Corporations, Securities & Antitrust

How the Proposed Amendments to the Organizational Sentencing Guidelines Will Affect Corporate Compliance and Ethics Programs

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On April 29, 2010, the U.S. Sentencing Commission ("Commission") submitted to Congress proposed amendments to, *inter alia*, the sentencing guidelines applicable to business organizations ("Organizational Guidelines") in Chapter 8 of the U.S. Sentencing Guidelines Manual ("U.S.S.G.").[1] The amendments, unless Congress acts to the contrary, will become effective on November 1, 2010.[2]

Because the Organizational Guidelines inform the design and implementation of business organizations' compliance and ethics programs and reporting structures, businesses should consider whether to change their existing compliance and ethics programs and structures in light of the proposed amendments. In particular, the Commission submitted to Congress an amendment that would allow an organization to receive credit for having an effective compliance and ethics program even if high-level personnel were involved in criminal conduct, but only if several conditions are met. These conditions include establishing a direct reporting line between those with operational responsibilities under the compliance and ethics plan and the board of directors or audit committee. Organizations that do not already have such a direct reporting line of authority will need to consider whether to change their reporting structure in order to secure credit for an effective compliance and ethics program, even if high-level personnel are involved in criminal conduct.

This article will provide a brief overview of the current organizational guidelines, summarize the amendments the Commission proposed to Congress and relevant debate surrounding each, summarize contemplated amendments that the Commission decided not to propose, and highlight some practical considerations in anticipation of the amendments.

I. Overview of the Current Organizational Guidelines

The Organizational Guidelines' purpose is to "provide just punishment, adequate deterrence, and incentives for organizations to maintain internal mechanisms for preventing, detecting, and reporting criminal conduct."[3] The Organizational Guidelines accordingly authorize courts to require guilty organizations to pay restitution, remedy past or prevent future harm caused by the offense, perform community service, and provide notice of the offense to victims.[4] To provide organizations with further incentive to prevent, detect, and report criminal conduct, the Organizational Guidelines allow courts to reduce an organization's "culpability score"[5] if the organization had "an effective compliance and ethics program" in place at the time of the offense. Separately, an organization can also receive varying levels of credit for reporting the criminal conduct to the government, fully cooperating with the government's investigation, or accepting responsibility for the criminal conduct.[6]

An organization cannot benefit from a pre-existing effective compliance and ethics program, however, if the organization, "after becoming aware of the offense, . . . unreasonably delayed reporting the offense to appropriate governmental authorities,"[7] or if the offense involved either "high-level personnel"[8] of the organization or individuals with oversight or operational responsibilities for compliance.[9] A rebuttable presumption that the organization did not have an effective compliance and ethics program exists for any organization whose "substantial authority personnel"[10] were involved in the criminal conduct and for small organizations (of less than 200 employees) whose high-level personnel were involved.[11]

The Organizational Guidelines set minimum standards for "effective" compliance and ethics programs and provide both general objectives and specific minimum requirements for such programs.[12]

Generally, a compliance and ethics program is "a program designed to prevent and detect criminal conduct."[13] To accomplish this end, an organization must design its program with two objectives in mind: "(1) exercise due diligence to prevent and detect criminal conduct; and (2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."[14] The Commission intended for the latter "cultural" requirement "to reflect the emphasis on ethical conduct and values incorporated into recent legislative and regulatory reforms, such as those provided by the [Sarbanes-Oxley] Act [of 2002]."[15]

Specifically, the Organizational Guidelines impose seven minimum requirements for an effective compliance and ethics program:

(1) The organization must establish "standards and procedures to prevent and detect criminal conduct";[16]

(2) The organization's "governing authority"[17] must exercise reasonable oversight over the program, identified "high-level personnel"[18] must have overall responsibility for the program, and identified individuals with adequate resources and authority, including direct access to the governing authority or an appropriate sub-group thereof, must have day-to-day operational responsibility for the program;[19]

(3) The organization must use reasonable efforts to exclude from "substantial authority personnel"[20] positions any persons with a history of conduct "inconsistent with an effective compliance and ethics program;"[21]

