CIVIL JUSTICE SYSTEMS

ETHICAL BUSINESS PRACTICE AND REGULATION

A Behavioural and Values-Based Approach to Compliance and Enforcement

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The Status of Corporate Governance

Having reviewed the status of the ideas and evidence on why and how things ought to operate in an ethical business world, we now summarise the status of the thought-leadership within the corporate world on best practice on governance. This will identify the current requirements on culture and ethics for boards of directors and companies. We will find the emergence of a strong focus on corporate culture, but only a tentative focus on ethical values. But first we should ask whether it is possible to balance profits and ethics. Is capitalism inherently incompatible with ethical business practice? No, it isn't.

The Conflict between Ethics and Profits

> Money blinds us to our social relationships, creating a sense of self-sufficiency that discourages cooperation and mutual support.
>
> Margaret Heffernan[1]

The question of the role of business in society underlies much of the change that we are documenting and advocating in this book. A critical issue that we need to confront is whether business can ever be ethical, given the inherent conflict that is faced between doing the right thing and making a profit, so as to hit targets in making returns, and maintaining employment and growth in owners' incomes, bearing in mind the effect that that has on pensions and investments.

If making money is inconsistent with always doing the right thing, then Western capitalism is doomed. However, the shifts in corporate practice and the case studies make clear that it is possible to make money by demonstrating that you care about delivering not just good service but also an ethical service. As we have noted, there has been plenty of criticism of the mantra that has driven businesses operating on the model of 'free world capitalism' for some decades, namely the goal of 'maximising shareholder value'. A new balance has been struck between profits and people, and between capitalism and social issues.

The classic theory runs like this. It is axiomatic that capitalism is a political and economic system in which enterprises compete to make profit. Firms are owned by shareholders, who choose to invest their capital in a firm in exchange for, and with the expectation of, making profit.[2] Avoidance of conflicts between the

interests of owners and managers (the 'agency problem') is minimised or avoided where the interests of both groups are aligned and managers are incentivised by being paid by results. This is the model of 'maximising shareholder value', which has dominated corporate theory and practice since the 1970s. It holds that the sole purpose of a company is to 'maximise shareholder value'.[3] It demands that firms should just pursue profits and act in their own self-interest.[4] Extensive pre-occupation with mechanisms that align (only) the economic interests of intermediaries with those of their supposed principals (agency theory)[5] paved the way for a utility-maximising model to become an all-encompassing theory of human behaviour.[6]

It is widely agreed that business behaviour became narrowly focused on maximising shareholder value from the 1980s,[7] linked with a widening of citizens' shareholding (and thus a dilution of external control by individual shareholders) and a political ideology linked with individualism[8] and individual liberty.[9]

The Mirage of Maximising Shareholder Value

Not surprisingly, the 'maximising shareholder value' and its associated 'agency theory' approach led to capitalism being attacked for 'greed, selfishness, exploitation and a crude disregard for any interests but one's own'.[10] The classic model has been identified as the cause of a series of serious adverse consequences.[11] Shareholders have held other stakeholders to ransom.[12] Risks have been misallocated, service providers have extracted huge rents,[13] and pay was significantly higher than was justified by long-term performance.[14] The equity market was overcome by the short-term maximisation of profits.[15] Remuneration structures involved annual performance fees for asset managers, with large bonuses based on short-term profits. Viewing an organisation as a nexus of contracts fails to see how it operates as a social institution.[16] The model of business as a linear process of production and consumption has been revealed as failing to recognise 'the full complexity of the flow of materials, energy and information in the modern economy' and, in so doing, the former version of capitalism 'has mistaken money for value, and growth for development'.[17]

The goal of maximisation of shareholder value has recently drawn strenuous criticism from leading scholars, especially on the basis of having been a root cause of the global financial crisis. John Armour and Jeff Gordon of the University of Oxford and Columbia University argue that the shareholder value norm creates incentives for firms to systematically undermine the efficacy of regulatory internalisation mechanisms, thereby failing to avoid the significant externalities that were thought to be avoided.[18]

Exclusive focus on shareholder wealth creates organisations typically characterised by a culture of compliance and control.[19] Employees, particularly those with high aspirations, are likely to find the culture constraining, and the culture itself tends to stifle innovative thinking from the lower ranks.[20]

In a 2017 article in the *Harvard Business Review*, Joseph Bower and Lynn Paine attack the traditional theory head-on.[21] They argue that the goal of exclusively pursuing shareholder value and its associated theory of agency are flawed in their assumptions, legally confused and damaging in practice. Shareholders have no rights as 'owners', managers are not shareholders' 'agents', shareholders have no incentives to exercise care in managing the company, and shareholder centricity is rife with moral hazard, as shareholders have no responsibilities (as directors and managers do) to protect the company's interests, and are unaccountable for their actions. The result is opportunism in share ownership and trading, in which activist hedge funds have wreaked havoc on the sustainable value of some companies. The average holding period for public company shares in the US has rarely been over one year since 1999 and is often a few months: 'much of what activists call value creation is more accurately described as value transfer. When cash is paid to shareholders rather than used to fund research, launch new ventures, or grow existing businesses, value has not been created'.[22]

Bower and Paine argue that the policy should be company-centred rather than shareholder-centred: 'The notion that managing for the good of the company is the same as managing for the good of the stock is best understood as a theoretical conceit necessitated by the mathematical models that many economists favour.'[23] Their model 'would have at its core the health of the enterprise rather than near-term returns to its shareholders. Such a model would start by recognising that corporations are independent entities endowed by law with the potential for indefinite life. With the right leadership, they can be managed to serve markets and society over long periods of time'.[24] The interests of the corporation are distinct from the interests of any particular shareholder or constituency group. Bower and Paine assert that corporations perform many functions in society and must create value for multiple constituencies. These are powerful arguments and they are central to our concepts of EBP and EBR.

