Dr. Stuart C. Gilman's Testimony to the Advisory Group on Federal Sentencing Guidelines for Organizations November 14, 2002

Introductory Remarks

Distinguished members of the Advisory Group panel, ladies and gentlemen in the audience:

It is a great honor for me to be here today, and I thank you for the invitation to address some of the important issues before you as you seek to revise the Federal Sentencing Guidelines for Organizations. As mentioned in my introduction, my name is Stuart Gilman, and I am the president of the Ethics Resource Center, a non-profit organization located here in Washington DC.

It is quite true that where a person stands on any given issue depends on where he or she sits. For that reason, I believe it is important to frame my remarks with some information about the Ethics Resource Center and the perspective we bring.

The ERC is one of the oldest nonprofits in the Untied States addressing the issue of ethics. Founded in 1922 as American Viewpoint, what is now the Ethics Resource Center was an educational corporation dedicated to helping immigrants become productive members of American society by teaching them about the values of our country. In the 1970s, with the upswing of concern for the ethical practices of business organizations, the Center's focus shifted to organizational ethics in business, government and non-profit entities.

In the Center’s changed role, we drafted, published and distributed the first U.S. Code of Ethics for Government Service in 1980. In 1985, we provided consulting services to General Dynamics that resulted in the formation of the first comprehensive organizational ethics office in the United States. The same year we advised the President’s Blue Ribbon Commission on Defense Management that led to the formation of the Defense Industry Initiative and served that body as its first independent reporting agency. Much of what the ERC helped create in concert with General Dynamics and in the DII was instrumental in formulating the model of “an effective program to prevent and detect violations” as later defined in US Federal Sentencing Guidelines for Organizations (FSGO).

Since then, the ERC has engaged in extensive applied research through its advisory services to organizations, and analytical research through such efforts as our National Business Ethics Surveys and projects undertaken by our Fellows Program. We have examined many of the issues under consideration by your group, including the role of leadership in the implementation of ethics programs, the sources of pressure to commit misconduct faced by employees, and the impact of an ethics program on the creation of an organizational culture.

Today the ERC has been asked to comment on three issues concerning proposed changes to Chapter Eight of the U.S. Federal Sentencing Guidelines for Organization. Specifically we have been asked to address the:

- Role of the leader in establishing and maintaining an ethical culture within an organization - including the positioning of the ethics office and ethics officer;

- Role of the Board of Directors in providing oversight and establishment of an ethical culture; and
- Creation of an ethical culture within an organization, and the extent to which the culture of an organization can be regulated by the Federal Sentencing Guidelines for Organizations.

I'd like to use the remainder of my time before you to address each of these important areas, in turn. The first is the role of the leader within an organization.

The Role of the Leader Within an Organization

Much of the recent conversation regarding organizational leadership has centered on business scandals and the most appropriate way to avoid similar circumstances in the future. As you already know, this response is most evident in the Sarbanes-Oxley Act of 2002. This legislation requires executive leadership to attest to the integrity of their organizations' financial reporting and overall operations. Such an outcome presumes an effective system of monitoring and oversight of the business conduct of the organization (as prescribed in Chapter Eight of the Federal Sentencing Guidelines for Organizations' reference to effective programs to prevent and detect violations). Attesting to fiscal integrity is only possible if monitoring and oversight are integrated into the systems and practices at all levels of the organization - this includes formal systems, the informal operating norms and the culture as understood by all employees.

To do that requires leadership. An executive can comply with Sarbanes-Oxley and attest to the integrity of his or her organization only to the extent that he or she has set a tone for organizational integrity at the top.

One of the most important ways this can be accomplished by a leader is by serving as a role model. A leader's behavior has the ability to shape employees' perceptions of what constitutes acceptable ethical behavior, as well as employees' views of the leader him or herself. In other words, leadership translates from the "top-down," the conduct of the superiors influencing the actions of the subordinates.

If ethical behavior is to be integrated throughout an entire organization, no matter the size, those who are seen as leaders must proactively encourage ethical behavior and facilitate (legitimize) ethical dialogue. When they do, their actions help shape and maintain an ethical culture.