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(4) The organization must take reasonable steps to train and inform personnel regarding the program;[22]

(5) The organization must monitor, audit, and evaluate the effectiveness of its compliance and ethics program and provide a means for personnel to ask questions or report potential violations;[23]

(6) The organization must promote, enforce, and incentivize compliance with its compliance and ethics program, including appropriately disciplining violators;[24] and

(7) The organization must respond appropriately to detected criminal conduct and take reasonable steps to prevent further similar conduct, including modifying its compliance and ethics program.[25]

An effective compliance and ethics program must also be "reasonably designed, implemented, and enforced" to be "generally effective in preventing and detecting criminal conduct."[26] Importantly, this standard requires only a "reasonable," "generally effective" program, recognizing that employees or agents might commit criminal acts even under the most extensive compliance and ethics programs, and the Organizational Guidelines recognize that the offense for which the court is sentencing the organization cannot preclude the organization from receiving a lower culpability score for its program.[27] Were it otherwise, no organization could receive any benefit under the Organizational Guidelines for having an effective program.

Finally, an organization must periodically review its compliance and ethics program and "design, implement, or modify" aspects of the program that correspond to the seven specific requirements listed above to address any changes in the organization's risk of criminal conduct.[28]

Despite the ubiquity of public discussion regarding organizations' compliance obligations, many organizations have yet to adopt any compliance or ethics program. According to the Commission's 2009 Sourcebook for Federal Statistics, during the United States government's 2009 fiscal year ("FY 2009"), all ninety-six organizational defendants against whom the sentencing court imposed a fine and for whom it specified its reasons under the fine guidelines had no compliance program at all.[29] The consequences can be dire: according to the Commission, the average criminal fine across all organizational defendants who received a fine was more than $17 million in FY 2009.[30]

II. Amendments Proposed to Congress

In addition to several technical or conforming amendments, the Commission proposed several substantive amendments to the Organizational Guidelines.

A. Credit for an Effective Compliance and Ethics Program Even if High-Level Personnel Were Involved

Very few organizations have ever received credit under the Organizational Guidelines for having an effective compliance and ethics program. According to public testimony, since the government's 1995 fiscal year, only three organizations received a reduction in their culpability scores for having an effective compliance plan.[31] Public comment suggested that, at least anecdotally, the dearth of reductions in culpability scores for having an effective compliance and ethics plan was due to the fact that rarely would an organization be able to show a lack of involvement by "high-level personnel."[32]

On January 21, 2010, the Commission proposed an "issue for comment" that would allow an organization to receive credit for an effective compliance program even if "high-level personnel" were involved in the conduct, under certain conditions.[33] After receiving public comment and testimony, the Commission proposed to Congress an amendment based on this issue for comment. As proposed, the amendment provides that an organization may still get credit for an effective compliance and ethics program, notwithstanding high-level personnel's involvement in the criminal conduct, if:

(i) the individual or individuals with operational responsibility for the compliance and ethics program . . . have direct reporting obligations to the governing authority or an appropriate subgroup thereof (e.g., an audit committee of the board of directors);

(ii) the compliance and ethics program detected the offense before discovery outside the organization or before such discovery was reasonably likely;

(iii) the organization promptly reported the offense to appropriate governmental authorities; and

(iv) no individual with operational responsibility for the compliance and ethics program participated in, condoned, or was willfully ignorant of the offense.[34]

If Congress does not modify or reject this proposed amendment, organizations might have to change reporting structures in order to maintain their eligibility to receive the effective program reduction in their culpability scores. This restructuring might be difficult if, for example, an organization designed its current reporting structure to meet the requirements of the current Organizational Guidelines, which only require personnel with day-to-day operational responsibility to report periodically to the governing authority, or an appropriate subgroup thereof, and to have only direct "access" to the governing authority or a subgroup thereof.[35]

The amendments proposed to Congress include an application note defining the "direct reporting obligations" referenced in (i) above, in response to public comment criticizing the ambiguity of the phrase,[36] as:

[A]n individual has "direct reporting obligations" to the governing authority or an appropriate subgroup thereof if the individual has express authority to communicate personally to the governing authority or appropriate subgroup thereof (A) promptly on any matter involving criminal conduct or potential criminal conduct, and (B) no less than annually on the implementation and effectiveness of the compliance and ethics program.[37]

The Commission intended for this proposed amendment to respond to the concerns that the current conditions on receiving credit for an effective compliance and ethics program are too restrictive "and that internal and external reporting of

criminal conduct could be better encouraged by providing an exception to [those conditions] in appropriate cases."[38] Additionally, the Commission explained that the proposed application note defining "direct reporting obligations" was in response "to public comment and testimony regarding the challenges operational compliance personnel may face when seeking to report criminal conduct to the governing authority of an organization and encourages compliance and ethics policies that provide operational compliance personnel with access to the governing authority when necessary."[39]

Despite this effort to increase the number of organizational defendants who might benefit from the effective compliance and ethics program credit, public criticism of many elements of the proposed amendment create doubt that the amendment will accomplish this objective. Several public comments criticized the prompt self-reporting requirement (iii), because it is redundant with another Organizational Guideline that rewards self-reporting (thereby potentially over-emphasizing self-reporting) and because the question of whether conduct was criminal is not always apparent, even after an internal investigation.[40] Additionally, public comment suggested that the discovery requirement (ii) is inconsistent with the Organizational Guidelines' acknowledgment that even an effective compliance and ethics program may not detect and prevent all criminal conduct and that the direct reporting requirement (i) fails to accommodate different reporting structures and organizational sizes.[41] Even the U.S. Department of Justice ("DOJ"), a strong supporter of requirements (ii) and (iii) above, expressed concern that the governing authority—even the audit committee—might not be responsive enough to accomplish effective reporting of criminal conduct, but the Commission declined to adopt the DOJ's proposed revision that would allow for direct reporting to either the organization's general counsel or the governing authority (or an appropriate subgroup of the latter).[42]

Organizations and their advisors should closely monitor any congressional debate regarding this proposed amendment because it appears that the Commission did not mollify many concerns raised in the public comments, in contrast to its responsiveness to concerns with the proposed amendment discussed below.

B. New Application Note Regarding an Organization's Response to the Discovery of Criminal Conduct

The amendments proposed to Congress include a new application note regarding an organization's response, under an effective compliance and ethics program, to the discovery of criminal conduct—the seventh minimum requirement for an effective compliance and ethics program. Currently, no application note addresses this particular requirement.[43] The Commission believes that the revised proposed amendments to the application note "may encourage organizations to take reasonable steps upon discovery of criminal conduct" and is "consistent with factors considered by enforcement agencies in evaluating organizational compliance and ethics practices."[44]

The application note, as proposed to Congress, stresses that an effective compliance and ethics program must address two specific issues upon discovery of criminal conduct. First, the organization must take "reasonable steps, as warranted under the circumstances, to remedy the harm resulting from the criminal conduct."[45] Such steps "may include, where appropriate," restitution, other forms of remediation, self-reporting, or cooperation with authorities.[46] As originally proposed, the amended application note stated that an organization "should take reasonable steps to provide restitution and otherwise remedy the harm resulting from the criminal conduct."[47] But after public comment included concerns about how the proposed application note might affect parallel or related civil litigation, the Commission adopted the more deferential, advisory language proposed to Congress.[48]

Second, the organization "should act appropriately to prevent further similar criminal conduct," including making any changes to its compliance and ethics program "necessary to ensure the program is effective.[49] The amendment initially included a suggestion that an organization "may take the additional step of retaining an independent monitor to ensure adequate assessment and implementation of [any such] modifications,"[50] but public comment raised the concern that, although technically precatory, such an express reference to monitors might over-encourage courts to impose outside monitors.[51] The Commission dropped the express reference to an independent monitor and only proposed to Congress a more general reference to the retention of an "outside professional advisor" for that purpose.[52]

The Commission's responsiveness to public criticism of the amended application note regarding discovered criminal conduct was exceeded in several instances, described below, where the Commission dropped contemplated amendments after critical public comment.