By contrast, UK law adopts an 'enlightened shareholder value' model,[25] under which directors must promote the success *of the company for the benefit of its members* and in doing so have regard to various factors, for example:

- the likely consequences of any decision in the long term;
- the interests of employees;
- the need to foster the company's relationships with suppliers, customers and others;
- the impact of operations on the community and the environment;
- the desirability of the company maintaining a reputation for high standards of business conduct.

We consider that Bower, Paine and colleagues are right, and that even the UK model is inadequate (although better than the US model). The basic idea is that a corporation is a distinct actor in society; not only must its interests be central, but it must also play a responsible role in society by respecting the interests of *all* its stakeholders.

Maximising shareholder value is a valid consideration for business, but it should rarely be the *only objective* of an organisation. We agree with Colin Mayer that shareholder value is an *outcome*, not an *objective*.[26] We argue in Part IV that the real guiding principle of an organisation should be to base all decisions and actions on ethical values, which means taking into account the objectives of all the organisation's stakeholders, and so delivering value to them is also relevant. A commercial organisation must, of course, have a valid commercial plan and value proposition, otherwise it will fail.

In short, it is entirely possible for businesses to be both ethical and commercially successful if they honestly place ethical values unequivocally as the centre of the enterprise and apply them consistently to all decisions and behaviours.

Can Corporate Structures Impede Ethical Behaviour?

Colin Mayer's view of the corporation is that it is a mechanism for providing commitment to others. His analysis of the causes of the 2008 economic crisis was that the Anglo-American models of corporations have destroyed essential trust and commitment, since they have enabled and incentivised short-termism, such that business continuity is systemically disrupted in pursuit of the realisation of instant profit by incentives to create mergers, and asset stripping by hedge funds.[27] He suggested that corporations need to exhibit morality, based on three sets of principles. First, companies need values that are credible, consistent and moral. The values will be those of the corporation's customers, investors and employees. Public and private values can be integrated. Second, since self-restraint, reputation and regulation are ineffective, a corporation needs third parties (trust boards) to restrain it from defaulting on its values. Third, the shareholding structure should allow enhanced control to be conferred on shareholders who commit to invest in the corporation for a long period.[28] Mayer argues for the German corporate model in which a supervisory board regulates the management board's operational decisions against the set of stated values of the company.

Whilst agreeing with the premise that a corporation should be run on ethical principles, we do not see the need for duplication of boards in this way. Such a mechanism would only act as a board controlling another board, and there is mounting evidence that single boards that are committed to ethical values can operate well. Further, a control at board level does nothing by itself to ensure ethical practice *throughout all levels* of the organisation.

At a structural level, Mayer's form of corporate governance and ownership—the 'trust firm'—combines responsibility with power and denies power without responsibility. It therefore defines the notion of a moral corporation and imbues the corporation with a degree of morality which exceeds that of the individual.[29] But ethical governance structures would not stop at the board level. Many publications are now appearing on how to grow an ethical culture within a business,[30] and we will talk about this in chapters 13 and 14.

Donald Palmer concludes in his review of the theories of misconduct in organisations 'that a large number of structures and processes without which organizations could not function can cause a significant number of the good apples to embark on wrongful behaviour or to join the few bad apples intentionally pursuing wrongful courses of action'.[31] While we agree with this conclusion, we do not share his apparent pessimism that structures cannot be changed. In fact, that is exactly what we are advocating.

Ethical Structures Tend to Be Open and Flat

It is striking that different case studies into ethical businesses find that their internal organisational structures tend to be flat rather than hierarchical. Decisions are made by empowered staff rather than by a limited number of managers. These businesses also report strikingly good economic results.

Case Study 20: Conscious Capitalism[32]

John Mackey is the co-founder and CEO of Whole Foods Market. His journey from counter culture to capitalism led him to propose a model of free-enterprise capitalism, grounded in an ethical system based on value creation for all stakeholders, involving four tenets:

A. higher purpose and core values;
B. stakeholder integration;
C. conscious leadership;
D. conscious culture and management.

Mackey and Sisodia defined the qualities of conscious cultures as: trust, accountability, caring, transparency, integrity, loyalty and egalitarianism. They asserted that the approach of traditional businesses in giving their managers hard targets for metrics (like market share, profit margins and earnings per share) merely confuses cause and effect.

In asserting conscious capitalism, they contrasted different leadership styles: first, masculine traits of aggression, ambition, competition and left-brain function; and, second, the rise of feminine values of caring, compassion, cooperation and more right-brain qualities, heralding a harmonious blending of these human values in work and life. It is critical to hire people who align strongly with the purpose of the enterprise.

The key principle is to locate decision-making at the lowest possible level by passionate and inspired team members, unless there is compelling evidence that the organisation would be better off making decisions at a higher level. Without empowerment, there is little innovation or creativity. In the company, leadership is mostly about facilitating change and transformation, and management is about efficiency and implementation.

Corporate Governance and Culture: International Statements

The response to the 2008 financial crisis included several strong shifts in corporate governance. One was that companies should adopt a long-term viewpoint to their activities so as to ensure that shareholders' investments remain sustainable and secure. This sense of stability is vital for any sophisticated market and for institutional investors who are responsible for assets such as pension funds. The second shift was a clear movement to considering the interests of *all* stakeholders in a company, thereby moving away from the previously dominant model that 'maximising shareholder value' was the sole objective. A third shift, integrally related to the other two, was an increased emphasis on the importance of corporate values and culture. Let's look at these more closely.

