lacks substance. Ethical behavior results from articulating standards, training employees on the importance of these expectations, through communications and employee training, ensuring employees comprehend the standards through written acknowledge-
ments, and reinforcing the standards in practice every day.
Define a good code of conduct

For years, corporations in industries such as health care, government contracting, regulated utilities and financial services have implemented programs of corporate compli-
ance. These programs are generally based upon a published code of conduct and follow the infrastructure outlined under Federal Sentencing Guidelines for Organizations. Most organizations have found there is no single "off the shelf" approach to implement a business ethics program. To be effective, the program's underlying elements should reflect the unique aspects of the organization's culture and man-
agement's operating style. Organizations implementing these programs to comply with recent regulatory require-
ments should consider the tone, style and level of authority necessary to make them part of any employee's daily decision making.

Typically, a code of conduct includes the following:

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• Practical examples of situations that an individual might encounter and that provide guidance to help clarify how the code should be applied in such situations.

• A discussion of the role the organization's policies, structure, risk management and internal controls play in ensuring the above objectives are met, including the role of personal accountability. For multinational organiza-
tions, this discussion may address relevant international considerations.

• Recognition of the company's responsibilities to share-
holders, employees, customers and other stakeholders, e.g., management and the board have a responsibility to recognize the importance of sustainability to its stake-
holders before taking on huge risks that could take the company down if they make the wrong bet.

• Prohibitions on and/or required disclosures related to conflicts of interest, e.g., borrowing from the organization accepting gifts from customers or vendors, related party transactions, political contributions, etc. Material transac-
tions or relationships that could reasonably be expected to create a conflict should be reported to a designated person (or persons) for approval.

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• Responsiveness and accessibility to internal and external auditors, including prohibiting actions to limit the scope of the auditors' work or restrict their access.

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plies or estimates, whether or not subsequently resolved.

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• Receipt, retention and treatment of accounting-related issues reported by "whistleblowers" consistent with procedures approved by the audit committee.

In writing their codes of conduct, companies should differ-
entiate areas warranting one-up approvals (e.g., vacation policy) from areas requiring a waiver approved by the board (e.g., conflicts of interest).

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• Write the code in a way that all employees can read and understand. This includes publishing it in several lan-
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ny's philosophy regarding executive compensation, and the roles and responsibilities of senior executives, including the role of and interaction with auditors. (For more information on these topics, please see our addendum to this issue of The Bulletin – "Broaden the Focus of the Code" – located at www.protiviti.com.)

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Key Questions to Ask

Key questions for board members:
• Are you satisfied that the CEO and management team emulate and practice the company’s code of conduct?
• Does the board oversee management’s communication, monitoring, reinforcement and enforcement of the company’s code of conduct? Does the board have its eye on the warning signs?
• Is there a corporate governance code for the board setting forth its mission, roles and responsibilities, charter, committees, rights of shareholders, and other relevant matters?
• Has the board considered its policies and procedures for evaluating requests for management for waivers of the code of conduct?
• Does the company operate in environments that might increase the exposure to ethical violations and issues, e.g., foreign operations or an industry that is struggling?

Key questions for management:
• Are you satisfied with the tone at the top? Are the right messages being sent? Do employees see clear evidence that management “walks the talk” with respect to the company’s code of conduct? How do you know?
• Does the company have a written code of conduct? Has it been updated recently? If there is no written code, does management intend to write up a code to address applicable Sarbanes-Oxley and exchange listing requirements?
• If the code has not been updated recently, has management considered the requirements of the proposed rules relating to Section 406 of Sarbanes-Oxley that were recently released by the SEC?
• Is there an effective compliance infrastructure in place to reinforce and enforce the code of conduct as well as ensure satisfactory follow-up on code violations?

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SUPPLEMENT TO ISSUE 5 OF THE BULLETIN

Broaden the Focus Of the Code

A company’s code of conduct for its executive management and employees may be expanded into a broader code of corporate governance. Alternatively, the code of conduct and the code of corporate governance may be two separate documents. The broader code would include topics detailed in Issue 5 of The Bulletin but would also address areas such as the board mission, the roles and responsibilities of the board and its committees, the rights of shareholders, the company’s philosophy regarding executive compensation, and the roles and responsibilities of senior executives (including the role of and interaction with auditors).

With respect to a code of corporate governance, examples of relevant topics include the following:

• Director qualifications and responsibilities and the process for selecting, inviting, orienting and continuously educating new directors.

• Board size, election term, term limits, mandatory retirement, and the mix of inside and outside directors, including the definition of independence.

• Separation of chairman and CEO or lead director, if the company has adopted either of these governance structures.

• Scope of board oversight. For example:
  o Responsibility for evaluating, approving and monitoring the strategic plan to create and preserve shareholder value, and for considering the interests of other stakeholders (e.g., creditors, employees, etc.) in the company’s plans.
  o Responsibility for providing oversight on identifying and managing major risks, including understanding management’s definition of risk appetite or tolerance.
  o Responsibility for providing oversight on significant proposed investments, divestitures, financings and other major corporate transactions.
Responsibility for evaluating operational performance and for ensuring a culture of effective internal financial controls, clear and candid communications, ethical behavior, and transparent and “plain English” public reporting.

