Is compliance quite enough?

Ethics – more than just doing the right thing

Many Australian institutions, particularly in the finance industry, have acknowledged the advantages of establishing a formal, proactive compliance regime. Some, however, are still unsure how to go about the task. GREG GOODMAN and STEPHEN COHEN consider the ethical and cultural aspects of compliance which an organisation should consider.

The impetus for the finance industry to become more compliance-oriented has resulted from a number of factors, including regulatory reform, self-regulation, industry standards and the "shock factor".

REGULATORY REFORM
There is growing evidence that regulatory reform is leaning towards a less prescriptive, and more "outcome-based" regulatory environment. As an example, the new managed investments legislation obliges entities electing to take on the role of "responsible entity" to have either an independent board or to establish an independent compliance committee.

The board or committee will administer formal compliance plans, which are to be audited by qualified auditors and overseen by the Australian Securities and Investment Commission (ASIC). The ASIC has indicated it will not require detailed content of such compliance plans, leaving it to the responsible entity to tailor the content to reflect the circumstances of the particular entity.

SELF-REGULATION
Industry representative bodies such as the Australian Financial Markets Association (AFMA), the Investment and Financial Services Association (IFSA), the Sydney Futures Exchange (SFE) and the Financial Planners Association (FPA) have promoted varying degrees of self-regulation. In the case of AFMA, this has included the setting of voluntary competency and accreditation standards for dealers employed by member corporations.

INDUSTRY STANDARDS
Standards Australia has issued a new compliance standard, AS 3806, against which organisations and self-regulatory agencies can benchmark their compliance systems.

THE SHOCK FACTOR
There is a grudging acceptance by senior management in Australia that failing to establish adequate compliance can have costly, and occasionally fatal, results. This awareness has been brought home acutely by the widely publicised disasters involving established and reputable organisations overseas such as Baring Brothers, Yamaichi Securities and Morgan Grenfell Funds Management.

Not only did the shareholders of these organisations suffer, but most senior managers and board members felt the repercussions, which included fines, bans, deregistration, civil actions, loss
of employment, tarnished reputations, loss of earnings and, occasionally, prison terms. Even if the organisation survived, the damage to morale and reputation was normally so severe that the company became a prime takeover target, staff and customers defected and the regulatory sword was constantly overhead. These serious consequences are the more lamentable given that adequate compliance procedures and a strong, ethical culture probably could have prevented such dire outcomes.

A QUESTION OF ETHICS
While the current interest in compliance is commendable, little attention has been given to the ethical, cultural and behavioural issues which underpin an effective compliance regime. The debate, and indeed every compliance process, should start with consideration of the "ethical and cultural" issues. Compliance is ultimately concerned with ensuring that an organisation, through its employees and management, carries on business not only in a legal manner, but in an ethical manner. It is an organisation's people and their behaviour, not just processes, which are at the heart of compliance.

How can ethics help? While most financial institutions have attempted to articulate their ethical aspirations by producing codes of ethics, unfortunately most languish in the bottom drawer, seldom referred to for guidance in day-to-day business dealings. Even more unfortunately, the importance of these codes is rarely explained to employees. In reality this is window-dressing, a sham. Unless statements of corporate ethics are reflected by a corporate culture which promotes and rewards ethical behaviour and penalises unethical behaviour, the process will probably fail.

An effective formal compliance regime – in the sense of implementation and maintenance of appropriate processes – is more the end-product of, rather than the starting point for, successful and sufficient compliance performance.

"Accountability" is an important notion in the concept of compliance. People and organisations are accountable for their behaviour and for the behaviour of their members. Organisations, and people within them, have something to answer for if things go wrong. An even more important notion than this, however, is "responsibility". It is important that people and the organisation as a whole "take responsibility" for their behaviour, and it is important that people and the organisation as a whole "be responsible" in their various activities.

Neither of these two senses of "responsibility" is satisfied by the simple act of signing off, an act of being accountable. They are more pro-active than this in producing a environment where accountability procedures can produce worthwhile results.

Instituting a regime of accountability without an ethos of responsibility (in both senses) is equivalent to establishing traffic police without accompanying mechanisms to improve people's driving skills, driving habits, and attitudes toward driving. Establishment of structures for enforcement, or policing, is important but those structures alone cannot succeed in the creation and maintenance of an effective compliance regime. The cultivation of an atmosphere of responsibility should be a priority for those charged with the compliance aspects of their organisation.

A word about codes. It can be important to distinguish "codes of ethics" from "codes of conduct". A code of conduct offers fairly specific prescriptions about fairly precisely identifiable situations. Deuteronomy – probably the best known code of conduct – is not primarily concerned with principles of conduct, even those which lie behind the specified duties; rather, it prescribes explicit direction to clearly defined situations.