The OECD issued *Principles of Corporate Governance* in 2015 that include the need for companies to provide for the interests of shareholders, key ownership functions, institutional investors, stock markets and other intermediaries, and all relevant stakeholders.[33] The OECD is promoting better corporate governance as a way to prevent corporate misconduct and to rebuild trust in private business, 'precisely to create an environment of trust, transparency and accountability necessary for obtaining long-term investment, financial stability and sustainable growth. If nothing is done, the very fabric and foundation of doing business in an effective and sustainable fashion is at risk'.[34]

In setting an agenda for the future governance of financial institutions, the G30 issued a notable report in 2012 in which it set out that behaviour 'appears to be key' and that to achieve the right behaviours a shift is required from the 'hardware' of governance (structures and processes) to the 'software' (people, leadership skills and values).[35]

> *Values and culture may be the keystone of FI [financial institution] governance because they drive behaviours of people throughout the organization and the ultimate effectiveness of its governance arrangements.*
>
> Suitable structures and processes are a necessary but not a sufficient condition for good governance, which critically depends also on patterns of behaviour. Behavioural patterns depend in turn on the extent to which values such as integrity, independence of thought, and respect for the views of others are embedded in the institutional culture.
>
> In a great FI, positive values and culture are palpable from the board to the executive suite to the front line. Values and culture drive people to do the right thing even when no one is looking.[36]
>
> ... The following are the specific views and recommendations designed to encourage FI board members, executive leaders, supervisors and shareholders to pay heed to the importance of values and culture ...:

> 1. Honesty, integrity, proper motivations, independence of thought, respect for the ideas of others, openness/transparency, the courage to speak out and act, and trust are the bedrock values of effective governance.
> 2. It is for the board of directors to articulate and senior executives to promote a culture that embeds these values from the top to the bottom of the entity. Culture is values brought to life.
> 3. Well-functioning boards set, promulgate, and embed these values, commonly in the form of a code, so that directors, senior executives, and all other employees in an entity are fully aware of the standards of behaviour that are expected of them.
> 4. Because of their power to influence behaviour and the execution of the FI's strategy, values and culture are essential dimensions of inquiry and engagement for supervisors. Major shareholders or their fund managers should be attentive to the culture of an entity when making their investment decisions and engaging with an investee board.[37]
>
> Absent impeccable personal values—honesty, personal integrity, and motivation—nothing is possible. Honesty and personal integrity are self-explanatory and important in any business, but especially in FIs, where public trust and a reputation for honesty and integrity are essential to the value proposition.

The G30 report regarded a customer-centred focus as driving business behaviours, and to be a strategic choice, not a governance issue, which is then translated into operational discipline. Financial institutions, it said, had societal responsibility, since they are licensed by society to serve the needs of society.

In 2013, the G30 followed up its 2012 report by describing 'a new paradigm' for interaction between supervisors and boards of major financial institutions across the globe, based on interviews with more than 60 senior supervisors and board members of some of the largest global and domestic banks in 15 countries.[38] It noted that much attention had been given to new regulations in areas such as risk-based capital, liquidity, resolution and risk management, but 'not enough attention had been placed on "softer" issues that rules alone cannot address, such as enhancing supervisor-board relations to improve supervisor and board effectiveness, or on the culture of firms'. The G30 said that the approach should be based on mutual respect and trust, and should involve a particular culture:

> Realism is important. The goal is not a partnership. The fact that it is the responsibility of supervisors to assess boards means there will inevitably be occasional tension, and the new paradigm requires a substantial increased time commitment from many board members and supervisors. But the potential payoff is large. What is needed is not more of the same, rather it is a step change in the level and quality of the interaction between boards and supervisors, and having the right people who take the time to make that happen.

The G30 considered that boards remain with primary responsibility for the implementation of effective corporate governance, and it emphasised the leadership role of the chairman, the need for adequate board skill sets, regular board effectiveness reviews, and good visibility on risk/prudential matters for the board. But boards and supervisors should adopt a paradigm of trust-based interaction based on clear mutual expectations, with a focus on examining business model vulnerabilities,

governance effectiveness and culture. The goal was effective two-way communication, predictability and no surprises from either party.

> Boards of financial institutions need to welcome interaction with high-quality supervisors, view such interaction as contributing to board effectiveness, and understand that it is the responsibility of the supervisor to seek reasonable assurance that the board is effective and the institution's risk culture is appropriate and to help the supervisors fulfill that responsibility. Boards need to make enhancing supervisory relations a priority and take specific action to support the new paradigm recommended in this report.

In emphasising the importance of culture and ethical standards, the G30 said:

> Boards must understand the culture of their organization, in conjunction with their business model. While an institution's broader culture affects its attitude toward risk taking, it is important to prioritize attention to risk culture since it has the most direct connection to safety and soundness of financial institutions. Boards should identify and deal seriously with risky culture, ensure their compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture. Supervisors should share their observations about the institution's risk culture with the board, and should watch for serious culture issues that need rectification. Supervisors and policy makers should be cautious about writing rules or guidance about culture, and should set realistic expectations about what is achievable.[39]

The G30 report noted that systems and messages can reinforce or undermine the culture of understood behaviours and attitudes within an organisation:

> Culture is the internal compass that guides individuals' behaviours when no one is looking. It involves soft features that defy quantitative measurement, but they cannot be ignored.
>
> There is no one culture that is appropriate for a major FI. Any culture can fail ...
>
> Culture is closely aligned with business model. Management, boards, and supervisors should carefully consider whether the business model reinforces a healthy culture. Business strategies and models that focus on sales rather than customers, short-term results rather than long-term value, growth rather than sustainability, and low cost rather than efficiency, can create unhealthy cultures. It can be very difficult to change the culture without also changing the business model.
>
> The risk culture of individual institutions will naturally be embedded in the institution's overall culture and in the financial culture of the country ...
>
> The realistic expectation of supervisors' interventions should be to deal with potentially seriously problematic cultures (outliers) that are not adequately mitigated and that boards have not dealt with. Understanding culture more broadly at major institutions is valuable. But supervisors should avoid attempts to make granular cultural distinctions between one firm and another. There is no one FI cultural ideal. To expect more than this is to ask for the undoable, to waste scarce resources, and to lead to excessive intrusion into how banks are run.

