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Governance and Ethics

In response to unethical and illegal conduct by some of the nation's major corporations and business leaders, the government, investors, and the public have demanded action. As a result, organizations in the private sectors, and increasingly in the public sector, must now demonstrate that their policies, practices, and activities comply and comport with legal requirements and ethical standards. The new governmental and public mantra is: Less trust; more verification (LTMV).

The enactment of the Corporate Accounting and Auditing, Responsibility and Transparency Act of 2002, also known as Sarbanes-Oxley Act (SOX), which — at its core, requires honesty, compliance, transparency, and accountability — is a symbol of this mistrust and institutionalizes good governance and ethical activities. The consequences of SOX — compliance with the technical aspects of laws and regulations — is **not** enough. An organization's governance and ethical activities must be a manifestation of an organizational culture and values that encourage ethical conduct and a commitment to both the letter and spirit of the law. Compliance and ethics program should be an essential component of organizational DNA.

An organization must exercise due diligence in preventing, detecting, and correcting violations of law by its employees and agents. Due diligence requires — at a minimum — a program reasonably designed, implemented, and enforced to deter and punish organizational, criminal misconduct. At the core of an effective compliance and ethics program, is a vigilant regime of internal prevention and self-policing that includes achieving compliance and an ethical culture through auditing and monitoring.

Sound corporate governance practices are designed to raise standards of corporate accountability and prevent wrongdoing, and should be considered a best business practices.

The formality, the features, and the scope of actions that an organization must take to meet the requirements for an effective governance programs, may be influenced by such factors as the size of the organization, the industry, and for-profit/not-for-profit status. As a general rule, the larger the organization, the more formal and structured the compliance and ethics programs should be and the greater resources the organization should commit to meet governance obligations.

Thus, smaller organizations may be able to meet their governance obligations by implementing a compliance program that:

- ◆ Trains employees through informal staff meetings, through regular management-employee interactions, or through continuous management observation and action.
- ◆ That uses available personnel, rather than employing separate staff, to carry out the compliance and ethics programs.
- ◆ Models in-house compliance and ethics programs on existing, well-regarded compliance and ethics programs and best practices of other similar organizations.

Another obvious factor influencing the organization's compliance and ethics program activities is the issue of ownership. Is the organization publicly held or privately held?

While most of the provisions of the Sarbanes-Oxley Act (SOX) apply specifically to publicly-held companies, there are significant provisions also applicable to privately-held companies, these include the following:

- ◆ Criminal liability for document destruction.
- ◆ Increased penalties for securities fraud.
- ◆ Increased liability for white-collar crimes.
- ◆ Liability for retaliation against whistleblowers.
- ◆ Notice of defined benefit plan blackout periods.

Further, SOX identifies best practices for both public and private companies, including the following:

- ◆ Restrictions on Loans to Officers and Directors.
- ◆ Board of Director independence.
- ◆ The use of independent audit committees.
- ◆ The promulgation of an audit committee charter.
- ◆ The promulgation of a code of ethics.

Additionally, the organizational sentencing provisions of the *U.S. Federal Sentencing Guidelines* (Guidelines), which helps the courts determine the appropriate sentence for organizations convicted of a federal crime, apply to both publicly and private and publicly companies regardless of size. Note that these Guidelines require that the organization train employees on the requirements of the governance and ethics program. In fact, compliance and ethics training is now mandated by the 2004 amendments to the Guidelines. Attendance at the training programs should be as inclusive as possible and not limited to "high-level personnel" and/or the Board of Directors. Legal experts further recommend that the training program include independent contractors, leased employees, project workers, and international employees.

In addition to ownership and size factors, the organization's industry classification can also play a role in determining the requirements of compliance and ethics programs. An organization should become familiar with applicable industry practices and any standards called for by government regulations; this will help an organization determine minimum requirements.

The location of the operations is increasingly becoming a factor with states proposing legislation for the regulation of business organizations. State compliance and ethics requirements are, of course, in addition to federal laws. An organization should continuously monitor corporate good governance activities to ensure that the organization complies with state, as well as federal, laws and regulations.

Also, because compliance and ethic laws and regulations are evolving, an organization should ensure that compliance and ethics program is a dynamic program that can adapt to changes in legal regulatory requirements and organizational factors. Organizations that become good governance dinosaurs may quickly become extinct.

