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WHITE-COLLAR CRIME

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Corporate Compliance Programs: No Longer Voluntary

A well-developed and effectively implemented corporate compliance program once may have been considered an expensive luxury that business executives believed put them on the cutting edge of best business practices.

Now, such programs are critical — not only to meet the specific dictates of the Sarbanes-Oxley Act (SOX) that took effect in November — but also, under the newly enacted corporate sentencing guidelines, to mitigate consequences to a company when employees' malfeasance subjects the corporation to criminal prosecution. Indeed, a wide array of government and quasi-government rules and programs explicitly provide that the establishment and effective use of compliance programs is a prerequisite for lenient treatment of businesses whose executives run afoul of the law.

Along with SOX and the sentencing guidelines, those rules and programs — including the listing standards of the major stock exchanges and the prosecution and amnesty policies of the Department of Justice, the antitrust division, and the Defense Department, among others — also dictate the form to which such programs must conform.

Organizational Sentencing Guidelines

Extensive amendments to the organizational sentencing guidelines became effective on Nov. 1. The sentencing commission's goal in promulgating the amendments was to "synchronize the guidelines with 'best practices' [and with

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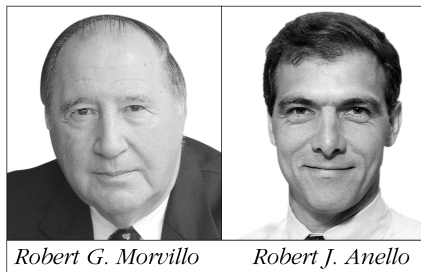

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Sarbanes-Oxley] and other relevant regulatory and administrative initiatives."[1] To that end, the commission created a new, separate guideline, §8B2.1, that "strengthens the existing criteria an organization must follow" to prevent criminal conduct.[2]

The new guideline supplements the requirement that corporations exercise due diligence to prevent and detect criminal conduct by mandating that an organization "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." In addition to requiring the establishment of "standards and procedures to prevent and detect criminal conduct," the new guideline implements this requirement in several important ways.[3]

Most significantly, the new guideline puts the onus of adequate compliance squarely on the board of directors and top-level management. The board of directors is charged with being knowledgeable about the company's compliance program, and the highest-level company executives must ensure that an effective compliance program exists. Moreover, a specific high-level executive must retain overall responsibility for the program, with particular individuals delegated with responsibility for ongoing compliance. Companies must give these individuals adequate resources. The individuals are required to report at least annually to the board on the program's implementation and effectiveness.[4]

Also, under the new guideline, companies are required to audit, monitor and evaluate periodically the effectiveness of their compliance programs. Potential whistleblowers must be permitted to "seek guidance" regarding criminal conduct anonymously and without fear. Compliance and ethics training is a requirement for all employees, including upper-level management, and compliance must be promoted through employee incentives and discipline. Organizations are required to screen personnel so as to eliminate the possibility of hiring individuals who have engaged in illegal activities. Once criminal conduct has been detected within a company, that company must take "reasonable steps" to respond to and prevent further similar offenses. Finally, in implementing these requirements, companies must "periodically assess the risk of criminal conduct."[5]

The amendments also revised and strengthened the criteria for reducing corporate fines for criminal convictions through corporate compliance and ethics programs. They provide an enhanced framework for corporate compliance programs. Under §8C2.5(g) of the guidelines, a successful compliance program is one of the mitigating factors that can reduce a corporation's fine punishment. The absence of an effective program may be a reason for a court to place a company on probation, and the existence of such a program may be a condition of probation.[6]

The Nov. 1 amendments to the organizational guidelines were, of course, drafted before the Supreme Court's decision in *Blakely v. Washington*,[7] although the fate of all federal sentencing guidelines is uncertain until the Supreme Court issues its imminent decisions in *United States v. Booker*[8] and *United States v. Fanfan*.[9] Even if the Supreme Court were to declare the federal sentencing guidelines unconstitutional, sentencing courts likely would still look to the standards enumerated in the organizational guidelines.

Sarbanes-Oxley

Although SOX is two years old, its first significant deadlines are arriving now. U.S.-listed companies with market capitalization of $75 million or more that close their books after Nov. 15 must be in compliance with §404 — the heart of SOX — which provides that publicly traded companies are required to document all of their internal financial controls. Annual reports issued after Nov. 15 for those companies must include a report by management on the company's internal controls over financial reporting and an accompanying auditor's report. The annual reports also must disclose any "material weaknesses" in those controls.[10]

Under the Securities and Exchange Commission (SEC) final rules promulgated pursuant to §404,[11] management in its internal control report must state its responsibility for establishing and maintaining adequate internal controls over financial reporting. Management also must make an assessment of the effectiveness of the internal controls and explain how that assessment was done. Management also is required to evaluate changes in the company's internal controls.

