SEMI-TOUGH: A SHORT HISTORY OF COMPLIANCE AND ETHICS PROGRAM LAW

Jeffrey M. Kaplan, Partner
Kaplan & Walker LLP

Remarks Presented on May 16, 2012

“Groucho: Just how tough are you? Chico: You pay little bit, we’re little bit tough. You pay very much, very much tough. You pay too much, we’re too much tough.” Monkey Business

This paper provides a short history of the compliance-and-ethics (“C&E”) program-related law – and offers some thoughts about its (somewhat uncertain) future.

Background on the Federal Sentencing Guidelines for Organizations

There is no one place where the law relating to C&E programs – referred to in this paper as “C&E program law” - begins. Early antecedents include, but are not limited to, the internal controls requirements of the Foreign Corrupt Practices Act of 1977; informal policy of the US Department of Justice’s Fraud Division dating back to 1988 providing that prosecutors should consider defense contractors’ C&E programs in determining whether to bring charges against such organizations in criminal investigations; provisions of an insider trading law passed in 1988 which created enforcement-related incentives for organizations to take preventive measures in this area; and in the “STAR” program of the Occupational Health and Safety Agency which provided regulatory relief to businesses that committed to taking certain strong compliance measures.

However, without question the most important development in this area was the advent of the Federal Sentencing Guidelines for Organizations (the “FSGO” or “Guidelines”) in 1991.

The FSGO were developed in response to the Sentencing Reform Act of 1984, the main purpose of which was to create sentencing guidelines for individuals convicted of federal crimes. Such guidelines were promulgated in 1987 by the U.S. Sentencing Commission (“the Commission”), which then took up the task of creating guidelines for organizations. Initially, the Commission considered an “optimal penalties” approach (based on what could be considered

2 Memorandum of William Hendricks, Fraud Division’s Chief to United States Attorneys, discussed in Kaplan and Murphy, Compliance Programs and the Corporate Sentencing Guidelines (West 2011 Rev.) (cited as “Kaplan and Murphy.”)
4 As described in Sigler and Murphy, Interactive Corporate Compliance: An Alternative to Regulatory Compulsion, (Greenwood 1988).
“Chicago School” economics) which had no direct C&E-program guidance or incentives. But in response to lobbying by business groups, the Commission ultimately turned to a model that incented companies to develop C&E programs (called at the time “effective program[s] to prevent and detect criminal conduct”), principally by providing for the possibility of very large fines, but also by the prospect that an organization with an effective C&E program at the time of its offense could receive a substantially more lenient punishment than would otherwise be the case.

The Guidelines were indeed path-breaking, not only because they provided the first broad-based incentive for organizations to implement formal C&E programs, but also because they set forth governmental expectations (albeit in a broad way) of what such programs should entail – the now well-known “seven steps.” These included written standards, program oversight, training, means to receive reports of suspected wrongdoing, discipline for violations, and auditing. All of these had long been, of course, a matter of sound risk management, but with the Guidelines they assumed something akin to the force of law.

The 1990s

Prior to the advent of the FSGO, there were a relatively small number of companies – mostly in the U.S. – that had C&E programs. The Guidelines prompted many such organizations to review and, as needed, revise their programs to meet the FSGO’s expectations – which, in effect, became a new standard of accountability in the C&E realm. The Guidelines also prompted a fair number of other companies to develop C&E programs. Reflective of these developments, the first trade association for C&E officers – the Ethics Officer Association – was formed in 1992.

Presumably owing to the fact that the FSGO penalty provisions were not applied retroactively, there were no very large fines imposed under the Guidelines for several years after they went into effect. However, by the end of the decade, there had been a few of these – including a $100 million fine imposed on Archer-Daniels-Midland in 1995 (for antitrust violations), a $340 million fine for Daiwa Bank in 1996 (for banking related offenses) and a $500 million one on Hoffman-LaRoche (another antitrust case). These and other prosecutions helped make the case that developing an effective C&E program was good for business.