The report recommended that supervisors and boards should use a short list of simple descriptors of culture:

> Useful descriptors of desired culture include: valuing risk awareness across the FI; sustainability; client-focused; integrity; accountability; independence of thought; respect for the views of others; transparency; doing the right thing; balanced decision making; open to constructive challenge, including from subordinates; viewing risk management and compliance as adding value; culture of ownership of risk and compliance in both the business and control functions; collaboration across functional groups; innovation; excellence in execution; learning from mistakes; inclusion of others; conservative; and prudent or cautious.
>
> While these traits appear to be uniquely desirable, they can also be problematic in certain circumstances; for example, too conservative or cautious a culture can lack the dynamism needed for success, which in turn is a key bulwark of safety and soundness. Again, as an example, the organizational culture literature has identified that an excess of collaboration can produce groupthink, which itself can pose risks.
>
> In contrast, various people interviewed for this report suggested elements of culture that can be problematic. Examples include: growth for growth's sake, an excessive sales- or cost-focused culture, an overbearing CEO (or business line head), an unduly deferential culture, an excessively aggressive culture that does not adequately consider whether the identified goal is the right thing to do, cultures that push business while disregarding risks and controls, an ego-driven or star-performer culture, hubris, seeing policies and limits as items to be gamed, siloed cultures, and excessively valuing autonomy over control and adherence to policies.
>
> Aspects of culture that could prove problematic can be mitigated. For example, some bemoan the powerful short-term-performance-driven-CEO culture. But organizations do need active, engaged CEOs who can push change and achieve complex strategies for success (which is important for safety and soundness). The downsides of this culture can be mitigated by an equally strong board, with highly effective challenge, including the counterweight of a very strong chair.

This approach can be contrasted with the policy of focusing on individuals through rules on accountability and criminal sanctions, which was discussed above at chapter 3. We suggest that the latter approach is doomed to failure and will produce inconsistent and ineffective results.

Restoring Confidence in the City of London through Corporate Governance and Culture

The 2008 financial crash caused not only an economic crisis but also a loss of confidence in banks and in the City of London-based corporate world generally. Virtually every subsequent report into the crisis emphasised not only the need to improve the regulatory system but also the importance of the culture of

businesses.[40] The Corporation of the City of London was particularly concerned that the ongoing sequence of financial scandals would undermine confidence in the City and would lead to significant deterioration in the ranking of London as a financial and corporate centre.[41]

The starting point is that the UK Companies Act imposes the following duties on a company director:

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a) the likely consequences of any decision in the long-term,
> (b) the interests of the company's employees,
> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the environment,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly as between members of the company.[42]

The Lord Mayor of the City of London spearheaded an initiative to restore the City's 'trust and values', recalling the traditional adage 'My word is my bond'. This produced a series of agreements on improving business culture and behaviour, based on the following actions:

- *Leadership with Integrity*. A new research and education programme at Cass Business School.
- *Performance with Integrity*. Recruitment, appraisal and development would be linked to ethics and behavior. A new policy guide and best practice toolkit in performance management was prepared to help employers embed values at three crucial stages: recruitment, performance appraisal and development. The toolkit particularly addresses the needs of the individual who delivers short-term financial results but does not work by the organisation's values and creates excessive risk. The work was cross-referenced to published professional standards, regulatory requirements and internal disciplinary processes.
- *Governing Values*. Designed to enable Boards to ensure that values are observed and 'lived'.
- *The City Obligation*. A personal pledge to be taken voluntarily by those working in the City to uphold the City's enduring values, the highest standards of integrity and professional behavior, with a focus on obligations to clients and other stakeholders. Similar to 'My Word is My Bond'.
- *Integrity Resources*. Defining and sharing best practice, including: next generation leaders; remuneration and regulation; diversity and inclusion; training and development; corporate social responsibility.[43]

The UK has had a principles-based approach to corporate governance since the 1992 Cadbury Report, which introduced a code based on openness, integrity and accountability.[44] The 2009 Walker Review concluded that the UK's unitary board

structure and Combined Code of the Financial Reporting Council (FRC), and its 'comply or explain' mode, remained fit for purpose for companies generally and not just financial institutions.[45] New editions of the UK Corporate Governance Code were issued in 2010,[46] 2012[47] and 2014.[48]

The Code calls for 'dialogue which is both constructive and challenging' and states that a key role for a board is to establish the culture, values and ethics of the company.[49] The Stewardship Code was issued by the Financial Reporting Council to enhance the quality of engagement between institutional investors and companies, to offer sharper emphasis on long-term company strategy and to tackle overly complex incentive schemes which encourage short-termism and tend to pay out asymmetrically.[50] Various supportive statements were issued by investors' bodies,[51] including clarifying the principles on 'comply or explain'.[52]

Taking a Long-Term View

When decisions are made in businesses, the profit-versus-ethics conflict discussed above depends on whether the decision is taken in the short term or long term. A short-term decision might easily save or delay spending money on making improvements, or maximise prices, whereas a longer-term perspective might support incurring the cost or foregoing the income now so as to build customer loyalty and reputation. As just noted, all the recent City policies have emphasised the importance of established UK companies taking a long-term view as a matter of supporting trust in investing in and doing business with UK companies.

