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PRESCRIPTION AND PRACTICE

Is a Code of Ethics or a Code of Behaviour sufficient to ensure proper behaviour? Or is it intended to supplement rather than supplant a value system based on a strong cultural foundation?

Any civilised society is expected to conduct its affairs in an orderly manner, so that the average citizen knows what he/she can do or cannot do. A corporate, being a subset of society, it stands to reason that it must also operate on the basis of clear and well-articulated principles governing the conduct of the institution as well as the individuals therein. Many companies refer to the document that lays down these broad principles as the Code of Conduct. A Code of Ethics provides principles, whereas a Code of Conduct is generally more prescriptive, but these are essentially variations on the same theme.

Transgressions and violations, which have surfaced in quite a few leading corporates, have made it necessary to address what a Code of Conduct is, and what value, if any, its existence adds to the functioning of that entity. No discussion on the Code of Ethics, as the Code of Conduct is sometimes referred to, can ignore the happenings in Enron more than a quarter century ago. Enron's Code of Ethics was arguably one of the longest documents of its kind, as it sought to address every conceivable detail regarding behaviour and responsibility. In July, 2000, Kenneth L Lay, then Chairman and CEO of Enron Corp, while releasing the Code of Ethics, had appealed to all employees to read, understand and practise the various measures set out therein. The fact that Enron filed for bankruptcy in December, 2001, roughly 18 months after the Code of Ethics was released, demonstrates, if such proof is needed, that having a Code of Ethics is not the same as practicing ethical conduct. Kenneth Lay, the signatory of that Code, which exhorted employees to behave properly, was himself shown as falling hugely short of the basic standards of morality. This ought to serve as a warning signal to those who put out elaborate Codes of Conduct, and decide that their work is done, without ensuring that the Code of Conduct should inform behaviour in the workplace and elsewhere.

Codes of Conduct are not, in their origin, a corporate phenomenon. Religious texts have laid down, in fairly elaborate terms, the dos and don'ts that humankind should understand and practise. Equally, it is not necessary that a document that seeks to capture all ethical principles should be very long or detailed. The Ten Commandments is a classic example of how important behavioural expectations can be captured in one page, without needless elaboration. It might be relevant to mention that Enron's Code of Ethics had as many as 64 pages.

It is useful to look at what some of these codes actually prescribe. The Enron Code of Ethics

mentioned that officers and employees were responsible for conducting the business of the company in a **moral and honest manner**. Off balance sheet arrangements, and dubious accounting techniques, seeking to hide significant liabilities and losses, as well as aggressive accounting practices, cannot, by any stretch of imagination, be said to reflect the conduct of business in a moral or honest manner. Employees were also charged with conducting their business affairs in accordance with the **highest ethical standards**. What transpired in practice was that the single-minded focus on earnings growth, and on meeting market expectations, led to ignoring the basic principles of governance and the avoidance of conflicts of interest. There were trades and Related Party Transactions (RPTs) with no valid business purpose. What is even more strange is that the Board approved arrangements involving the CFO, Andrew Fastow, and the LJM Private Equity Funds, ignoring the obvious conflict created by the CFO's managing entities that did business with Enron. If this was not conflict of interest, it is necessary to ask ourselves what exactly conflict of interest meant to Enron's Board of Directors. The Enron Board, which approved the Code of Ethics, clearly failed in its fiduciary duty to safeguard Enron shareholders.

Closer home is the example of a group that is, notwithstanding recent developments, even now touted as the benchmark for corporate governance and high moral standards. Its Code of Conduct states that **"we will be fair, honest, transparent and ethical in our conduct; everything we do must stand the test of public scrutiny"**. It is to say the least, curious that longstanding and respected members of the group jump into print to defend what is clearly an attempt to deflect public scrutiny. The Code also says that **"we shall strive to balance the interests of our stakeholders, treating each of them fairly and avoiding unfair discrimination of any kind"**. Questions are already being asked whether the largest shareholder group, which is clearly a significant stakeholder, is being treated fairly in the ongoing battle for power.

The Code also states: **"we are committed to enhancing shareholder value and complying with laws and regulations that govern shareholder right"**. If that were true, was it necessary to stay quiet when the Regulator, in March, 2024, laid down what a Core Investment Company should be doing to stay consistent with laws and regulations. Separately, is an ongoing boardroom battle, with no clear winners likely to emerge, in the interest of shareholders and other stakeholders.

As far as Independent Directors are concerned, we do not have to look beyond Schedule IV of the Companies Act, 2013 to figure out the elements of conduct and behaviour that have to be complied with. Unlike most other codes, there appear to be a larger number of dos, than don'ts. There are also some provisions which, on a plain reading, seem to be difficult to comprehend. For example, Independent Directors are not expected to "unfairly obstruct the functioning of an otherwise proper Board or committee of the Board". The question would arise at what stage, active and constructive participation could be interpreted as unfairly obstructing the functioning of the Board.

The RBI from time-to-time issues instructions on what it expects bank Boards to do or not to do. Taken together, these also constitute a Code of Conduct, even if no such label is given to it. Separately, when it comes to dealing with customers, there is a separate body, the Banking Codes and Standards of India, which has laid down a code for customer service that banks are expected to conform to. In addition, there are codes laid down by professional bodies to

ensure certain acceptable standards of conduct by their members.

If all codes, standards and regulatory diktats are taken together, we will find that there has been an overdrive in prescribing, without necessarily having in place the instruments or the bandwidth to ensure effective and speedy compliance. This creates a bigger problem than not having such prescriptive arrangements because such arrangements give rise to expectations, which if not met, create serious problems. What then should the approach be to ensuring orderly conduct?

Firstly, Codes of Conduct should be much shorter and much sharper in focus than they presently are. While even a minor transgression should be discouraged, it is necessary for codes to lay more emphasis on possible major violations, as well as instances of misconduct which have a destabilising influence on the organisation. One principle of criminal law can be suitably imported into such codes. The requirement of *mens rea* could be used to distinguish between serious offences or instances of misconduct, and relatively minor procedural transgressions, which merit no more than a slap on the wrist.

The Code that should inform RPTs has been more than adequately captured in law and regulations. Will it not be possible to articulate the problem elements in much simpler terms, rather than periodically amending the regulations, and creating more confusion than exists at present? We seem to have got to a stage where every RPT is seen not only with suspicion, but with complete distrust, leading Audit Committees, the custodians of the faith, worried about whether they are approving the right transactions. When it comes to Prohibition of Insider Trading, have we, through very strict prescriptive arrangements, stood the principle of jurisprudence on its head, by passing on the burden of proof impliedly, if not expressly, to the person who is alleged to have parted with price sensitive information?

Yet another problem in administering Codes of Conduct is the time taken to deal with complaints, and in some cases, the lack of clarity on the procedure in dealing with such complaints, as also the level at which such complaints ought to be addressed. An elaborate procedure that does not point in the direction of quickly addressing the issue is self-defeating. The quantum of punishment is also a major factor in determining compliance with the Code of Conduct. A just and fair society lays emphasis on the reformative aspect of dealing with delinquents. Can the corporate world live with this liberal approach, while the interests of shareholders, and stakeholders, are exposed to serious risks?

The violation of a Code of Conduct can normally lead only to disciplinary action, but not to other penal consequences. To that extent, it is more an exhortation than a prescriptive arrangement. The limitation of the code should be clearly understood, in that while it can at best deter misconduct and unethical practices, it cannot prevent any of them.

Finally, any Code of Conduct if it is to be understood and followed, must be premised on culture. A value system that is pervasive is far more effective than prescription and enforcement.