Thus while SOX was enacted in response to the accounting and corporate scandals at Enron, WorldCom, Tyco, and other large public companies, its reach extends far beyond to smaller public companies, private companies, and nonprofits. Regardless of the legal classification, size, industry, or the states in which an organization operate, an organization should assume that the spirit — if not the letter — of compliance and ethics laws and regulations apply to the organization.

The first requirement of an effective governance program is that it contains a formal, written set of compliance standards and procedures. The written compliance standards and procedures should include a general statement of ethical principles evincing the commitment to integrity and honesty in the conduct of all affairs and the intent to operate within the law.

The organization should further promulgate a code of conduct that communicates specific expectations of the organization's compliance and ethics program, including the importance of addressing and reporting financial impropriety. At a minimum, the code of conduct should also include the following:

- ◆ The organization's commitment to ethics and compliance.
- ◆ A discussion of employees' responsibilities under the governance program.
- ◆ The types of issues that require action, such as the reporting of financial fraud.

The organization must be able to demonstrate that its leadership team, for example, the Board of Directors (BOD), and senior management are knowledgeable about nature, scope, and details of the governance program, exercises reasonable oversight, is actively engaged, and is accountable for results. To satisfy these requirements, the organization should appoint a compliance committee or compliance officer that has operational responsibility for compliance and ethics program. This committee or individual should be recognized as an extension of the BOD, should report directly to the BOD, have the authority and ability to exercise independent judgment, and have the authority and ability to make changes and correct noncompliance to ensure achievement of the governance program.

Note that the appointment of a compliance committee or officer should not, and **does not**, relieve the obligations of employees and management from their individual responsibility to comply with compliance and ethics policy.

The Guidelines make organization-wide compliance and ethics training a requirement. An organization should not limit the training program to Board members and senior executives, but should extend it to include managers and supervisors and employees. An organization may also find it necessary to include third parties in the training program. Thus, it may be necessary for an organization to develop and regularly update multiple educational tracks or curricula: one for the BOD and senior management, and one or more for managers and supervisors, the general employee population, and others.

The compliance and ethics program should:

- ◆ Determine whether the activities deter employees from engaging in “other conduct inconsistent with an effective governance program.” Compliance and ethics activities, beyond meting out discipline for violations of law and policy, should ensure that the governance standards are achieved through “appropriate incentives to perform. . .” and should deter nonrepetition of violations.

- ◆ Ensure compliance and ethics training adequacy. Training plays a key role in a number of ways under the new Guidelines. The original Guidelines merely suggested training was one avenue that organizations should consider. The new Guidelines make compliance training a requirement. An organization must ensure that the BOD, senior management, managers and supervisors, employees, and others as required receive the required training. Note, the new Guidelines specify that organizations should train, as appropriate.
- ◆ Adequately monitor and assess compliance results. This aspect of the Guidelines was strengthened to mandate the use of auditing and monitoring systems designed to evaluate periodically the effectiveness of the organization's compliance and ethics program and to detect illegal and unethical conduct. The organization must take reasonable steps to ensure that its compliance and ethics program is followed and that systems and procedures are in place to detect criminal conduct and governance violations.
- ◆ Conduct background checks of individuals assigned to positions of "substantial authority." An organization must take reasonable precautions to ensure that an organization do not place individuals with a previous history of illegal conduct into positions that allows them to negotiate, approve, and oversee contracts, agreements, or pricing schedules.
- ◆ Demonstrate a commitment to ferreting out policies violations and criminal conduct by creating an environment that encourages and-supports the confidential and anonymous reporting of governance program violations.

The organization should encourage employees to report compliance and ethics violations. This requires the development and the ongoing communication of violation reporting procedures and protocols that seek to prevent and detect violations. These procedures and protocols should include the following:

- ◆ A clear description of the process employees should use in seeking guidance about potential or actual violations of law.
- ◆ Anonymous reporting by employees, contractors, and agents.
- ◆ Multiple channels for reporting, including bypassing an employee's immediate supervisor and/or department manager.
- ◆ A whistleblower's hotline.
- ◆ Prompt and fair resolution of reported violations.
- ◆ Procedures for the receipt, retention, and treatment of confidential information; and
- ◆ A commitment to nonretaliation. This is critical. Employees will not report violations — at least not internally — if they do not trust the commitment.