III. Amendments Dropped after Public Notice & Comment

The Commission proposed several amendments on January 21, 2010, that it ultimately did not propose to Congress. These contemplated amendments would have expressly required high-level and substantial authority personnel and employees to be aware of document retention policies and organizations to modify such policies as their compliance risks changed.[53] Public comment critical of such amendments generally argued that these amendments did not appear to be necessary to resolve any actual issues and were unrealistically over-burdensome for large organizations that might have numerous policies for different types of records.[54]

The Commission also dropped two controversial amendments to the Organizational Guidelines applicable to organizational probation. The first would have allowed courts to impose independent monitors as a condition of organizational probation, and this met with criticism from public comment for promoting the overuse of controversial independent monitors.[55] The second would have allowed unscheduled facilities inspections of organizations on probation, beyond the inspections of books and records and interviews of knowledgeable company personnel permitted under the current Organizational Guidelines.[56] Although enforcement agencies supported the latter amendment,[57] the Commission did not propose either amendment to Congress. The Commission did, however, propose amendments to

organizational probation that would eliminate a distinction in the existing Guidelines between the conditions of probation available to enforce a monetary penalty and those available for any other reason.[58] Under the amendment, all conditions of probation are available whenever probation is available.

IV. Practical Advice for Preparing a Response to the Proposed Amendments

The most controversial amendment proposed to Congress is the amendment that would remove the absolute bar to receiving effective compliance program credit if a high-level official was involved in the criminal conduct. Given the practical and bureaucratic challenges involved in changing any compliance function, organizations would be well-advised to decide, if they have not already, whether and how they will modify their compliance structures to secure the benefits of their compliance and ethics programs under the Organizational Guidelines against criminal conduct by high-level personnel.

More generally, compliance planning requires organizations to make judgment calls in light of experience and the best information available to them about their likely legal, business, and reputational risks, given the nature and location of their operations. Compliance planning also includes planning for misconduct to occur, given the inability of even the most efficient and comprehensive compliance programs to eliminate completely the risk of non-compliance. And compliance planning is not limited to compliance with the Organizational Guidelines; several other U.S. agencies have adopted their own requirements for effective compliance programs.[59] Organizations must be aware of which agencies' requirements apply to them.

Given the unpredictability of compliance challenges facing any business organization and the Organizational Guidelines' frequent reliance on vague reasonableness standards, it is important for a business organization to make informed, deliberate, and documented decisions when designing, implementing, assessing, or modifying its compliance and ethics program. Any decisions about compliance risks and the allocation of (often limited) compliance resources should be made under the assumption that someday the organization will need to defend its decisions before a skeptical regulator, prosecutor, or court. The Commission's proposed 2010 amendments to the Organizational Guidelines are, however, significant enough to justify the time and expense required to re-calibrate existing compliance programs.

Endnotes

1 Sentencing Guidelines for United States Courts, 75 Fed. Reg. 27,388, 27,394-27,395 (May 14, 2010). Unless otherwise noted, all references to the U.S.S.G. are to the Guidelines Manual and Appendices effective November 1, 2009. "Organizations" are legal persons other than individuals, 18 U.S.C. § 18 (2006), including "corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations." U.S.S.G. § 8A1.1, app. n.1.

2 *See* 28 U.S.C. § 994(p) (2006).

3 U.S.S.G., Ch. 8, Introductory Commentary.

4 U.S.S.G. §§ 8B1.1, 8B1.2, 8B1.3, 8B1.4.

5 *See generally* U.S.S.G. §§ 8A1.2 (explaining how to calculate an organization's sentence and the relevance of the "culpability score"), 8C2.5 (explaining how to calculate a "culpability score").

6 U.S.S.G. § 8C2.5(f)(1), (g).

7 U.S.S.G. § 8C2.5(f)(2).

8 "'High-level personnel of the organization' means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest. . . ." U.S.S.G. § 8A1.2, app. n.3(b).