There were several other major law-related developments in the 1990’s that contributed to the growth of C&E programs:

---

6 The history of the drafting of the Guidelines can be found in Chapter 2 of Kaplan and Murphy.
7 However, the Guidelines excluded antitrust offenses from such mitigation.
9 Now the Ethics and Compliance Officer Association.
The “Holder Memo” – issued in 1999 - which provided (among other things) that pre-existing C&E programs should be considered, at least in some instances, by federal prosecutors in determining whether to bring charges against business organization. (The Holder Memo was revised in 2003 by then Deputy Attorney General Larry Thompson; again in December 2006 by then Deputy Attorney General Paul J. McNulty; and again in 2008, when it was incorporated into the U.S. Attorneys’ Manual.\(^{10}\)

- Several decisions of the U.S. Supreme Court holding that, in certain circumstances, an organization could escape liability and/or punitive damages in hostile environment sexual harassment cases if, among other things, it had an effective sexual harassment compliance program in place at the time of the wrongdoing.\(^{11}\)

- A ruling by the Delaware Chancery Court that, broadly speaking, imposed C&E program-related fiduciary duties on corporate directors,\(^{12}\)

- Several subject-matter specific developments promoting C&E programs.\(^{13}\)

During this period, C&E programs were becoming more commonplace, at least in the U.S. Indeed, the EOA, which had only 12 members in 1992 when it was founded, had 632 members by 2000.\(^{14}\) The country outside the U.S. with the strongest C&E legal regime was Australia – where a national standard for C&E programs was implemented in 1998 and applied in certain law related contexts.\(^{15}\) Also, the Canadian Competition Bureau established compliance program guidelines in 1997.\(^{16}\)

**2001-2004**

This was the period that by far had the most important legal developments in this field, and which could be considered the “golden age” of C&E law. Among these developments were:

- Several landmark incidents of wrongdoing in businesses (often financial reporting related) involving such prominent companies as Enron and WorldCom. These instances helped demonstrate the need for more preventive efforts. They also drew unprecedented

---


\(^{12}\) In Re Caremark Int’l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).


\(^{14}\) Sentencing Guidelines: The First Ten Years, n. 8 above.


\(^{16}\) These were amended in 2008. See http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/02732.html.
attention to the role of organizational culture in fostering crimes in business.\textsuperscript{17}

- Adoption of a policy by the Securities and Exchange Commission ("SEC") in 2001 that provides (among other things) for giving credit in enforcement decisions to issuers with C&E programs.\textsuperscript{18}

- Passage of the Sarbanes-Oxley Act in 2002, which created several C&E-program-related expectations for public companies.\textsuperscript{19}

- Adoption by the New York Stock Exchange\textsuperscript{20} and NASDAQ\textsuperscript{21} of corporate governance listing requirements with several C&E mandates.

- Publication of highly detailed C&E program guidance from the Office of Inspector General of the Department of Health & Human Services\textsuperscript{22} and other risk-area-specific C&E program mandates/guidances.\textsuperscript{23}

- Enactment of laws by several states requiring sexual harassment training in business organizations.\textsuperscript{24}

But more important than any of these, from the prospective of shaping C&E program expectations, were the 2004 revisions to the FSGO, which made the definition of an effective C&E program far more detailed and rigorous than that found in the original seven steps. Among other things, these revisions:

- Created an expectation of C&E risk assessments, which the FSGO presents as a foundational element to an effective program.
- Articulated program-related expectations of boards of director and senior management, and also regarding day-to-day program management.\textsuperscript{25}

\textsuperscript{17} See In Re WorldCom, First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, Nov. 4, 2002, available at http://fl1.findlaw.com/news.findlaw.com/wp/docs/worldcom/thornburgh1strpt.pdf at 63 (describing a “culture of greed which may be said to have permeated top management…”)


\textsuperscript{20} NYSE Rule 303A.10.

\textsuperscript{21} Nasdaq Rule 4350(n).


\textsuperscript{23} Such as those related to money laundering provided by Patriot Act - Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, Pub. L. No. 107-56, § 352(a) (2001).

\textsuperscript{24} E.g., California’s AB 1825.
• Included in the consideration of an effective C&E program an organization’s culture, based, in part, on the above-mentioned lessons from Enron and WorldCom.

• Added to the purely law/compliance focus of the definition of an effective program an ethics dimension.

• Also included consideration compliance-related incentives in the definition of an effective program.

• Enhanced expectations around other program elements, such as training and communications.

• Set forth expectations regarding self-assessing the efficacy of programs.26

During this period, C&E program law was still largely a U.S. phenomenon, but with some exceptions. One example of what could be called the Guidelines approach being adopted outside the U.S. was the passage of a statute in Italy in 2001 that created enforcement-related incentives for C&E programs – initially in the context of corruption cases, but since applied to a wide variety of other areas.27

2005-Present

This period is much harder to categorize in any broad way than the prior ones, as there has been both forward and backward movement with respect C&E program law.