Recent research from the ERC Fellows Program[1] supports the notion that being perceived as an ethical role model requires more than simply being an ethical person. Leaders must make visible the ethical challenges they face and the ethical standards they apply to any given situation. To illustrate, consider downsizing. Most CEOs freely describe the ethical challenges of downsizing in private conversations. Off the record, most executives will openly discuss the struggles, the dilemmas and the ethical reasoning that led to their decisions. But, these same leaders, when making public statements about downsizing, never mention ethics. Their decisions are often supported with statements about operating efficiencies, streamlining, increased productivity and cost controls - messages designed to impress stock analysts. Employees and other stakeholders naturally assume that these CEOs never considered the ethics of their choices. That is how ethical leaders can fail in the role of being an ethical role model - simply by failing to make the ethical issues explicit.[2]

This brings us to the question of who, in an organization, is a leader. While it is clear that high-level personnel such as the CEO, CFO, members of the Audit Committee of the Board, and other highly visible personnel are key leaders within an organization, it may be less intuitively apparent how much the behavior of employees down the "chain of command" affects the ethical culture because they too are leaders themselves. The key is not the "title" of the executive, but the role of the individual. Leaders must be understood in terms of impact on other individuals-senior leadership must be understood in terms of their impact on supervisors, who in turn impact on employees. According to an Office of Government Ethics survey conducted in 2000, "…supervisory attention to ethics has strong relationships with program outcomes. Simply put, when employees believe that their direct supervisors are genuinely concerned with maintaining an ethical environment and supporting ethical performance, their positive perceptions of the organizational culture and other employees' behavior also increases. Second, an unanticipated finding of the study is that supervisors…tend to have a more positive perception of cultural factors and outcomes than do non-supervisors."[3] Thus, leadership changes culture, but individual employee behavior is most directly impacted by the employee's immediate supervisor.

ERC Fellows Program research[4] provides supporting evidence that one's immediate supervisor(s) and peers exercise the most influence over one's perceptions of the standards for ethical business conduct in organizations. While lower level employees might not be recognized as "formal" leaders in the organizational hierarchy, it is clear that people at all levels of organizations can serve as "opinion leaders."

Despite the widespread nature of leadership in an organization, it is indeed true that in nearly every case the leader with the most impact over the entire culture of the organization is the CEO. We cannot safely conclude that any one individual can effectively discern the needs of the entire organization when it comes to setting ethical standards, and for that reason we are especially concerned about the observed reality that ethics office staffs and ethics officers themselves seem to be "migrating" further down into the organizational hierarchy. In short, ethics officers in many companies are becoming increasingly removed from the CEO and the ethics committee of the Board. Ethics officers provide a critical linkage between senior executives' cultural values and supervisors' direction of behavior. Good ethics officers serve as a transmission link between supervisors and managers. If they are buried in the organization, ethics officers will become ineffective as advisors to and communicators for senior executives. And because of this, ethics officers are playing less of a role in communicating the values of the organizational culture to supervisors, who in fact have the greatest impact on the behavior of employees.

One reason for this migration downward of the ethics officer is the failure of the current language of Chapter Eight to specify to whom the ethics officer should report. Although the guidelines state that there should be high-level personnel responsible for an effective program, the ERC believes this language is too vague. It is our position that the ethics officer must have direct and unfettered access to the highest authorities within an organization, including the CEO, COO, CFO and appropriate members and/or committees of the Board.

One way to characterize this level of access is to see the ethics officer as a direct report of both the CEO and the Board. In contrast, when ethics officers are several levels away from the CEO/CFO/Audit Committee, it becomes very difficult for them to impact an ethical culture or contribute substantively to the ethical integrity of an organization.

The Role of the Board

Related to the idea of leadership and the integrity of an organization is the role and direction of the Board of Directors. The current business landscape makes it vital that Boards take an active role in shaping the ethical culture of the organizations they oversee. The Board of Directors sets the tone for the company as a whole. Since the Board is ultimately accountable for the consequences of an organization's actions, it has the responsibility of holding the CEO and other high-level employees liable for their decisions and actions. To exercise this responsibility effectively, the Board must be actively involved in ensuring that key aspects of ethics and compliance are addressed. The Board must oversee the design of the ethics program itself and accept accountability for its eventual success.