The 2012 Kay report set out principles to provide a foundation for a long-term perspective in UK equity markets and made recommendations to re-establish equity markets that work well for their users.[53] The 2014 Corporate Governance Code emphasised that the purpose of corporate governance was to deliver the *long-term* success of a company:

> Governance and the Code. 1. The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the *long-term* success of the company ...
>
> Section A: Leadership: Every company should be headed by an effective board which is collectively responsible for the *long-term* success of the company.[54]

The requirements were carried over into the 2016 Code:

> 4. One of the key roles for the board includes establishing the culture, values and ethics of the company. It is important that the board sets the correct 'tone from the top'. The directors should lead by example and ensure that good standards of behaviour permeate throughout all levels of the organisation. This will help prevent misconduct, unethical practices and support the delivery of long-term success.[55]

The 2014 Code update increased the provision by companies of information about the risks which affect longer-term viability.[56] There was also an update in 2016 that focused on confidence in audit.

The focus on the long term can be noted elsewhere, such as in the 2004 United Nations Global Compact on Corporate Sustainability, the 2010 UK Stewardship Code promoting responsible investment and the 2015 UN Global Compact update's six Principles of Responsible Investment.[57] In 2016, the UK Committee on Standards in Public Life also re-emphasised the importance of its seven principles of selflessness, integrity, objectivity, accountability, openness, honesty and leadership.[58]

In 2016, the Investment Association launched an initiative aimed at using long-term investment to promote productivity.[59] This called for a series of actions, including pressing companies to cease quarterly reporting, managing capital in ways that allow for investment, simplifying behavioural incentives, encouraging investment consultants to promote a long-term approach and improving reporting on culture.

Under the FRC's leadership, a package of reports by different institutions involved in the City of London was issued together in July 2016, which emphasised the importance of corporate culture and gave advice on how to support it.[60] The general philosophy was stated in the Foreword to the FRC's document by its Chairman, Sir Winfried Bischoff:

> There needs to be a concerted effort to improve trust in the motivations and integrity of business. Rules and sanctions clearly have their place, but will not on their own deliver productive behaviours over the long-term. This report looks at the increasing importance which corporate culture plays in delivering long-term business and economic success.
>
> A healthy culture both protects and generates value. It is therefore important to have a continuous focus on culture, rather than wait for a crisis, Poor behaviour can be exacerbated when companies come under pressure. A strong culture will endure in times of stress and mitigate the impact. This is essential in dealing effectively with risk and maintaining resilient performance.
>
> Strong governance underpins a healthy culture, and boards should demonstrate good practice in the boardroom and promote good governance throughout the business. The company as a whole must demonstrate openness and accountability, and should engage constructively with shareholders and wider stakeholders about culture.
>
> In taking action on culture, I should like all those involved to consider three important issues:
>
> **Connect purpose and strategy to culture.**
>
> Establishing a company's overall purpose is crucial in supporting the values and driving the correct behaviours. The strategy to achieve a company's purpose should reflect the values and culture of the company and should not be developed in isolation. Boards should oversee both.
>
> **Align values and incentives.** Recruitment, performance management and reward should support and encourage behaviours consistent with the company's purpose, values, strategy and business model, Financial and non-financial incentives should be appropriately balanced and linked to behavioural objectives.
>
> **Assess and measure.** Boards should give careful thought to how culture is assessed and reported on. A wide range of potential indicators are available. Companies can choose and monitor those that are appropriate to the business and the outcomes they seek. Objectively assessing culture involves interpreting information sensitively to gain practical insight.

The strong emphasis on culture is notable. However, if we read both the Code and the related documents closely, there is a striking omission. They are peppered with references to the importance of a 'healthy', 'strong' or 'positive' culture and to the problems caused by a 'weak' or 'bad' or 'toxic' culture, but there is no reference to the basis for making an evaluative judgement on the moral value of the desired culture. The FRC hardly indicates that culture should equate to a particular value-system or be ethical. At least the OECD's 2015 *Principles of Corporate Governance* mention that 'the board should apply high *ethical* standards' (emphasis added), even if it is only once in a long document.[61]

A criminal gang, such as the Mafia, has a strong culture, which can drive its commercial success. The precise problem with the corporate world has been that the single-minded pursuit of profits and shareholder value has caused a disconnect between the *ethical values* of the societies in which corporations operate and those demonstrated by many businesses. Public objections to corporate practice are widespread—unfair trading, misleading advertising, exploiting vulnerable consumers, poor service, being ripped off, senior executives being paid huge sums of money, traders selling products that customers do not deserve to be sold, fixing rates, fiddling expenses, paying bribes, hiding fraudulent devices intended to avoid regulatory requirements, covering up bad practice, not paying tax in jurisdictions that produce large revenues, polluting the environment and using slave or underpaid labour. In voicing these objections, people are responding from an innate sense of *fairness*, irrespective of the precise rules of legality.

What people expect to see is behaviour that is fair, just and ethical, based on shared norms and values. If that is so, corporations or trading centres that fail to demonstrate that they also require ethical commercial behaviour will not deserve the trust of their customers, workers, investors or regulators. We suggest that the next step is for the City and the corporate world to focus on the absolute requirement of demonstrating that trust can be placed in its organisations because they demonstrate that they act in accordance with the ethical values that society expects.

Room for Improvement in Ethical Business Practice

There is empirical evidence that ethical values are not currently as strong as they should be in business. Although a 2016 survey of the values most prized by FTSE

100 companies found that integrity was the highest scorer at 35%, responsibility, trust and honesty were all far lower, each only scoring 14%. Table 9.1[62] sets out the percentage of FTSE 100 companies espousing the particular value. These results clearly indicate that more emphasis could be placed on values in general corporate culture.