The most promising developments from this period lie in the anti-corruption realm. That is, principally due to a rapid increase in this period of FCPA enforcement actions, many companies started to create or enhance anti-corruption compliance programs, with some spill-over to C&E general program areas. Among the reasons for this strong approach to anti-corruption compliance was that:

• The internal controls provisions of the FCPA make C&E directly relevant to the consideration liability.

• The prosecutors responsible for this area of law (the Department of Justice’s Fraud Division) have spoken publicly about the importance of C&E programs more than have

25 Among other revisions, the 2004 revisions set forth the expectation that the board must be “knowledgeable about the content and operation” and “exercise reasonable oversight with respect to the implementation and effectiveness” of the compliance program.

26 The current version of the FSGO can be found at


- Large FCPA fines\footnote{29A list of the largest fines under the FCPA can be found at http://www.fcpablog.com/blog/2011/4/8/jj-joins-new-top-ten.html.} have made the business case for strong compliance in this area particularly compelling.

- Large fines have also led to an unprecedented number of Caremark claims, which has caused corporate directors to pay greater attention to the compliance in this area.\footnote{30Grow, Bribery investigations spark shareholder suits, Reuters, Nov. 1, 2010 available at http://www.reuters.com/article/2010/11/01/us-bribery-lawsuits-idUSTRE6A04CO20101101.}

Indeed, this period also saw the imposition of other large fines, particular in the areas of pharma fraud and abuse and – both inside in the U.S. and elsewhere - antitrust (competition) law.\footnote{31A list of some of the largest federal criminal fines generally can be found at http://www.corporatecomplianceinsights.com/risk-assessment-biggest-mega-fines/.} In a sense, then, it took about 15 years for the penalty provisions of the FSGO to fully come into play.

Additionally, developments outside the US concerning anti-corruption enforcement and compliance have led to an unprecedented expansion of C&E programs globally. The two principal events here are:

- In December 2009, a working group of the Organization of Economic Cooperation and Development (“OECD”), representing the thirty OECD member nations (including the United States) and eight other countries, issued its “Recommendation for Further Combating Bribery of Foreign Public Officials in International Business Transactions,” which, among other things, provides that member countries should encourage companies “to develop and adopt adequate internal controls, ethics and compliance programmes or measures for the purpose of preventing and detecting foreign bribery.” A few months later, the working group issued its “Good Practice Guidance on Internal Controls, Ethics and Compliance” for anti-bribery compliance programs, which, like the revised FSGO, provide considerable detail on compliance program expectations.\footnote{32Available at http://www.justice.gov/criminal/fraud/fcpa/docs/oecd-good-practice.pdf. See also Murphy & Boehme “OECD Adds Three Words to its Anti-bribery Recommendations” (Ethikos, March 2010).}

- In 2010, a bribery act went into law in the United Kingdom, which both expanded the prospect of organizational liability for corruption and also incented anti-corruption compliance programs by creating a defense relating to such programs. Subsequently, the
U.K. Ministry of Justice issued an influential anti-corruption compliance program
guidance for business organizations.\textsuperscript{33}

Another important legal development from this period was the further revision of the
FSGO in 2010. While not as sweeping as the 2004 revisions, the 2010 amendments did enhance
independence-related expectations for C&E officers.\textsuperscript{34} Such expectations were also reinforced in
various settlements (deferred prosecution or non-prosecution agreements) setting forth C&E
program expectations of the defendant organizations.\textsuperscript{35}

There were numerous other, subject-matter-specific legal development which promoted
C&E programs, including (but by no means limited to) those having to do with government
contracting\textsuperscript{36} and energy utilities.\textsuperscript{37}

In a different vein, the financial meltdown of 2008 has also been important to C&E
programs in two ways. First, it demonstrated how important incentives and organizational culture
are to compliance risk and mitigation. Second, it led to the Dodd-Frank Act of 2010, which,
among other things, involved the SEC offering large financial awards to whistleblowers in
certain cases, which further enhanced the business case for strong programs.\textsuperscript{38}

During this period, the C&E profession continued to expand, as reflected in the growing
memberships of the ECOA – and of a newer C&E trade organization, the Society of Corporate
Compliance and Ethics.

However, as indicated above, during this period the C&E picture became increasingly
mixed. At least based on anecdotal evidence, by the end of this period, many companies had
begun to cut back on their commitment to C&E programs, although obviously they did not do so
in any public way.