At a minimum, the Board needs to understand its responsibilities in determining the scope of the ethics program in several areas. In particular, the Board should have a role in determining:

1. The form and content of the information required of the ethics officer. Examples include: help line activity numbers, patterns in issues raised, disciplinary actions taken, actions to protect those reporting observed misconduct, training activity, internal assessments of employee perceptions of ethics program effectiveness, general employee attitudes, and evidence of adherence to or violations of the organization's compliance and ethics standards.

2. The focus of the ethics and compliance efforts, whether strictly compliance-based, more broadly values-based or reaching beyond the corporate boundaries to address broader social issues.
3. The role and organizational positioning of the Ethics Officer. We believe it is essential for Boards to recognize the urgency of expanding compliance programs (and simultaneously ethics officer roles) beyond satisfying legal and regulatory minimums.

It is our opinion that the FSGO should encourage Boards to go past simple benchmarking of current industry standards and compliance with current law and regulation. As the ultimate custodians of corporate ethics, Boards are responsible for meeting their fiduciary obligations to employees, shareholders, and ultimately society as a whole. In this way the FSGO will be empowering the judiciary to address society's demands that organizations meet the ethical standards of honesty, integrity, fairness and transparency-so evidently absent based on our recent experience.

Since a Board of Directors has ultimate authority over the scope of ethics programs within an organization, it naturally has jurisdiction over the search and selection criteria for CEOs. In order to ensure that the ethical goals of their organization are met, the Board is obliged to establish objectives for the ethical conduct of CEOs. Ideally, the Board would articulate selection criteria that reflect those characteristics that allow the organization to fulfill its ethical obligations.

Furthermore, the Board must design a performance review and compensation system for the CEO and other high-level personnel to ensure that the ethical culture of the organization is maintained. One example of such a system can be found in Royal

Dutch Shell. In this company, 168 country chairpersons are required to submit a detailed annual accounting of such issues as: the ethical challenges they have addressed; steps they have taken to prepare staff to address those challenges; the impact of ethics and compliance on joint-ventures, local economies and local politics; how they have measured their ethics and compliance success/progress; specific measurable goals they would set for the coming year and more. These accounts must be submitted in a standardized format provided by Shell's International Directorate - an arm of the Committee of Managing Directors. All these letters are then gathered, summarized and analyzed for the Committee of Managing Directors.

To further lend legitimacy to the process, each country chair has a face-to-face meeting with his/her Managing Director to discuss the letter and amend the future plans. This meeting has direct feedback into the compensation decisions for that year. As the Shell example suggests, in essence, the Board's role in the framing of the ethical culture in a company gives it tremendous authority over the course of development for all of its employees.

A major challenge that every Board of Directors must face is the potential for conflicts of interest among high-level personnel and the Board. Conflicts may appear in decisions such as the selection of future Board members, executive selections, evaluations, compensation, and when to recuse oneself from the decision-making process. Some measures, however, may be taken to minimize the opportunity for such conflicts.

To reduce the potential for conflicts, the ERC believes that the involvement of a truly independent third party is necessary. At minimum, each Board should regularly subject itself to an independent review of its major actions and decisions. That review should concentrate on the Board's oversight of the executive management team and its own freedom from conflicts of interest. Without such a platform of integrity coming from the highest level, the future of the organization will always be uncertain.

Ethical Culture

All of these actions ultimately result in the creation of a culture for an organization. In the final portion of my time this morning, I'd like to address the need for an ethical culture within an organization, and more importantly, the extent to which culture can be regulated by the Federal Sentencing Guidelines for Organizations.