Table 9.1: The values most valued by FTSE 100 companies

Value	*Percentage of respondents mentioning*
Integrity	35%
Respect	28%
Innovation	24%
Safety	18%
Transparency	16%
Excellence	15.5%
Teamwork	14.5%
Responsibility	14%
Trust	14%
Honesty	14%

The 2015 survey of employees by the Institute of Business Ethics (IBE) found that Britain's attempt to 'move on' from the financial crisis and second wave of corporate scandals has led to higher engagement in business ethics, but the UK is 'drifting in the doldrums', with trust being lost as a result of companies 'not playing fair' with levels of tax and executive pay.[63] The position it reports across Europe is far from satisfactory. In Spain, there was a demand for greater openness and accountability, and management is increasingly focused on social responsibility and good governance. France is preoccupied with improving efficiency, whilst the defence sector has been repeatedly implicated in corruption, and banks are also facing misconduct allegations (a leading instance being Jérôme Kerviel, who lost Société Générale €4.9 billion). French organisations are less likely to have ethics programmes. Corruption scandals occurred in Germany from 2005 to 2010, and business ethics have commonly been perceived as unnecessary. However, the VW emissions fraud shocked the world and a profound response is needed. Italy suffers from a continuing economic crisis, such as the *Mafia Capitale* scandal over contract rigging and embezzlement. Overall, the IBE reports that there has been a major decrease in trust in institutions.

The UK Institute of Directors has concluded in 2016 that 'many FTSE 100 companies see governance in pure compliance terms and it has mainly been reduced to the production of boilerplate paragraphs in annual reports', and that 'good governance isn't a question of meeting minimum requirements but rather it is the consequence of tuning many variables to produce optimal performance'.[64]

It may not be so easy to deliver ethical behaviour in practice, given the current state of the corporate world. Much needs to change and it will take time to deliver the requisite change. After all, mis-selling of payment protection insurance (PPI) was universal in the financial services industry,[65] and convicted traders report that they were basically behaving in accordance with the incentives and expectations of the system.[66] The relevance of values within business is a relatively recent idea[67] and has developed in its sophistication.[68] The IBE report notes that:

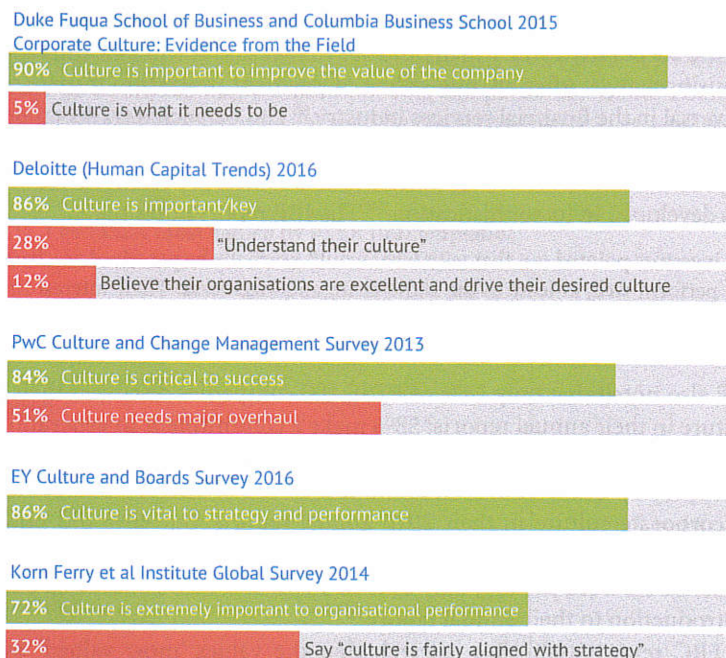
> Some investors pointed out that with what would normally be perceived as a bad culture could perform well, at least in the short term, and vice-versa. Their interest in culture was aroused primarily when it was affecting performance, particularly if it was a well-publicised regulatory breach which had affected the share price.[69]

The IBE also noted that only 14% of FTSE 100 companies discussed their corporate culture in their annual reports; 58% make a commitment to generating value for their shareholders and 47% explain value creation in their business model. A 2016 survey by Grant Thornton found that 86% of FTSE 350 companies mentioned corporate culture in their 2016 annual reports, but 48% did not clearly communicate their organisation's values. Despite wide acknowledgement that the tone must be set from the top, only 21% of FTSE 350 CEOs addressed culture in their introduction to their annual report.[70]

The FRC report itself cites research that the values 'most valued' by FTSE 100 companies are integrity (35%) and respect (28%), whereas responsibility, trust and honesty come noticeably lower, each with 14%.[71] The Chartered Institute of Personnel and Development said upfront that 'it is often said that leaders think they know what the culture is, but rarely fully understand it'. The FRC report said:

> **Understanding culture**
>
> There is strong agreement among stakeholders that a determined effort is required to build a picture from various indirect indicators and proxies of the true culture at different levels in the organisation.
>
> Companies report that they struggle fully to understand the complex chain of interactions that drive individual behaviour. Traditionally, management has focused on the mechanisms, policies and processes that make up the operational framework of the company and which establish boundaries, norms and minimum standards of behaviour.
>
> The realisation that management and boards need to understand and address less tangible drivers of behaviour, such as closely held values and attitudes or social and power-driven pressures, that can lead people to make poor choices is changing the conversation in the boardroom. To do this justice boards need to shift focus and seek new ways of understanding what is really going on in their organisations.[72]

Figure 9.1 illustrates the gap between senior managers' acknowledgement of the need to understand culture and their confidence that they know how to deal with it. The data was reported in a series of studies[73] and is illustrated by Tor Eneroth of the BVC in Figure 9.1. The responses to questions asked in the surveys indicate that while managers are aware of the importance of culture, when asked about their own organisational cultures, the perceptions were not encouraging.



