

# Corporate Compliance

## Compliance: A Corporate Lifeline

Effective compliance programs help companies, directors, and officers avoid liability, heavy fines, damaging scandals, and bad publicity. They also encourage healthy corporate culture. But what is a compliance program? In very general terms, compliance programs are institutional practices designed to prevent and detect violations of law. Compliance programs focus on accountability, and exist to ensure that corporations conduct business practices in accordance with federal and state law. The United States Sentencing Commission placed special emphasis on compliance programs in 1991 by introducing aggravating and mitigating factors into the basic formula used to calculate fines for violations of federal law. Companies charged with legal infractions could experience significant fine reduction if they had an adequate compliance program in place. Similarly, absence of such a program often serves as an aggravating factor, thereby increasing punitive fines.

The United States Sentencing Commission Organizational Sentencing Guidelines Manual for 1991 notes that the core of effective compliance lies in organizational due diligence designed to detect and prevent criminal misconduct. The Manual lists seven due diligence requirements for contemporary compliance programs.

- 1) The corporation must develop standards and procedures reasonably capable of reducing potential criminal conduct.

The storied fall of Prudential Securities Group, Inc.'s General Counsel and compliance officer Loren Schechter provides a particularly harsh example of just how critical this basic approach to compliance is viewed by governing authorities. In 1994, the SEC accused Prudential of a wide range of inappropriate behavior from unauthorized trading to fraudulently misleading investors. The scandal left Prudential reeling, having spent in excess of \$750 million in legal fees and settlement costs, and brought compliance to the forefront of Wall Street boardrooms. The SEC charged, among other things, that Prudential failed to adequately review, supervise or control employees regarding the creation and distribution of false or misleading promotional materials, and cited one particular group as operating completely outside Prudential's regular supervisory structure. In essence, Prudential failed to control potential for criminal conduct, and certainly failed to detect such conduct once in place. For Schechter, this had repercussions two-fold, not only did he lose his job as General Counsel, he also became the target of a SEC investigation for failing to stop the violations.

What makes a compliance program reasonably capable of reducing potential criminal conduct? Generally, an effective program is one that ingrains compliance with all applicable federal laws firmly within the corporate culture. In other words, employees should conduct themselves in accordance with federal statutes out of habit. Developing and maintaining a compliant corporate culture requires heavy commitment from all management levels. Managers and corporate officers must lead by example. Compliant

operational procedures must be communicated clearly and effectively to all employees, and become part of an ongoing education process. Communication is essential both for education purposes and for administrative efficiency. Because internal auditors and compliance officers cannot possibly monitor every aspect of compliance programs, employees must feel comfortable relying suspicions of inappropriate activity to compliance officers. Finally, systematic internal audits help reinforce approved company practices, and help ferret-out violations.

- 2) The corporation must appoint a senior-level manager to supervise the compliance program.

After identifying the scope of compliance issues, companies must appoint a senior level manager, one who reports directly to the Board, to administer the program. The compliance officer is then responsible for both initial and ongoing internal assessments, and the development of internal controls designed to ensure compliance.

- 3) The corporation must take due care to prevent placing authority in the hands of individuals the corporation knows or reasonably could know have a propensity to participate in illegal activity.

Fiduciary duty makes a clear distinction between the intentional offender and the corporate officer who makes a valid decision that turns out to be wrong. In the latter case, if an officer acts in an informed manner in good faith with the honest belief that their actions are in the best interest of the company, that officer will find protection from liability or losses resulting from such action. The former, however, finds no assistance in the criminal statutes, and will be held responsible for loss. The burden, however, falls on the corporation to identify intentional wrong-doers, or at least those with the potential for misconduct, and to keep those individuals away from positions of authority. Failure to do so violates the tenets of due diligence required for effective compliance, and could expose the corporation to additional liability.

- 4) The corporation must provide adequate training for and disseminate information to all employees regarding compliance procedures and regulation.

The law is constantly changing- the rules that affect daily operations are in constant motion, and companies are held responsible for educating their employees on the latest changes in their field. Corporations today, large and small, use every possible means to communicate compliance programs to their employees. Many companies use email and faxes, and post changes to corporate compliance programs on the company web site. Moving beyond traditional handbooks and occasional memoranda, companies engage in comprehensive compliance training programs on an on-going basis. In another example, one large software firm tapped resources in its own HR and marketing departments to develop a quarterly compliance newsletter in conjunction with each quarter's closings. Some firms conduct topical seminars focusing on key compliance issues like ethics, employment practices, reporting standards, or sexual harassment.

