

“Group Thinking’ or lack of courage to ask the tough and strategic questions is the chief weakness on Boards today.”

- Pearl Zhu, *Digitizing Boardroom: The Multifaceted Aspects of Digital Ready Boards* (2016)

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Ensuring An Ethical Lens on the Board Member Selection Process ***Due Diligence is a Two-Way Street***

By Annie Searle

Too rarely do companies select a new board member based in part on an analysis of whether a candidate understands the principles of right and wrong and possesses a moral compass. Though Enron is over 20 years behind us, some may recall that eleven different Congressional committees held hearings that examined both Enron and its auditor, Arthur Anderson, and found Enron’s board of directors to be at fault:

“...the Enron Board of Directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive off-the-books activities, and excessive executive compensation.” [1]

That finding ultimately led to the passage of the Sarbanes-Oxley (SOX) Act in 2002. SOX better delineated a board’s oversight role where financial accuracy is concerned, called for board level audit committees made up of outside (independent) directors, required attestation on internal controls and emphasized that directors on boards are responsible for direct supervision of the company. [2]

As reputational or financial losses mount from new technologies, mismanaged vendors, gaps in internal controls or from cyber attacks on publicly traded entities, many boards have paid more attention and modified selection criteria for its members. Technology has become more critical and companies have sought out directors with IT expertise, as they have recruited independent financial experts to sit on their audit committees. The recent focus on specific types of board expertise, be it cybersecurity, environment risk management or something else, is most noticeable for *not* focusing on ethical issues from a board governance perspective. In some cases the social structure of boards, among other factors, has made it more difficult to recruit candidates who bring both the right business qualifications and the proven right value set.

ETHICAL TRAITS THAT CAN INFORM THE BOARD SELECTION PROCESS

In their comprehensive Conference Board white paper, "Ethics and the Board: Integrating Integrity into Business Strategy [3]," its authors discuss the selection of board members in depth, identifying traits that the nominating committee should look for. Running through all these traits is the theme that candidates should be selected because of their qualifications, abilities and integrity above all else. The first trait is *independence* from the CEO or other board members. The second trait that Bonime-Blanc and Brevard identify is *knowledge and analytical abilities* which connect back to the first trait of independence. The third trait identified is *business integrity experience*, for which a background in governance, risk, and compliance (GRC) is desirable because those candidates will likely already have grappled with ethical quandaries. Essential in the actual selection of candidates is an integrity and conflicts review, which may include a background check, "and a thorough vetting and interview process." Finally, firm-specific education of board members, and even of new board candidates, is key. The report recommends an "ethics and compliance review so that they fully understand the company's expectations upon joining the board," as well as a grasp of "the company's code of conduct, SOX escalation procedures, the audit committee's role, and CEO reporting on material concerns."

Questions Boards Should Ask When Considering New Members:

Conversations with a candidate

- Ask candidates to describe a business situation where a project failed and steps the candidate took to make an effective course correction.
- Based on firm-specific scenarios developed for the purpose, ask candidates to describe what decisions they would make and why. This exercise will help the organization better understand the candidate's self-awareness, judgement and decision-making process.

Questions the board should consider

- Can the candidate function as a truly independent director?
- Does the candidate bring the specific qualities the organization is seeking to improve board effectiveness as well as organizational short- and long-term performance?

CAUTIONARY TALES

Well-informed board members bring us one step closer to corporate stability. When board members do not grasp their responsibilities, the risks are exponential. Two quick examples may help: Washington Mutual (WaMu) and Wells Fargo banks. In the former example, most board members were paid, but also rewarded with stock shares or options and felt a deep sense of comradery with the CEO, who was also the chairman of the board. It has been argued that the WaMu board continued to believe in its CEO, believed that matters would improve, right up until the moment that the bank was seized and sold. One can only assume the board was reading the newspapers but drinking the CEO Kool-Aid, believing that their shares and the bank itself would be protected right up until the end.

Wells Fargo is an example of a firm which – on paper – seemed to have a risk management structure highly appropriate to its business, with industry standard positions and processes in place. In reality, the Wells board stands as a classic example of a board with no effective independence from the firm's CEO. Executive management at the Wells retail bank routinely encouraged employees to take unethical actions to inflate performance results, often terminated employees who complained about the practice, and created a

culture that enabled the division to hide those actions from a weak board of directors for years. So weak was the Wells Fargo board of directors that in 2018 the Federal Reserve stepped in to set a \$1.95T asset cap to limit the amount of the bank's growth until it resolved its compliance failures and, at the same time, ordered the bank to replace four of the weakest board members. To this day, it is not clear that the bank's culture has been substantially changed. Remember Peter Drucker when you think of these two banks: "Culture eats strategy for breakfast."

Irony: John Stumpf (Wells CEO) quote from his Financial Crisis Inquiry Commission interview: "culture eats strategy for breakfast every day." [4]

What Boards Should Do:

- Understand that regulators and auditors are examining the overall structure of the firm and are not hesitant to recommend changes in boards of directors where problems persist. This is particularly the case since the global financial crisis in 2008-2009.
- Ensure that the board is diverse. Ensure that a variety of voices and perspectives are heard at the table.
- Ensure that senior management presents directly to the board at least once a year so that the board understands the senior management team and the strategies that are being pursued.
- Discuss whether adding an ethics-centric executive position with meaningful stature (Chief Ethics Officer, Chief Trust Officer, etc.) is appropriate in your organization.