Other sections of SOX determine the components of a successful compliance program as well. Under §302,[12] a company's CEO and CFO must certify to the SEC financial information contained in the company's quarterly and annual reports. Specifically, these officers must confirm that they have reviewed the report, that it contains all material facts needed to render the financial results "not misleading," and that it "fairly presents" the financial condition of the company. Moreover, §302 requires the officers to aver that they are responsible for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal controls. Signing officers also must certify that they have disclosed any fraud or deficiencies in the internal controls to the company's auditors and audit committee and that they have indicated any significant changes to the internal controls in their reports.

As with the organizational guidelines, SOX provides that companies must make provisions for potential whistleblowers. Under §301,[13] audit committees must establish procedures for complaints and for employees to come forward confidentially and anonymously regarding questionable accounting matters. Whistleblowers are given specific protection in §806,[14] which provides them with the right to bring a civil action in the case of retaliation.

Under §406[15] of SOX, companies must disclose in their periodic reports whether they have in place a code of ethics for senior officers and if not, the reasons they do not.

The Stock Exchanges

In part in response to SOX, the New York Stock Exchange (NYSE), the Nasdaq Stock Market (Nasdaq), and the American Stock Exchange (AMEX) revised their listing standards relating to corporate governance earlier this year. Though the three entities drafted slightly different sets of rules for their listed companies, they share some basic requirements that inform how listed companies should shape their compliance programs. All three exchanges have instituted a requirement that a listed company have a code of conduct.[16] The exchanges also mandate that their listed companies provide them with prompt notice after an executive officer of the company becomes aware of any material noncompliance with the corporate governance requirements.[17] The NYSE goes a step further, requiring each listed company CEO to certify each year that he or she is not aware of any violation by the company of NYSE corporate governance listing standards.[18]

The NYSE also goes further in general in its code of conduct standards, which are lengthier and more detailed than those of the Nasdaq and the AMEX. The code for Nasdaq-listed companies simply provides that they must satisfy the requirements of §406 of SOX. By contrast, the NYSE's standards actually state that the following subjects "must be addressed": conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection; proper use of company assets; compliance with laws, rules and regulations; and encouraging the reporting of illegal or unethical behavior.

In both parts of the Justice Department's policy on antitrust violations, corporations must satisfy four criteria: First, the company must take "prompt and effective action to terminate its part in the activity." Second, it must report the wrongdoing "with candor and completeness …." Third, the confession must be truly a "corporate act." Fourth, where possible, restitution is required.

Justice Department Policies

The Department of Justice from time to time sets forth nonbinding statements and policies. In the realm of corporate compliance, two stand out: the DOJ's "Corporate Leniency Policy" concerning antitrust violations and Deputy Attorney General Larry D. Thompson's Memorandum on "Principles of Federal Prosecution of Business Organizations."

Any company that is potentially at risk of being prosecuted for an antitrust violation should tailor its compliance program to the unusual "first-in" policy the Department of Justice has put in place concerning antitrust violations. The Department's "Corporate Leniency Policy"[19] has two parts — one granting leniency for corporations that report illegal activity before an investigation has begun and the other for those who are first in the door with respect to illegal activity, whether before or after an investigation has begun.

In both instances, corporations must satisfy the following four criteria. First, the company must have taken "prompt and effective action to terminate its part in the activity." Second, it is required to report the wrongdoing "with candor and completeness and provide full, continuing and complete cooperation."[20] Third, the confession must be truly a "corporate act" and not merely isolated individual confessions. Fourth, where possible, restitution is required.

In the case of leniency before an investigation has begun, the corporation is not permitted to have "coerce[d] another party to participate" and cannot have been the leader or originator of the illegal activity. In addition, the antitrust division cannot have received information about the illegal activity from any other source.

Under the alternative requirements for leniency, the company has to be "the first one to come forward and qualify for leniency." In that case, the antitrust division cannot yet have any evidence against that company "that is likely to result in a sustainable conviction" and must determine that granting leniency would not be unfair to others.

In his Jan. 20, 2003 Memorandum on "Principles of Federal Prosecution of Business Organizations,"[21] Deputy Attorney General Larry D. Thompson singled out the department's antitrust policy, noting that, although "it is entirely proper in many investigations for a prosecutor to consider the corporation's pre-indictment conduct … this would not necessarily be appropriate in an

antitrust investigation … for which the Antitrust Division has … established a firm policy … that credit should not be given at the charging stage for a compliance program and that amnesty is available only to the first corporation to make full disclosure to the government."

In a later section of his memorandum, the deputy attorney general specifically addresses corporate compliance programs. Although the Department of Justice has no formal guidelines for compliance programs, it suggests that prosecutors ask the following "fundamental questions." First, "is the corporation's compliance program well designed?" Second, "does the corporation's compliance program work?" Prosecutors are urged to consider the comprehensiveness of the compliance program. Specifically, the memorandum directs them to look for corporate governance mechanisms that effectively can detect and prevent misconduct, including ample director independence and information; sufficient staff to audit, document, analyze and utilize the results of the company's compliance efforts; and an adequate system for informing employees about the compliance program so that they become convinced of the corporation's commitment to it.