Some observers believe that the problem lies with government agencies who (with the
above-noted exception of the Fraud Division of the Justice Department) have failed to provide
any meaningful indication that effective C&E programs do in fact matter in enforcement

\textsuperscript{33} Available at \url{http://www.justice.gov.uk/legislation/bribery}.
\textsuperscript{34} The FSGO are available at \url{http://www.ussc.gov/Guidelines/2011_guidelines/Manual_HTML/8b2_1.htm}. See
also Greenberg, \textit{Perspectives of Chief Ethics and Compliance Officers on the Detection and Prevention of
Corporate Misdeeds} (Rand 2009).
\textsuperscript{35} See, e.g., this corporate integrity agreement involving Eli Lilly and Company \url{http://lilly.com/Documents/CIA.pdf}.
\textsuperscript{36} FAR 52.203-13.
\textsuperscript{37} Federal Energy Regulatory Commission, Revised Policy Statement on Enforcement, Docket No. PL08-3-000, par.
57-60 (May 15, 2008).
\textsuperscript{38} Pub. L. No. 111-203, § 922(a), 124 Stat. 1376 (2010). Under section 922 of the Dodd-Frank Act, the SEC is
required to pay cash bounties of 10-30% of a recovery to a whistleblower who provided original information
concerning any violation of securities laws that results in a recovery of more than $1 million.
decisions. This has been examined in detail in a 2009 report by the Conference Board\textsuperscript{39} and a 2011 draft report by the Ethics Resource Center.\textsuperscript{40}

In effect, while the FSGO C&E program provisions are clearly tough as written, as applied, they may more accurately be characterized as only semi-tough. And, to follow the “Marxist” economic logic at the beginning of this paper (meaning Chico – not Karl), this has caused many C&E programs to be only semi-effective.

Yet at the same time some companies have cut on C&E others have developed programs of unprecedented scope and rigor. These tend to be organizations that do business in highly regulated areas, and also companies whose managements and boards truly understand the business case for strong C&E. Among the hallmarks of such organizations are paying real attention to promoting an ethical culture and, in some instances, appointing an independent C&E officer.

So, in 2012 we are in a world of increasing divide between C&E “haves” and “have-nots.”

\textbf{Conclusion: What Lies Ahead for C&E law}

I basically see two possible scenarios, with the most likely real-world outcome being some combination of both.

In the good scenario for C&E programs:

\begin{itemize}
\item The U.S. government finally develops a sound approach to making the most of the Guidelines and related C&E laws through, among other things, communicating about actual cases.
\item The application of C&E requirements generally, and regarding culture, incentives and independent C&E officers in particular, continues to expand in the U.S. (i.e., with application to other governmental bodies\textsuperscript{41} and to other areas of law such as antitrust\textsuperscript{42}).
\item C&E expectations continue to go global as new anti-corruption mandates expand to cover more parts of the globe.\textsuperscript{43}
\end{itemize}

\textsuperscript{40} Published May 1, 2012, available at http://fsco.ethics.org/FSGO
\textsuperscript{41} E.g., as New York Country District Attorney did in 2010. Memo from Chief District Attorney Daniel R. Alonso to All Assistant District Attorneys, May 27, 2010, at 9.
\textsuperscript{43} Organic Law 5/2010. For example, a new Spanish law extending the potential for criminal sanctions to organizational misconduct is discussed at
• The almost certain increase of large fines outside of U.S. (due to governments increasingly needing funds) leads global companies to see more clearly the economic logic of strong preventive measures.

• C&E professionals develop more compelling approaches to program design and deployment.

In the bad scenario, none of the above happens to any meaningful degree. Instead:

• The government allows C&E to be sacrificed to the cause of business necessity.  
• The C&E profession fails to make progress in gaining independence and developing compelling approaches to programs.  
• C&E becomes absorbed into general area of risk management, and even more programs are, in effect, “hollowed out.”

As of this writing, recent news offered support for C&E pessimists and optimists alike. The former can point to the FCPA scandal involving Wal-Mart – a company which had what seemed to be a strong C&E program – as showing the limits of internal C&E measures. But at around the same time, the Justice Department and SEC took the apparently unprecedented step of publicly crediting a pre-existing C&E program as a reason to decline to prosecute an organization (Morgan Stanley – in an FCPA prosecution involving one of its former employees). If Justice and the SEC use this case as a model for promoting C&E programs, we could one day have a world of C&E programs that are “very much” – rather than merely being “semi” – tough.


44 Examples include efforts to weaken the FCPA and certain provisions of the “JOBS Act.”