IF YOU'RE CONSIDERING JOINING A BOARD

Conduct appropriate due diligence on the organization and the board itself.

Be cognizant of warning signs:

- **Overconfidence from the C-Suite.** The belief that 'it can't happen here' is suspect. If in fact, the board is not receiving regular, thorough reports directly from the Chief Financial Officer, the Chief Information Security Officer and the Chief Internal Auditor on a quarterly basis, one should ask why not and raise the bar. For each explanation received from the executive team, one should ask how clearly the company's program is explained in terms of importance and relevance, to employees and customers, in a show of 'tone at the top'.
- **Vague or inaccurate responses to questions.** Don't let executives 'dumb down' explanations. Read widely in the company's lines of business, and make sure you receive direct answers to your questions, even if the subjects of inquiry are outside your areas of expertise. It is possible for executives to prepare briefing papers in clear English even though the material may be technical. In each case, the questions of risk and impact to revenues and reputation should be dealt with in addition to the costs being discussed.
- **Issues not on the radar.** Sometimes the CEO and CFO are far removed from important issues developing on the operational side. At each level of the company, analyses may be simplified as they are communicated through the management ranks. In some cases the CEO/CFO may believe that the risk levels are already being managed or should be manageable. In such instances, it is not that the C-suite is trying to conceal information from the board. But one of your primary responsibilities as a board member is to ask questions based on information you've received from other sources or events

experienced by other companies. A prime example of this circumstance would be General Motors, where damaging information and costs were concealed for years. Asking questions is the best way to be sure that the board has all the information from a detailed briefing before making a decision.

Due Diligence Questions Board Candidates Should Ask:

- Examine regulatory (if available), 10K, and audit reports for the past few years. Look for evidence of control gaps and evidence of remedial actions taken to close those gaps.
- Are there consistent patterns, such as mishandling of confidential information?
- Understand the technology capabilities of the firm. Is there adequate redundancy of both inhouse systems and outsourced activities?
- Determine the level of turnover at both the senior management and the executive levels.
- Develop a sense of how hard it will be to make your voice heard in board meetings.

REFERENCES

[1] <https://www.cnn.com/2002/ALLPOLITICS/07/07/senate.enron/index.html>

[2] Sarbanes-Oxley Act, 2000 and "SEC.gov | The Laws That Govern the Securities Industry"
<https://www.sec.gov/answers/about-lawsshtml.html#sox2002>

[3] Bonime-Blanc, Andrea and Brevard, Jacqueline E. for the Conference Board Global Council on Business Conduct. "Ethics and the Board: Integrating Integrity into Business Strategy." Council Perspective CP-013 © 2009 by The Conference Board, Inc. https://www.conference-board.org/pdf_free/councils/TCBCP013.pdf

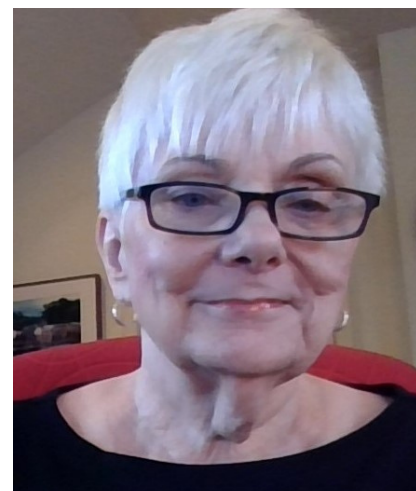
[4] <https://cybercemetery.unt.edu/archive/fcic/20110310171826/http://fcic.gov/resource/interviews#S>
Financial Crisis Inquiry Commission interview with John Stumpf (Wells CEO), 9-23-10

ABOUT THE AUTHOR

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Annie Searle teaches courses in information ethics, operational risk and emerging cybersecurity topics. She spent ten years at Washington Mutual Bank, most of it as a senior executive with dual reporting to the Chief Information Officer and the Chief Risk Officer. Her areas of responsibility included technology architecture, research and planning; vendor and application assessment for information security; technology change management; business continuity and emergency management; enterprise-wide crisis management; and audit and regulatory compliance for the technology group. Portions of this report have appeared previously in Searle's work.



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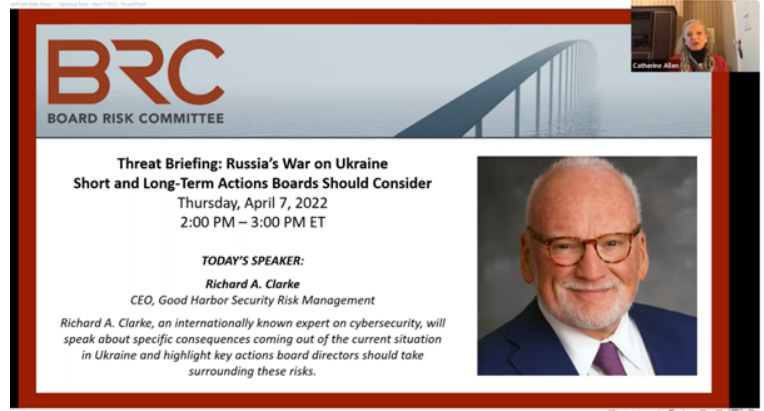
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Click here to access Richard Clarke's recent *Board Risk Report* referenced during the webinar.

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