Source: Barrett Values Centre

Figure 9.1: Multiple surveys illustrating the gap between leader's understanding of the importance of culture and their ability to deal with it

Similarly, the IBE report says:

> Dialogue between companies and shareholders on culture and long-term strategy has been improving, but there is a long way to go to open up discussion. Shareholders are heavily focused on performance, often but not exclusively in the short term. Moreover, they do not believe that they can change a 'bad' culture from the outside.[74]

However, the IBE report noted that 'shareholders were not convinced that they had the power or the ability to change a bad culture … Investors generally said a weak culture made them more aware of risk and more likely to sell'.

The OECD's 2015 stocktake of corporate practices found:

> The OECD's results show that even top rank firms struggle with effective implementation and achieving the desired outcomes may take years of dedicated work …
>
> The findings in this report suggest corporate leadership is taking integrity more seriously after the financial crisis. Eighty percent of survey respondents indicated that their company's board was strongly involved in the design and implementation of their company's integrity policy; almost half indicated that the policy was established following a decision by the board. Increased prioritisation of integrity may well have led to an increase in investment in integrity: almost 20% of respondents considered integrity budgets to have increased from 25% to more than 50% over the last 5 years. The way that such budget use is perceived speaks volumes about a company's commitment to promoting a culture of integrity, and the results show that 60% of respondents characterised the use of such budget as an investment, as opposed to an expense. At the same time, some companies are exploring cost-efficient ways to a more holistic approach to the business integrity function, to address breakdowns in communication between the various independent business integrity areas in the company.[75]

EY's 2016 Fraud Survey involved interviews with 2,825 senior executives with responsibility for tackling fraud, bribery and corruption from 62 jurisdictions. This survey found that an alarmingly high number of executives continue to justify unethical acts, more than a third said they would be willing to justify unethical behaviour during an economic downturn, while almost half would justify such conduct in order to meet financial targets.[76] A 2016 survey of workers in 13 countries found that in 10 of the countries, 50% or more of the respondents said they had reported observed misconduct. In 11 out of 13 countries, at least one in three respondents had also experienced retaliation, and 90% of this retaliation occurred within the first six months of the initial report.[77]

In April 2017, a parliamentary committee cited evidence that unethical behaviour is 'absolutely embedded' in the culture of foreign aid contractors.[78] In the same month, the House of Commons' Business, Energy and Industrial Strategy Committee reviewed the UK's corporate governance regime and concluded that it is 'a considerable asset which enhances the reputation of the UK as a place to do business', but needs a series of improvements in view of evidence that 'levels of trust in business are lower than in many other countries', given perceptions of unfairness on executive pay levels and payment of tax.[79] The Committee noted with concern various barriers to engagement by investors in influencing corporate decisions and called for increased dialogue facilitated by the Investor Forum.[80]

So, the current position appears to be that although there is wide recognition that corporate culture is important, many businesses have not yet focused on culture as a contributor to success or perhaps even recognised the value of having an ethical culture. Nevertheless, it is clear that an ethical culture is not only the inescapable ultimate goal of a company that aims for sustainable high performance, but that there are also clear moves in that direction by many major companies and business leaders.

A Shortfall in UK Employee Engagement

In 2014, a study of corporations in 34 countries found that only around 4 in 10 employees were highly engaged.[81] The level of 'employee engagement' in the UK is dangerously low. In 2012, only 27% of employees in the UK were 'highly engaged'.[82] This engagement deficit drove output per hour in the UK that was 15 percentage points below the average for the rest of the G7 industrialised nations

in 2011; on an output-per-worker basis, UK productivity was 20 percentage points lower than the rest of the G7 in 2011. This represented the widest productivity gap since 1995.[83] We have already discussed the correlation between low employee engagement and elevated culture risk.

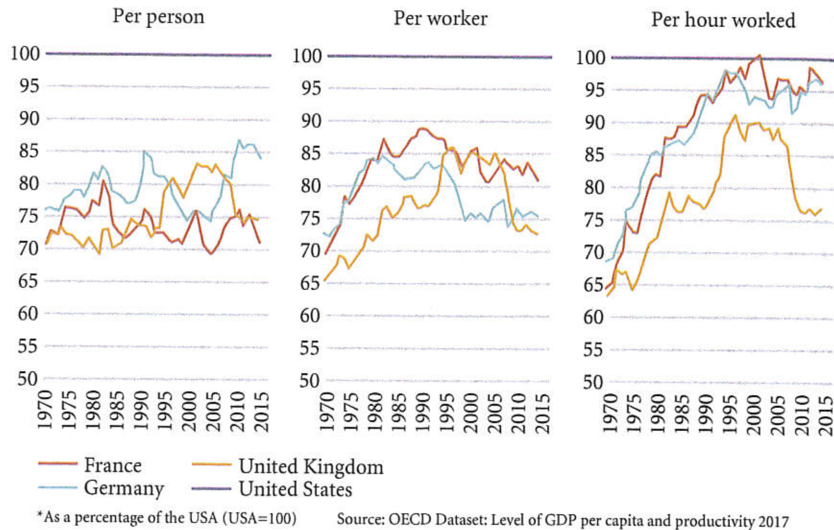


Figure 9.2: Productivity and output in the UK, France and Germany compared to the US

