



Good practice in ethics and compliance

One of the biggest risks companies face is that those who work for them will break the law or breach accepted ethical standards. Breaches range from the payment or receipt of bribes to mis-selling and other forms of dishonest sales and marketing activity to various forms of discriminatory practice in hiring, firing and promotion to price-fixing and other kinds of anti-competitive practice to failing to follow health and safety procedures to covering up bad news about products or performance. Sometimes breaches are not in themselves costly, but they can lead to costly consequences – prosecutions, civil law suits, damage to brands and reputation, loss of trust and loyalty from customers and other employees, and removal of license to operate. In extreme cases – like Arthur Andersen – they can destroy the company.

In order to reduce these risks, many companies work to create an organisational culture in which integrity is encouraged and upheld. Insight has begun work to understand how companies go about doing this and to form a view about which practices are most effective and most appropriate to different business models. This work takes forward some of the key issues relating to boards and corporate responsibility described in our Rewarding Virtue report available at www.insightinvestment.com/Documents/responsibility/Rewarding%20Virtue%20-%20sv.pdf.

As a first step, during the first quarter of this year, we held a series of meetings with the managers responsible for ethics and compliance work in several of the UK's larger companies – including National Grid, GlaxoSmithKline, Shell, BAT and BT with additional meetings planned with HSBC and BP. These companies have made significant efforts to embed ethical behaviour in their corporate cultures in recent years.

We have discovered a number of common elements:

- The publication of a statement of business principles or values, supported by a more detailed code of conduct for staff, generally issued by the chief executive or the board as a whole. They typically define principles of conduct on a variety of the key ethical issues faced by the company. They also included guidance for staff on what to do if they have a concern about a breach.
- Communications and training programmes, to educate staff about the purpose and content of the code. Good training programmes include worked examples of the difficult situations staff might encounter, the behaviours expected from them and the consequences of non-compliance.
- Monitoring and reporting systems to identify actual and potential breaches. These systems tend to include both formal quarterly internal audit reviews as well as whistleblowing telephone and email services. Some companies have introduced 'attestation statements' for managers that require them to attest that the operations for which they are accountable are in compliance with the code of conduct, or to raise any exceptions. Some companies cascade attestation letters upwards from middle to senior managers. Others require all managers to attest independently.
- Reporting breaches to the audit or risk committee of the board of directors. All companies we have spoken to have processes for reporting information about breaches all the way up to the board. Usually, reports are made to the audit committee, though in some cases, they are made to new risk and responsibility committees.

- Breach investigation and disciplinary procedures to fairly assess allegations of breaches and to take action. Codes of conduct are unlikely to be taken very seriously unless staff believe that breaching the code will result in material consequences for those that do so. A number of companies now publish information about the number of investigations and disciplinary events. GSK, for example, conducted 900 investigations and sacked 200 staff and BT sacked 120 in 2004.
- Aligning incentives. Several companies take the view that it is not enough to have a code of conduct. They believe that they must also consider whether financial and other incentives are aligned with, or in conflict with, the company's business principles. In some cases, companies have responded by introducing annual bonus incentives for meeting corporate responsibility goals; in others, non-financial incentives are included in the executive remuneration arrangements at board level.

Two of the companies we have spoken to emphasised that they have explicitly sought to take an ethics- or values-based approach to this aspect of risk, rather than a compliance-based approach. This is partly because they think it is better to seek to encourage their staff to apply general principles of good conduct than to draft extensive rules prescribing what is or is not acceptable in each particular case. It is also because the companies hope to harness the values of their staff, something a compliance-based approach is, they argue, less able to do.

All of the companies we have met have most of the elements described above in place. This should not be a surprise given our initial focus on some of the largest and most respected companies in the UK. However, it is apparent that some of the companies in our initial round of meetings have significantly more developed approaches than others. This may be a reflection of the nature of the risks they face: some companies' operations expose their staff to greater temptations to behave unethically than others. One would therefore expect greater attention from such companies to codes of conduct. Another factor seems to be the extent to which the business is controlled centrally: companies with decentralised structures have a more challenging job in encouraging subsidiary divisions and businesses to follow centrally mandated practice.

There is some evidence to suggest that the advanced approaches to embedding ethics taken by these leading companies are not replicated across the FTSE 350. Therefore, once we have developed a rounded picture of good practice on embedding ethics, we plan to engage with companies in which we invest to encourage those with less developed policies and practices to improve their governance and performance in this area.

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