

New Compliance And Ethics Standards For Organizations To Take Effect November 1, 2004

The roles of directors and senior management continue to evolve in the post-corporate-scandal world, as shareholders, regulators, and courts require more diligence and skepticism than ever before.

Among the less visible provisions of the Sarbanes-Oxley Act, Section 805 directed the United States Sentencing Commission to review and amend the United States Sentencing Guidelines to ensure that they are sufficient to deter and punish criminal misconduct in organizations. Many organizations had adopted compliance programs in the early 1990s in response to the introduction in 1991 of the Sentencing Guidelines provisions for organizations. Those compliance programs, in the view of many, soon devolved into “paper tigers” that failed to achieve the objective of detecting illegal and unethical business practices. According to one federal study, between 1993 and 2000, 99.6% of the organizations that were sentenced under the federal Sentencing Guidelines were found to have deficient compliance programs. The general consensus within Congress, the Department of Justice, and the regulatory community was that the proliferation of corporate fraud scandals partly reflects the lack of effective compliance programs within many organizations.

On November 1, 2004, the legal landscape for compliance programs will shift. New provisions of the Sentencing Guidelines that apply to organizations¹ will take effect at that time, with one of the most important changes being an emphasis on effective compliance programs and ethics.

Even though it is rare that an organization will actually be convicted of a crime and have its sentence determined under these guidelines, these new provisions deserve serious attention. The new criteria are almost certain to become “best practices,” and the Sentencing Commission’s definition of what constitutes an effective compliance program will be relied upon in many contexts outside of the sentencing process. For example, the potential liability of directors for breaches of the fiduciary duties of care and good faith arising out of organizational misconduct may depend on the strength and vigor of the organization’s code of ethics and compliance program. Failure to have such a program could give rise to a breach of fiduciary duty claim (and bring into question indemnification and exculpation) under the *Caremark*, *Disney*, and *Abbott Labs* line of cases. In addition, when an organization does find itself embroiled in a criminal investigation, the existence of a robust compliance program will be a critical aspect of any effort to persuade a prosecutor to forego criminal charges. Under Department of Justice guidelines, federal prosecutors examine, among other things, whether an organization has an effective compliance program, which is truly enforced by management and which is aimed at preventing wrongdoing by employees. Over the last few years, organizations caught up in criminal investigations have avoided prosecution due, in part, to their ability to persuade prosecutors that they had vigilant compliance programs.

¹ The organizational Sentencing Guidelines apply to all organizations, whether publicly or privately held and of whatever nature, including corporations, partnerships, labor unions, pension funds, trusts, not-for-profit entities, and governmental units.

In anticipation of the November 2004 change in the law, this Client Alert describes the key elements of an effective compliance program under the revised Sentencing Guidelines, and outlines the types of questions and issues every organization should consider to ensure that its compliance program addresses the new standards.

Compliance Programs Under the New Sentencing Guidelines

The revised Sentencing Guidelines place an unmistakable emphasis on the need for organizations to “promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” Indeed, the revised Sentencing Guidelines are now peppered with references to the promotion of ethics and ethical conduct, in conjunction with the need to prevent and detect criminal conduct. The commission’s goal was to add “rigor” to the prior treatment of compliance programs under the Sentencing Guidelines, and to impose “significantly greater responsibilities on an organization’s governing authority (*e.g.*, Board of Directors) and executive leadership.”

The pertinent amendment to the Sentencing Guidelines is entitled “Effective Compliance and Ethics Program” (U.S.S.G. § 8B2.1). In order to achieve the ambitious goal, which is now an expectation, of ethical conduct and a commitment to compliance with the law, an organization’s compliance program must, *at a minimum*, include the following components:

- The organization must adopt standards and internal control procedures to prevent and detect criminal conduct;
- The organization’s Board of Directors (or like body) must be knowledgeable regarding the content and operation of its compliance program, and reasonably oversee its implementation and effectiveness;
- Senior management must ensure the existence of an effective program; and a member or members of senior management must have overall responsibility for the program
 - the person or persons within the organization with day-to-day operational responsibility for compliance must report to senior management and, at least annually, to the Board of Directors as a whole or to a Board committee;
- The organization must provide the person or persons responsible for compliance with adequate financial resources, appropriate management authority, and direct access to the Board of Directors or to a Board committee;
- The organization must use reasonable efforts to exclude from its supervisory personnel any individual who the organization knows, or should know - consistent with employment laws - has engaged in illegal activities or other conduct inconsistent with an effective compliance program;
- The organization must periodically communicate, through compliance and ethics training and other dissemination of information, its standards and procedures to the Board, senior management, supervisory personnel, employees, and, as appropriate, to agents;
- The organization must use monitoring and auditing systems designed to detect criminal conduct, and must periodically evaluate the program’s effectiveness;
- The organization must offer a means for its employees and agents to anonymously or confidentially report actual or potential criminal conduct, without fear of retaliation;
- The organization shall use the carrot and the stick to promote and enforce its compliance program through incentive systems to encourage adherence to the organization’s ethical code, *and* sanctions for non-compliance and for failing to take reasonable steps to prevent or detect non-compliance; and
- Once an organization detects criminal conduct, it must take reasonable steps to respond appropriately and to prevent further similar conduct. The organization must periodically assess the risk of criminal conduct and modify its compliance program to reduce any risk identified in the assessment.

How Should Organizations Respond to the New Sentencing Guidelines?

The adoption of the revised Sentencing Guidelines puts the onus on every organization to take stock of its current compliance program, identify its deficiencies, and determine and make whatever alterations are necessary. The overall goal, as noted above, is to make sure that a compliance program is a vibrant aspect of the organization, as opposed to a policy that is issued by the legal department and promptly assigned shelf space in every office and cubicle. The Sentencing Guidelines specifically recognize that a “one-size-fits-all” approach is not feasible and that the specifics of an organization’s compliance program will necessarily be tailored to the size of the organization, the industry in which it operates, and other distinguishing features. In crafting such a program or reviewing an existing one, organizations should consider the following issues as they relate to the efficacy of its compliance program:

- Is there one clearly identified individual with ultimate responsibility for the management of the organization’s compliance program?
- Can each director identify the individual with ultimate responsibility for the compliance program? Do the directors have a working knowledge about the major risks of unlawful conduct facing the organization and the primary compliance features aimed at addressing those risks?
- How much access does the person in charge of compliance have to senior management, the audit committee, and the Board?
- How often are the compliance program and ethical issues addressed at senior management meetings and at directors’ meetings?
- Are the related policies easily accessible and prominent on the organization’s web-site or intranet site? Have they been translated into all languages pertinent to your workforce? How many employees know whom to contact if they have a compliance issue or ethical concern? What systems are in place, such as a compliance hotline, to encourage anonymous or confidential reporting of concerns?
- How adequate is the organization’s training for its compliance program? Is the training mandatory? How is attendance enforced? Do employees sign annual certifications? How are newly hired employees trained in the compliance program and how much emphasis is placed on compliance and ethics issues during the orientation process?
- What systems are in place to screen potential offenders in hiring for senior supervisory positions?
- How does senior management convey the importance of the compliance program and ethical conduct to employees? What systems are in place to reward ethical conduct? Does the organization have a method of disciplining employees who fail to prevent or detect criminal conduct?
- What systems are in place to assess the efficacy of the program in the wake of the particular business of the organization and of incidents and issues implicating the program? What systems are in place to assess the risks of criminal conduct by employees?
- Should an outside expert be hired to audit the organization’s compliance program and recommend steps to enhance and bolster the organization’s compliance efforts?

The individuals currently responsible for compliance need to step outside their organization and view their compliance programs through the skeptical eyes of a government lawyer or judge who may be called upon to assess the “rigor” of the program at some future date. With an eye towards that perspective, the organization needs to proactively devise methods to breathe life to its compliance program, in order to build a convincing case that the organization truly adheres to the values set forth in its compliance program and ethical code.

Lastly, note that these compliance program requirements are unlikely to be affected by the current constitutional challenges to the Sentencing Guidelines arising from the 2004 Supreme Court decision in Blakely v. Washington. In Blakely, the Supreme Court declared that the State of Washington's sentencing guidelines, which are similar to the federal Sentencing Guidelines, are unconstitutional because they allow a defendant's sentence to be increased based on conduct that was not proven to a jury. While the Blakely decision creates uncertainty for specific aspects of the Sentencing Guidelines, it is unlikely that the Supreme Court will invalidate the entire Sentencing Guidelines system.

Contact Information

If you have any questions or would like to learn more about this new development, please contact your usual legal advisor at Ropes & Gray or any of the attorneys listed below involved in the preparation of this Client Alert.

