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Shark-Infested Waters: The New (And Much More Aggressive) Role of Regulatory Oversight and What You Can Do to Keep Your Company Clean

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Whether you work in a small legal department with a handful of lawyers or a large department spanning multiple continents, the importance of managing the behavior of your business clients in this increasingly regulated environment is paramount. The aggressiveness of civil and criminal law enforcers has never been higher. Recent cases involving financial statement fraud, bribery, misleading disclosure, and improper marketing practices (to name a few) have resulted in multi-billion dollar fines, jail sentences, job losses, debarment from government contracts, huge legal bills and other penalties which are unprecedented in modern times. Corporate legal departments should be dedicating significant time to counseling, training and, perhaps most importantly, maintaining a high degree of visibility in their clients' activities to ensure their companies do not appear on the radar screens of the regulators and suffer years-long investigations with uncertain and potentially catastrophic outcomes. This paper examines the most common pitfalls companies experience and suggests some simple, easy steps lawyers and compliance staff can take to avoid this fate.

How Did We Get Here?

It is tempting to blame the growth in regulatory oversight of corporations on the scandals of the last decade, combined with the near collapse of the global economy and the emergence of political forces which believe government oversight is the solution for all our ills. The reality is, all of these circumstances have converged to create an environment in which every misstep is viewed with suspicion and investigated with vigor. Whether we choose to accept this new world, compliance-centric order as the most efficient or productive means by which corporations should operate misses the point. We got to this point because of the snowball effect brought on by corporate greed, hubris, miscalculation and inattentiveness. Perhaps it all began with Enron.

The Enron scandal represented corporate malfeasance at its worst. Led by a single-minded management with a voracious appetite for making money whose sole purpose was to enrich its executives at the expense of its investors, the fraud that was perpetrated upon the public was breathtaking. The creation of offshore entities to hide losses, the intentional misstatement of its public financial reports and the unheard-of riches bestowed upon its officers came crashing to an end when a member of Enron's accounting staff blew the whistle. The fraud left investors with losses never before seen in history.

What is striking about Enron is that the culture of corruption and wrongdoing was woven into the fabric of the company. While instances of malfeasance sometimes can be blamed on the "lone wolf" or the "rogue employee," Enron was unique in that the very purpose of the company was corrupt and those leading it unabashedly convinced that its way of doing business was perfectly acceptable. With almost no checks and balances built into Enron's way of doing business, company management brought fraud and deceit upon the public to new levels, and in so doing evoked a regulatory and public backlash we see to this day.

The reaction to Enron was swift and far-reaching. In 2002, with almost no dissent and with astonishing speed, the U.S. Congress passed the Sarbanes-Oxley Act, a sweeping piece of legislation intended to prevent future Enron-type scandals. Among other things, SOX aims to regulate all aspects of public company behavior. From requiring a maze of internal controls, financial reporting obligations, and whistleblowing provisions, SOX changed the game forever. But did it stop the bad behavior?

As it turns out, the scandals kept coming. Worldcom, led by its CEO Bernard Ebbers, committed an $11 billion fraud by underreporting expenses and overinflating revenue. The founders of Adelphia Communications were more brazen – they simply stole the company's money and tried to hide their theft with fraudulent accounting entries. Corporate greed and opulence were never more glaring than with Dennis Kozlowski, CEO of Tyco, whose notoriously extravagant lifestyle (a $30 million apartment in New York, including $6,000 shower curtains, and a $1 million party for his wife, all paid for by Tyco) was legendary. Seemingly disgusted with this behavior, jurors convicted Kozlowski for paying himself nearly $100 million in unauthorized bonuses, artwork and other property.

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The list of bad acts continued. From the insider trading case involving Joseph Nacchio at Qwest Communications, to the options backdating cases of recent years and the Siemens bribery scandal, culminating in perhaps the most shocking financial fraud ever – Bernard Madoff – it is clear that there is no shortage of players in the corporate and financial worlds with bad, if not evil, motives. Behavior that years ago may have been viewed as acceptable, or "just the way business is done," is now looked at with skepticism under a microscopic lens by government investigators and prosecutors emboldened by the outrageousness of these scandals and given wide latitude to right these wrongs. Perhaps there is no better example of this than the prosecution of corporate bribery (once thought of as a "normal" way to do business, but now outlawed through the Foreign Corrupt Practices Act and other regulatory regimes in place worldwide). Often thought of as just how business is done, paying off officials to get business is now widely sanctioned and vigorously prosecuted worldwide.