9 U.S.S.G. § 8C2.5(f)(3)(A).

10 "'Substantial authority personnel' means individuals who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization. The term includes high-level personnel of the organization, individuals who exercise substantial supervisory authority (e.g., a plant manager, a sales manager), and any other individuals who, although not a part of an organization's management, nevertheless exercise substantial discretion when acting within the scope of their authority (e.g., an individual with authority in an organization to negotiate or set price levels or an individual authorized to negotiate or approve significant contracts). Whether an individual falls within this category must be determined on a case-by-case basis." U.S.S.G. § 8A1.2, app. n.3(c).

11 U.S.S.G. § 8C2.5(f)(3)(B); § 8C2.5, app. n.1.

12 The current minimum standards became effective on November 1, 2004, and were the Commission's response to Congress's instruction in the Sarbanes-Oxley Act of 2002 to "review and amend, as appropriate," the Organizational Guidelines to ensure they "are sufficient to deter and punish organizational criminal misconduct." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 805(a)(5), 116 Stat. 802 (2002) (codified as a note to 28 U.S.C. § 994); *see* U.S.S.G. Supp. app. C., amend. 673 (Nov. 1, 2004). Before November 1, 2004, the Organizational Guidelines allowed for a reduction in culpability score for organizations that adopted an "effective program to prevent and detect violations of law," the "hallmark" of which was the exercise of "due diligence in seeking to prevent and detect criminal conduct by [the organization's] employees and other agents." *See* U.S.S.G. § 8A1.2, app. n.3(k) (2003). In turn, the Organizational Guidelines provided seven "types of steps" as the minimum amount due diligence in an effective program: (1) "establish[ing] compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct," (2) assigning to "[s]pecific individual(s) within high-level personnel of the organization . . . overall responsibility to oversee compliance with such standards and procedures," (3) "us[ing] due care not to delegate substantial discretionary authority to individuals whom the organization knew, or should have known through the exercise of due diligence, had a propensity to engage in illegal activities," (4) "tak[ing] steps to communicate effectively its standards and procedures to all employees and other agents, e.g., by requiring participation in training programs or by disseminating publications that explain in a practical manner what is required," (5) "tak[ing] reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution," (6) "consistently enforce[ing] [the standards] through appropriate disciplinary mechanisms, including, as appropriate, discipline of individuals responsible for the failure to detect an offense. . . .," and (7) "tak[ing] all reasonable steps to respond appropriately to [an] offense and to prevent further similar offenses—including any necessary modifications to its program to prevent and detect violations of law." *Id.* The Organizational Guidelines stated that the precise actions necessary would vary with the size of the organization, the likelihood of certain offenses given the nature of the organization's business, and the organization's prior history. *Id.*

13 U.S.S.G. § 8B2.1, app. n.1.

14 U.S.S.G. § 8B2.1(a).

15 U.S.S.G., app. C, amend. 673, Reason for Amendment.

16 U.S.S.G. § 8B2.1(b)(1).

17 Defined as "(A) the Board of Directors; or (B) if the organization does not have a Board of Directors, the highest-level governing body of the organization." U.S.S.G. § 8B2.1, app. n.1.

18 *See supra* note 8.

19 U.S.S.G. § 8B2.1(b)(2).

20 *See supra* note 10.

21 U.S.S.G. § 8B2.1(b)(3).

22 U.S.S.G. § 8B2.1(b)(4).

23 U.S.S.G. § 8B2.1(b)(5).

24 U.S.S.G. § 8B2.1(b)(6).

25 U.S.S.G. § 8B2.1(b)(7).

26 U.S.S.G. § 8B2.1(a).

27 U.S.S.G. § 8B2.1(a) ("The failure to prevent or detect the instant offense does not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct.").

28 U.S.S.G. § 8B2.1(c).

29 U.S. Sentencing Comm'n, 2009 Sourcebook of Federal Sentencing Statistics, Table 54, http://www.ussc.gov/ANNRPT/2009/Table54.pdf (last visited May 16, 2010); see id. n.1 (explaining why the remaining 81 cases sentenced out of a total of 177 cases against organizational defendants did not include a fine).