Not everything that is important about ethical conduct can be covered by a code of conduct. In fact, one problem of a code of conduct standing alone is that it can give the false impression that anything that it does not prohibit is, in fact, permissible. Another problem is that it can give the false impression that if you follow its prescriptions, then that is all there is to being ethical: nothing else is required, and nothing else could be asked, in the name of behaving ethically. On both these counts, a code of conduct by itself is inadequate.

A code of ethics is a different kind of document. Some codes of ethics are characterised as being "aspirational". They are expressions of what we are trying to be and what we aim to live up to. This cannot be specified as particular duties; it is more a matter of modes of conduct or character. Consider, for example, an ethical requirement to maintain confidentiality. As a serious ethical requirement, this is not merely a matter of not revealing a clearly specifiable type of information to a clearly identifiable recipient. It is, rather, a matter of exercising good judgment about what is and what is not sensitive. It is riskier to try to specify precisely the scope of the confidentiality than it is to offer a principle which explains the company's serious concern to maintain confidentiality in its dealings with clients. Or, consider "trust" or "honesty". These important ethical notions cannot be articulated as specific prescriptions without damaging their roles in a code of ethics.

If properly conceived, a code of ethics will be a statement of what the

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organisation stands for in terms of behaviour and values. The construction of a code of ethics requires the organisation to take serious stock of the values which are important to it in carrying out its particular business.

Several studies in the US have found that organisations which pursue aggressive business strategies coupled with a strong ethical culture are more successful in the long term than those which pursue strategies focused exclusively on profit. In an industry such as banking and finance, where short-term, opportunistic strategies are common, the need for "responsible" behaviour, supported by effective compliance processes, is essential. This is particularly true given that most reward systems in the finance sector are heavily performance-oriented.

Contrast this with the reality in the Australian finance industry. Mention compliance to a stockbroker or investment banker and the response may include words such as "intrusive", "heavy-handed", "costly" and "bureaucratic". A reference to ethics may elicit quizzical looks, but not much else. While the industry bodies have made considerable and commendable progress towards self-regulation, there is still a long way to go. Hurding this obstacle of indifference, and bringing about the necessary behavioural change in favour of accountability and responsibility, requires well articulated arguments and a strong political will from the most senior ranks.

It is often left to a designated compliance officer to try to bring about this cultural change. Genuine cultural change can only occur with the backing and active support of senior management and the board. It cannot be achieved by compliance personnel working in a vacuum. Interestingly, it is far easier for compliance officers to gain support from senior people who have suffered at the hands of an aggrieved client or a hostile regulator than those who have not; perhaps unfortunately, there has been very little successful litigation or regulatory "big stick" in Australia to heighten the sensitivity or awareness of most senior executives and board members, other than under the Trade Practices Act.

This is unlike the UK and the US, where there is highly visible and active regulatory oversight in the financial and securities markets. Whether such heavy-handed regulation has been effective is arguable, given the complete breakdown in compliance processes and regulatory oversight in cases such as Barings and Morgan Grenfell Funds Management in the UK. In this environment, cultural change can be difficult and requires a sympathetic yet determined approach. However it is achieved, compliance officers must have support from the stewards and senior managers of the organisation.

Given that the Australian audience is likely to include many more cynics than converts at all levels of the organisation, the question arises: "What will encourage individuals to become believers in the value of a strong ethical culture?"

Following are some suggestions about how a compliance officer should tackle this difficult task.

- Make sure the board and senior management are owners and visible supporters of your ethical culture. If necessary, seek external help
- Step back and take stock of your corporate culture from an ethical perspective (i.e., conduct an ethics audit).
- Once you have agreed on appropriate standards, formulate draft codes of ethics and conduct.
- Involve employees from all levels in developing your codes.
- Benchmark your codes against others in the same industry.
- Make the final codes an integral part of the terms of engagement for employees. The codes should be sufficiently specific for significant or constant breaches to be identified and remedied. Regular and blatant disregard of the codes should be penalised in the performance appraisal process.
- Communication is critical. It is not simply a matter of developing the written word. Employees should be educated on the key points at the time they are inducted into the organisation, with regular refresher programs.
- Make sure that the codes are easily accessible, preferably by making them available "on-line".
- Obtain positive affirmation at least annually from all employees, including the board and senior management, of their continuing compliance with the codes throughout the preceding period.
- Make sure that you file these affirmations; they are important documents in the event that breaches are subsequently detected. They also help to demonstrate to regulatory agencies that a due diligence process is being properly administered.
- The codes should be living documents, constantly being revisited to ensure they still reflect the true ethos of your organisation and best industry practice.
- Ensure that there are adequate supervision and review processes to identify possible breaches, and the political will to investigate and take appropriate remedial action. There must be one rule for all, with no favours or leniency given because of "seniority" or "importance".
- Finally, promote the fact that you have a strong ethical culture, both internally and to the outside world. It will become self-fulfilling; clients will acknowledge and place value on your commitment, leading to more business, which in turn encourages the ethical behaviour. A win-win situation.