Voluntary Disclosure

Several government agencies have instituted voluntary disclosure programs, and companies want to be in a position to take full advantage of these. The Department of Defense's (DoD) voluntary disclosure program, for example, has been described by the DoD's inspector general as "not an amnesty or immunity program, but rather a means by which defense contractors can bring to light potential civil or criminal fraud matters." (Purely administrative matters are outside the scope of the program.) In return for disclosing potential fraud and for cooperating in any government audit and investigation, the government generally allows the contractor the opportunity to conduct an internal investigation, which the government then attempts to verify in an expedited manner. The DoD further agrees generally not to initiate administrative actions until its verification process is complete.[22]

Disclosures are made "with no advance agreement regarding possible DoD resolution of the matter and with no promises regarding potential civil or criminal actions" by the DOJ. Although what benefits will accrue to participating contractors is thus not exactly clear, prompt voluntary disclosure and full cooperation are noted in the program as "key indicators of an attitude of contractor integrity even in the wake of disclosures of potential criminal liability." Corporations that have an effective compliance program in place — specifically, one with a successful internal monitoring and reporting system component — will be able to avail themselves of this opportunity should it become necessary.

The Environmental Protection Agency's "compliance incentives" program serves a similar purpose. Its goal is to provide incentives for companies that "voluntarily discover, promptly disclose, and expeditiously correct environmental problems."[23] The EPA rewards these companies by reducing civil penalties, by not recommending criminal prosecution, by not reclaiming financial benefits obtained from noncompliance and by not routinely requesting environmental audit reports.

The Department of Health and Human Services' corporate voluntary disclosure program was set up to "allow increased participation by providers in detecting and preventing Medicare and Medicaid fraud and abuse."[24] To that end, the program encourages corporate health care providers to come forward and disclose potential problems they have discovered. These corporations then may be able to negotiate monetary settlements and to reduce or avoid criminal prosecution.

Required Elements

In light of the broad array of regulators that require a corporate compliance program, no public or regulated company can avoid developing and implementing a bona fide program. Each program must be tailored to the industry and the business activities of the company. The following six components, however, are essential for such programs:

- Every company must draft and implement a code of conduct.
- Under SOX, companies now are required to perform two audits — one financial and a second one for internal controls. The latter is a huge undertaking — involving top management, accountants, attorneys and information technology employees — that requires reviewing and documenting most company transactions.
- The board of directors and top-level management must be involved significantly in compliance. A culture of compliance — from the top down — must be put in place, and every employee must understand that legal and ethical conduct is required at all times. Ethics training is a key component of a successful compliance program, as is feedback to the board.
- A mechanism must exist for whistleblowers to report actual or potential criminal conduct without fear of retaliation.
- Every system, program and policy that is put in place must be evaluated and monitored regularly.
- Companies must keep abreast of developments in regulatory areas of particular concern to them, such as voluntary disclosure programs affecting companies in the antitrust, defense, environmental and health care areas.

Conclusion

The existence of a compliance program never has provided, and does not today provide, a corporation with blanket protection from prosecution. A well-thought-out plan that leads to a true culture of compliance, however, can go a long way toward protecting an organization that comes under scrutiny — when that day arrives.

1. Paula Desio, Deputy General Counsel, United States Sentencing Commission, "An Overview of the Organizational Guidelines," available at http://www.ussc.gov.
2. United States Sentencing Guidelines, Effective Compliance and Ethics Programs in Chapter Eight, Synopsis of Amendment (Nov. 1, 2004), available at http://www.ussc.gov.
3. USSG §§8B2.1(a)(2) & (b)(1) (Nov. 1, 2004).
4. Id., §8B2.1(b)(2) & App. Note 3.
5. Id., §8B2.1(b)(3)-(7); §8B2.1(c).
6. See id., §8D1.4(c).
7. 124 SCt 2531 (2004).
8. 375 F3d 508 (7th Cir.), cert. granted, 125 S. Ct. 11 (2004).
9. 2004 WL 1723114 (D. Me.), cert. granted, 125 S. Ct. 12 (2004).
10. Companies with market capitalization of less than $75 million ("non-accelerated filers") are not required to be in compliance until the first fiscal year ending on or after July 15, 2005.
11. 17 CFR §§210, 228, 229, 240, 249, 270, 274. These rules went into effect on Aug. 14, 2003.
12. 15 USC §7241.
13. 15 USC §78f(m)(4).
14. 18 USC §1514A.
15. 15 USC §7264.
16. See NYSE Listed Company Manual, §303A(10), NASD Manual, Rule 4350-7; AMEX Company Guide, §807.
17. NASD Manual, Rule 4350(m); AMEX Company Guide, §801.
18. NYSE Listed Company Manual, §303A(12)(a).
19. Available at www.usdoj.gov.
20. Under the scenario where a company is the first to come forward, either before or after an investigation is begun, it is required to give cooperation "that advances the [Antitrust] Division in its investigation."
21. Available at www.usdoj.gov.
22. Department of Defense, "Voluntary Disclosure Program: A Description of the Process," available at www.dodig/osd.mil.
23. EPA Compliance Incentives, available at www.epa.gov.
24. HHS Press Release, "Inspector General Announces Procedures for Voluntary Disclosure Program," June 12, 1995, available at www.hhs.gov.

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