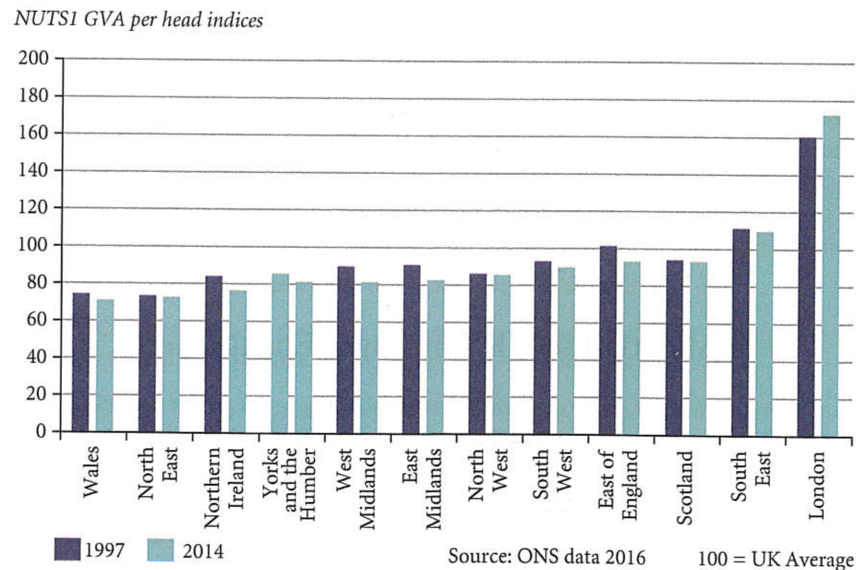


Figure 9.3: Productivity by UK region (1997 and 2014)

The UK government's 2017 Industrial Strategy Green Paper[84] noted that whilst the country had experienced 14% growth since 2010 and unemployment was at its lowest level for 11 years, earnings were still recovering from a substantial decline following the recession of 2008 and productivity was poor, with workers in France, Germany and the US producing on average as much in four days as UK workers did in five (see Figures 9.2 and 9.3). There were significant regional disparities in productivity that were wider in the UK than in other Western European nations, with 61% of people in the UK living in areas with incomes 10% below the national average. Against this evidence, the issue of disaffection by the populace shown in the June 2016 Brexit vote should not be surprising.

The UK National Values assessment by the Barrett Values Centre in 2012 found that the personal values of UK citizens showed that personal relationships were vitally important to them.[85] The values favoured were: caring, family, honesty, humour/fun, friendship, fairness, compassion, independence, respect and trust. However, a far more challenging picture was painted when people were asked about their perceptions of life in the nation. There, people identified bureaucracy, crime/violence, uncertainty about the future, corruption, blame, wasted resources, media influence, conflict/aggression, drugs/alcohol, and apathy as the top ten current culture values.

The Global Level

The latest policy paper by the business group B20, which is attached to the governmental G20 group, does not demonstrate that the importance of ethical values has been grasped by business generally. The 2017 B20 policy paper on 'responsible business conduct and anti-corruption' included a recommendation that compliance efforts by businesses should be 'recognised'.[86] It said:

> **Recommendation 2: Recognize Compliance Efforts – G20 members should be supportive of a company's proactive engagement by providing positive recognition of effective anti-corruption and compliance systems.**
>
> Policy Action 2.1: Acknowledge Adequate Measures—G20 members should recognize corporate compliance efforts when awarding public contracts and when imposing sanctions for breaches, and they should explore additional ways to acknowledge compliance efforts.
>
> Policy Action 2.2: Encourage Self-disclosure and Self-cleaning—G20 members should be encouraged to harmonize their administrative and legal approaches to self-disclosure of compliance breaches, recognize effective and safe internal reporting, and support adequate self-cleaning.
>
> Policy Action 2.3: Promote a Culture of Integrity—G20 should continue its commitment to building a global culture of intolerance towards corruption by reinforcing international cooperation, including the promotion of key international instruments, supporting the provision of capacity building and training for SMEs and in non-G20

countries, as well as improving education on anti-corruption and integrity in schools and universities.

These priorities are the wrong way round. Basing behaviour on an ethical foundation, and hence requiring a culture of integrity, should be the starting point, not the final recommendation. Placing 'recognising compliance efforts' first reflects a US-dominated enforcement policy based on deterrence and large sanctions, based on the assumption that they alone will affect future behaviour. Such an approach will never work. The B20 requests reflect the approach that the authorities incentivise businesses to have a compliance system rather than to act ethically. Hence, the name of the game for businesses is to operate systems to earn lower fines rather than to address their ongoing behaviour.

We suggest that it is time that business leaders and public representatives adopted a fresh approach based on empirical evidence of what works. And this means starting with ethical values.

Conclusions

1. Individuals and commercial organisations can act both commercially and ethically at the same time if they wish to. But if they want to achieve this balanced approach, they need to plan consciously how to balance the competing issues that will arise daily.
2. The classic theory of shareholder value has been criticised and undermined by well-reasoned arguments. New models are company-centred, consider the interests of all stakeholders and facilitate a more long-term view likely to create the conditions for unethical behaviour to diminish.
3. The design of ethical commercial organisations starts with leadership and corporate governance, but also must go further and encompass how everyone in the organisation is going to act and make decisions daily at an organic level. We will discuss these points in greater detail in Part IV.
4. The self-regulation of corporate governance by OECD and in the UK has evolved to be based on the fundamental importance of *values*, by which is meant *ethical values*, but they stop just short of saying so. However, the global debate on compliance is still stuck in an old-fashioned space where compliance systems are thought to guarantee ethical behaviour; they will not and the approach must be modernised.
5. Empirical evidence reveals that employee engagement and hence productivity in the UK are low.
6. Recent reports emanating from the City of London and financial services industry focus on the role of governance in improving behaviour and therefore trust in the sector.
7. The statistics on the extent to which corporate practices and individuals' behaviour is unethical show that there is room for serious improvement.
8. Although senior executives purport to consider culture to be important; in practice they don't seem to pay much attention to it.