WHERE ARE WE NOW?

So unless you didn't notice, the game has changed. For us lawyers and compliance officers, we now are charged with the responsibility to mind the store, "gatekeepers" if you will. The landscape surely looks different with "Compliance and Ethics" now occupying a critical position in nearly every public company and increasingly in privately-held corporations as well. Any company which has not institutionalized the compliance function in some form or fashion is behind the times. For those companies, the question is not if, but when, trouble will come knocking.

Although there is plenty of discretion as to how far a company needs to go in its push towards establishing an effective compliance program, in today's world no one should consider this an option. SOX of course mandates effective internal controls and compliance procedures. Beyond that, the U.S. Sentencing Guidelines for corporations prescribes a list of criteria to be analyzed in determining the harshness of a sentence for a company which has committed a violation (focusing in excruciating detail on all aspects of an effective compliance program). Globally, regulators in just about every region of the world have asserted their presence. Suffice it to say that the absence of an effective compliance program in the eyes of the regulators is an aggravating factor in determining the punishment for a corporation found to have committed a violation, and with the government holding all the cards, does not bode well for that corporation when fines and other penalties are imposed.

While in many cases the increased push toward driving compliance into organizations found its roots in U.S. scandals, the growth of regulatory oversight is a global phenomenon. Governments from across the globe are working together to detect, investigate and prosecute compliance violations. The breadth of the enforcement effort is staggering and includes public company financial reporting and disclosure oversight, anti-bribery and anti-corruption efforts, and increased antitrust, import/export, data privacy, insider trading, health and safety, and environmental regulation, to name a few.

The question is not whether you will experience a regulatory problem, but when. It is virtually impossible to be perfect in every area of compliance and undoubtedly problems will surface. The challenge for us is to follow a formula for compliance, a series of best practices to be more precise, which will lessen significantly the chances that your company, its officers and directors, and perhaps even you, will get swept up in a scandal which you should have seen coming and could have prevented.

WHAT YOU SHOULD BE DOING

Much has been written about the role of the in-house lawyer in managing risk and driving compliance throughout the organization. Undoubtedly the lawyer will be tasked with making sure the company does not violate the laws of the various countries and jurisdictions where it does business. However, in many instances the corporate in-house lawyer may be faced with a dilemma and potentially get caught in a conflict situation. This results from the tension that may arise due to the many hats that the in-house lawyer may be asked to wear at any given time. For instance, as "trusted advisor," the in-house lawyer must be a resource for his or her clients – someone whom the company's senior management and its employees can come to for advice. Issues concerning attorney-client privilege and, perhaps more importantly, the willingness of management and employees to seek out the lawyer's advice and views may be adversely impacted if the lawyer is also charged with acting as corporate "cop" whom the regulators look to for rooting out and, in some cases disclosing, wrongdoing.

Many companies have sought to solve this problem by bifurcating the roles held by compliance staff and lawyers, in essence splitting the roles into separate departments. Companies need to carefully consider the ramifications of

appointing one person to the dual roles of Chief Legal Officer and Chief Compliance Officer (and blending all of the responsibilities required of compliance and legal personnel). However, there is no doubt that in-house counsel, whether they like it or not, will have measurable, if not significant, responsibility to ensure that sound corporate compliance behavior exists in the company, and that it becomes part of the company's DNA. This can only be done with the support and visibility of the Board and senior management.

This support has often been referred to as the "tone at the top." Others have described good compliance practices as being an integral part of a company's "culture." No matter how one characterizes it, the critical factor that drives a sound compliance program is that the program is fully supported at all levels, starting with the Board of Directors to the CEO and the rest of senior management. In some companies, this may involve a sea change in the way business has been conducted. In other companies, it is nothing more than formalizing, in a sound compliance program, what has been the corporate culture all along.