The ERC believes that Chapter Eight of the Sentencing Guidelines should encourage organizations to foster ethical cultures, to ensure focus on the intent of legal and regulatory requirements as opposed to mere technical compliance that can potentially circumvent the intent or spirit of the law or regulation. We agree that the FSGO should require organizations to make systemic and sustained efforts to create a culture that fosters ethical business practices and ethical employee behavior. Those behaviors are, in part, based on perceived organizational expectations and observation of those actions that are modeled, punished and/or rewarded. Frequently, what we see modeled, rewarded and punished influences our beliefs of what is truly valued by the organization. These beliefs set a standard of ethical business conduct and such conduct becomes the presumptive choice of most employees.

The organization's efforts to create an ethical business culture should be observable, measurable and open to audit. There should be a demonstrated alignment of the organization's mission, goals, values, code of conduct, policies, compliance activities and performance management with integrity and transparency of those systems and processes as a foundational element.

A thorough independent, third party assessment of senior management's (including the Board of Directors') actions regarding exceptions to policy, preferential treatment of employees, selection/promotion practices and disciplinary employee actions should be a regular element of the organization's governance systems and will reveal the degrees of consistency with legal requirements, stated organizational values and ethical business practice.

A natural question arises from this observation involving how guidelines can effectively mandate ethical cultures. A first step is to regularly assess the effectiveness of the organization's leadership - at all levels - in applying the stated organizational values in strategic and tactical decisions and actions. Organizations should be able to identify the steps they have taken to assure that employee behavior is consistent with the values and codes of that organization. Outcomes can be evaluated including those evidenced in hiring practices, previous audits, violations of policy, recruiting and marketing practices, and rewards and disciplinary actions. Initial assessments evaluate the current ethical performance and provide baseline data for defining future objectives and assessing future progress.

For many organizations, an essential element of an effective ethics and compliance program is the creation of systems to encourage employees to report observed misconduct and to appropriately raise and voice their ethics concerns. It is well documented that employees are often unwilling to take such actions. Research on whistle blowing suggests that the top two reasons employees fail to raise ethics concerns and/or report misconduct are: (1) a belief that nothing will be done and (2) fear of retaliation. These reasons have as much to do with organizational culture as with formal mechanisms such as anonymous reporting lines. A greater emphasis on ethical culture may help to encourage reporting by ensuring that such reports are valued, acted upon and result in appropriate responses. That includes positive consequences for the employee making the report.

Another way to understand the concept of an ethical work culture is to consider what we know about social interaction. Humans derive at least some norms of conduct from our peers, leaders, and environment. As strong as the moral compasses of individual employees may be, ethical dilemmas and uncertainties in the workplace will at some point lead them to seek confirmation of their views with others in the work environment. As a result, it is not uncommon for employees to align their actions to address the beliefs and expectations of the organization and/or their peers. If organizations impact on employees' moral development, they have an obligation to help employees refine their ability to recognize the ethical components of the situation with which they are dealing. They must show their employees how to apply ethical reasoning to the challenges that they face on a day-to-day process.

A commitment to intentional, positive moral development is more than just good public relations. When organizations effectively communicate why they want their employees "to do the right thing" it becomes easier for employees to conceptualize and put those values and expectations into action.

Additionally, when employee evaluations include doing more than merely checking a box on ethics and compliance (e.g. checking if there were no reportable violations) there is increased positive reinforcement that is essential in developing an ethical culture. The ERC believes that moral development does not stop as the child leaves the household, or the student leaves college, but rather continues for life. This makes it imperative that organizations take a direct hand in the moral development of their employees so that the positive, ethical values of that organization will be reflected in the actions and decisions of their employees.

Summary

In summary, my comments today reflect our commitment to a core principle - that legal compliance is a minimum standard. The FSGO should encourage organizations to reach higher, evolving towards the highest standards, not seeking the minimum which society will tolerate. We are experiencing a crisis of trust and confidence today. In part we attribute that crisis to the belief that many hold regarding the value of the ethical minimum - skating on the fine line of legal defensibility and turning one's back on the higher ethical principles. Public confidence in our institutions is too dear a price to pay for ethical minimalism. The bar must be raised and the suggestions and recommendations we have presented here today seek to urge you to do just that.

Thank you for the honor of allowing me to testify here today. I'll be happy to take any questions you have.