High-technology and Bio-technology firms often regard the issue of educating employees on compliance issues as vital to their own best interests. In any situation where the relative safety of proprietary information lies in the hands of employees, companies do well to protect themselves by implementing both external and internal compliance programs. Often, internal programs place more harsh restrictions and require more strict adherence than do federally mandated external programs.

5) The corporation must take reasonable steps to achieve compliance.

Effective compliance starts with effective compliance teams, which in contemporary terms means a careful combination of legal, human resource, and financial representatives charged with managing compliance programs. The primary responsibility of such compliance groups is to determine what operational activities require compliance programs and establish exactly what those programs must cover. From there, compliance groups can develop appropriate compliance or disclosure programs, and monitor further developments in the field to ensure continued conformity.

Human resource officers should be involved in any communications between corporate officers and employees. Where compliance issues are concerned, human resource representatives help make sure compliance issues are well received and presented in a comfortable tone.

Other steps in practice today to ensure reasonable compliance include the use of external law and accounting firms to stay abreast of latest regulations governing daily operations. Companies cannot be expected to maintain expert status on every federal regulation affecting their business, but they can be expected to hire such experts. Additionally, there are several consultant groups specializing in helping corporations develop and maintain compliance programs.

Internal audit teams mirroring auditing protocols used by regulating agencies are an effective means to ensure compliance standards are being followed by corporate units. Companies that experience yearly or even quarterly audits by regulating bodies implement audit teams designed to perform an internal assessment in anticipation of scheduled compliance audits. Such internal audits are, of course, scheduled with sufficient time to cure any defects.

6) The corporation must consistently enforce standards set forth in the compliance program through reasonable disciplinary action.

Remedial measures for detected violations must be clearly documented and rigidly enforced if the company wishes to satisfy this particular requirement. A compliance program should have clearly defined protocols for detected violations, with special emphasis on disclosure to avoid harsh fines. The United States Sentencing Commission placed special emphasis on voluntary disclosure by placing heavy punitive fines on failure to reveal misconduct. Also, consistency is the precursor of legitimacy,

and must exist to not only satisfy the due diligence requirement but also to encourage internal compliance.

- 7) The corporation must take reasonable steps to respond in the event of non-compliance and to prevent future non-compliance.

Prompt action by the company in the event of non-compliance is the best way to avoid harsh government sanctions. Companies that conduct internal investigations into allegations of misconduct take significant steps to fulfill their obligation to stop unlawful corporate activity. Internal investigations should be authorized in the event that corporate misconduct is likely occurring. In other words, do not wait for the FAA to come sniffing around on a Qui Tam action before launching an internal investigation. In addition to the compliance standard, conducting an internal investigation offers the company the opportunity to enter into potential litigation fully informed, and so best positioned to protect its own interests. Public disclosure demands full knowledge as well. Internal investigation should be conducted by external professional consultants specializing in corporate investigations. Results of such investigations should be reported directly to the Board, orally and in writing, so that the Board can decide on the appropriate course of action. In general, regulating bodies would prefer non-obtrusion, and therefore encourage companies to both disclose misconduct and take swift action to correct procedural defects. Such action on the company's part may serve as the cement binding all other due diligence elements in a single, comprehensive compliance program.

A practical lesson.

Assaults on corporate business practices are often couched in terms of a failure of fiduciary duty of care on the part of corporate officers in monitoring the company's compliance program, illustrating all too well the need for top-down understanding of how compliance works. Generally, corporate officers are charged with the duty to act in good faith in the best interest of the company at all times. This includes development and administration of effective compliance programs. Liability for corporate misconduct flows to the top, as the executives of Caremark International, Inc. learned in 1996. Caremark International settled a massive shareholder derivative action asserting that Caremark failed to protect shareholder's interests by failing to operate in compliance with applicable federal law. Indicating its support for the shareholder's claims, the court in the Caremark action stated that failure of a corporate officer's fiduciary duty subjects that officer to liability for losses resulting from that failure. In so doing, the Caremark court shifted compliance programs from a suggested business practice designed to avoid excessive fines to an affirmative duty of corporate officers designed to avoid criminal liability.