30 United States Sentencing Comm'n, 2009 Sourcebook of Federal Sentencing Statistics, Table 52, http://www.ussc.gov/ANNRPT/2009/Table52.pdf (last visited May 16, 2010); *see id.* n.2 (noting that the Commission counted a fine imposed on multiple defendants jointly or severally for each defendant, likely resulting in overstatement of the average fines imposed).

31 David Debold, Chair, Practitioner's Advisory Group, Testimony Before the U.S. Sentencing Comm'n, at 4 (Mar. 17, 2010) ("PAG Letter").

32 *See, e.g., id.* at 4; Letter from Susan Hackett, Sr. Vice President & General Counsel, Association of Corporate Counsel, to the U.S. Sentencing Comm'n at 8 (Mar. 17, 2010) ("ACC Letter").

33 75 Fed. Reg. 3,535 ("(A) the individual(s) with operational responsibility for compliance in the organization have direct reporting authority to the board level (e.g. an audit committee of the board); (B) the compliance program was successful in detecting the offense prior to discovery or reasonable likelihood of discovery outside of the organization; and (C) the organization promptly reported the violation to the appropriate authorities[.]").

34 75 Fed. Reg. 27,394.

35 U.S.S.G. § 8B2.1(b)(2)(C).

36 ACC Letter at 8-9.

37 75 Fed. Reg. 27,394.

38 75 Fed. Reg. 27,395.

39 *Id.*

40 *See, e.g.,* PAG Letter at 5-6; ACC Letter at 9-10; Written Statement of Cynthia Hujar Orr on behalf of the Nat'l Ass'n of Criminal Def. Lawyers at 5-6, 8, Mar. 17, 2010 ("NACDL Statement").

41 *See* NACDL Statement at 8.

42 *See* Letter from Jonathan J. Wroblewski, Director, Office of Policy and Legislation, to the Hon. William K. Sessions III, at 20-21 (Mar. 22, 2010) ("DOJ Letter").

43 *See* U.S.S.G. § 8B2.1, cmt.

44 75 Fed. Reg. 27,395.

45 75 Fed. Reg. 27,394.

46 75 Fed. Reg. 27,394.

47 Sentencing Guidelines for United States Courts, 75 Fed. Reg. 3,525, 3,535 (Jan. 21, 2010).

48 *See, e.g.,* NACDL Statement at 5-6.

49 75 Fed. Reg. 27,394.

50 75 Fed. Reg. 3,535.

51 *See, e.g.,* ACC Letter at 4 ("[T]he Guidelines should not suggest that appointment of a monitor to address remediation going forward is some kind of common best practice that a company would choose, nor should it be a necessary consideration as a show of good faith in cases where such an extreme option is not warranted.").

52 75 Fed. Reg. 27,394.

53 75 Fed. Reg. 3,535.

54 *See, e.g.,* PAG Letter at 3-4; ACC Letter at 4-5, 7; NACDL Statement at 7.

55 75 Fed. Reg. 3,535; PAG Letter at 1-2; ACC Letter at 5-7; NACDL Statement at 6-8.

56 75 Fed. Reg. 3,535.

57 *See* DOJ Letter at 18-19; Letter from Cynthia Giles, Assistant Administrator, Environmental Protection Agency, to Michael Courlander, United States Sentencing Comm'n, at 1 (Mar. 22, 2010); Letter from Lois J. Schiffer, General Counsel, National Oceanic and Atmospheric Administration, at 1 (Mar. 22, 2010).

58 75 Fed. Reg. 27,394-27,395.

59 *See, e.g.,* U.S. Attorney's Manual, Principles of Federal Prosecution of Business Organizations, 9-28.800 (the U.S. Department of Justice's Corporate Compliance Program); Final Rule: Compliance Programs of Investment Companies and Investment Advisors, Exchange Act Release Nos. IA-2204, IC-26299, File No. S7-03-03 (effective Feb. 5, 2004); Contractor Code of Business Ethics and Conduct, Federal Acquisition Regulations 52.203-13 (Apr. 2010); Dep't of Health & Human Servs., Publication of the OIG Compliance Program Guidance for Hospitals, 63 Fed. Reg. 8,987 (Feb. 23, 1998).