Formal evaluation of the CEO, succession planning, management development and executive compensation.

- Number, structure and composition of committees, including their processes, the related management support roles, assignment and rotation of committee members and committee meeting frequency, length and agenda.
- Shareholder rights, including voting practices (cumulative and confidential voting, one share/one vote, etc.), voting powers, meetings, proxy proposals and anti-takeover devices.
- Other matters, such as board compensation reviews, executive sessions of outside directors, access to and use of internal and outside advisors, evaluating board and director performance, attendance of non-directors at board meetings, board access to senior management, handling of disclosures regarding corporate governance, directors’ liability, board meetings and agenda, board materials and presentations, and board interaction with institutional investors, customers, employees, the press and others.

While far from exhaustive, the above examples illustrate the broader scope of a code of corporate governance.
SUPPLEMENT TO ISSUE 5 OF THE BULLETIN

Ethics Warning Signs Directors Should Look For

The topic covered by Issue 5 of The Bulletin is “The Code of Conduct – Laying a Cornerstone for Effective Governance.” This issue discusses the importance of setting the tone at the top, defining a code of conduct, communicating and disclosing the code, broadening the focus of the code and reinforcing the code. The article concludes with a reference to vital signs that directors should keep an eye on. The cover of Issue 5 includes a sidebar listing these signs. Following is an expanded explanation of these vital signs.

1. The extent to which the code of conduct is emphasized and reinforced by management in operating the company - There is little value to a code that is published but not regularly reinforced by management.

2. The manner in which management engages the board - Management’s relationship with the board could be a sign of how it engages its people. For example:
   - Management only brings good news and highly structured presentations to its meetings with the board. The board rarely hears bad news until it is too late.
   - Management only presents plans to the board for approval and rarely seeks input or advice as plans are being developed. Insufficient time is devoted to forward-looking issues.
   - The CEO controls the board’s agenda, board meetings are highly regimented and orchestrated, and directors have little opportunity to discuss issues and concerns.

If these signs exist, are they an indicator of how management works with subordinates, e.g., the CEO doesn’t really listen to his or her people? If so, does that behavior permeate the organization?

3. The existence of circumstances within the organization or aspects of its culture that could lead to unethical or dysfunctional behavior - Most business environments are demanding. Unless effectively managed and checked, past successes and growth
along with sustained pressures to perform can breed a “warrior culture” and a cavalier attitude that spawns reckless initiatives, unhealthy internal competition, institutional resistance to bad news, a general lack of change readiness, unrealistic stretch sales and profit goals, variable compensation plans linked to those goals, and lack of particular attention to protecting the company’s brand image. If downsizing initiatives lead to middle managers having to do more with less -- with no refinements to internal processes -- and that result is ignored by management, important internal controls can be stripped away and employees can be tempted to “cut corners” and act in an unethical manner. If management is driven by unsustainable market expectations, the emphasis on managing earnings for short-term results can lead to the generation of sales or earnings at any cost.

4. The existence of direct or anecdotal evidence that the CEO and senior management lack credibility with employees - Such evidence might surface in employee surveys conducted by an independent consultant. It also can surface in other ways. Management may consistently make excuses for poor results and are unwilling to acknowledge their own errors in either strategy or execution. If the board notes that the CEO and executive management are unable to discern or are unwilling to admit when a strategy is not working or when execution of the strategy is obviously failing, it can safely bet that employees have noted it as well. A lack of management credibility within the organization can lead to immediate and lasting undesirable effects, including the loss of talent.

5. The existence of direct or anecdotal evidence that certain business activities might be on the verge of running out of control - For example, is there evidence of a pattern of high-pressure sales practices, bullying negotiation tactics, disregard of regulatory authority and other similar activities? If these conditions persist unabated, could they lead to problems, even illegal acts or brand erosion, down the road?

6. The identification of problem areas or process failures that may be a symptom of a potential ethics issue - When a significant problem or process failure occurs, is it a symptom of an ethical breakdown? If not, does it indicate a lack of clarity that, if addressed, might have helped to mitigate the problem or even have avoided it altogether?
7. **Requests to waive conflicts of interests or other significant ethics requirements** - The board should pay close attention to requests from management to waive significant provisions of the code, including the immediate and long-term effects if a waiver is granted.

8. **The effectiveness of management’s follow-up on instances of code violations and noncompliance issues reported by “whistleblowers” and third parties** - The board should be informed of matters related to financial reporting raised by “whistleblowers” as well as the identification of lack of adherence to policies and procedures by regulators and auditors. The investigation of such matters, the conclusions reached and the remedies taken should be disclosed to the board.

Success achieved at any cost does not lead to sustainability. If a combination of these and other “red flags” are noted, the board should investigate them to determine whether there are integrity issues that require particular attention at the highest levels of the organization. Where there is smoke, there may be fire.