Nothing challenges the corporate culture more than the argument that compliance and robust business are incompatible. The skeptics say the only way deals can get done is if rules are stretched, if not broken. Make no mistake, the only way culture shifts can occur is with some measure of pain. But to focus on the short-term potential negative effect of walking away from a corrupt deal misses the point. The issue is whether this way of doing business is sustainable. In today's world, the answer is a resounding no.

That is not to say that we live in a world of absolutes – black or white, so to speak. We all know there are shades of gray and that is where judgment, reason and good old fashioned common sense come into play. Our job as lawyers and compliance officers is to bring that judgment to our stakeholders with a view towards changing the previously unwritten way of doing business – with a wink and a nod ("everyone else does it, this is just the way things are done!") – in other words, changing our cultures. A challenge indeed, but it starts with us.

Also important is creating an environment where transparency is encouraged, good corporate values are reinforced, and retaliation for bringing possible violations to light is eliminated. Anonymity in the reporting process helps with this concern, but the better way to inculcate your organizations with compliant cultures is to promise, and indeed follow, strict non-retaliation practices.

However, the tone at the top is not enough. In too many cases, top management has been stellar in its own behavior and in designing a best in class compliance program on paper, only to have employees "in the middle" continue to engage in practices and behaviors that invariably lead to violations of law, lawsuits, investigations and other avoidable consequences. Management has to avoid the temptation to convince itself that putting in place a compliance department, hiring compliance staff, sending nice-sounding messages and other superficial measures will be enough. Rather, the "tone at the top" has to become more than that – a "tone throughout" so to speak. In other words, the effort has to be effective. How that it is done is not cast in stone.

THE BASICS

If your companies are not already doing so, there are some basics that every company should follow at a minimum. They may seem obvious, but they are worth mentioning here:

1. Design a Program: Every company should have a plan, a program if you will, laying out how its compliance function will work. Budget should be set aside, staff with a compliance "mission" should be dedicated, and someone, a Chief Compliance Officer, should be in charge and held accountable. The Chief Compliance Officer should have a seat at the table with other top executives (and the Board) and be given meaningful leeway to drive compliance throughout the organization.

2. Conduct a Directed and Focused Risk Assessment: Every company is different. We operate in different industries and countries. We come in all different sizes, public and private. We face different regulatory regimes. Our success and failure is driven by varying macro- and microeconomic forces, politics, trends, markets and customers. The efficacy and skill of our management and the corporations they oversee are critical. Working as teams with everyone pulling in the same direction often drive our ultimate success.

Nevertheless, none of our companies can succeed if we are unaware of the risks we face. Each company has to assess those risks both theoretically and in practice. This assessment should be done by staff appointed specifically to lead the compliance effort for the company and it must be thorough and realistic. Once the company identifies its risks, it needs

to move to the next step, namely establishing "rules of the road," often referred to as policies, that set the boundaries of permissible and unacceptable practices and behavior. These policies should be simple, straightforward and easily understandable by everyone in the company.

3. Policies: Companies accept as dogma the creation of policies to cover just about every situation. While there is no doubt that policies serve an important purpose, proceed with caution before you draft and publish a policy that covers everything from soup to nuts regardless of the relevance of that policy to the business of the company, the regulation applicable to the company or the risks facing it.

All too often policies are written that are verbose, overly technical, incomprehensible and, after all is said it done, ignored. Lawyers have to accept that most people do not actually read the policies, and this is especially true if policies are written in legalese. Rather, policies should be written simply and clearly, and must be short. Anything more than 2 or 3 pages will get lost in the shuffle.

4. Communication: A compliance program which sits on the shelf gathering dust does no good to anyone. Management must communicate often with its employees about the compliance activities of the company, current issues in the world and the company's markets which influence how the company does business. In some sense, senior leaders need to become evangelists. The downside risk, of course, is that your employees may feel over-saturated with messages, alerts and announcements to the point that they tune out. Resist the temptation to abandon a robust communication plan merely because the employees are tired of hearing about it. Clearly a balance must be struck, but it would be hard to argue to a regulator or a jury which may be weighing the company's fate that it over-communicated. Almost always, penalties imposed by governments or liabilities assessed by juries result from companies that never or rarely talked to its employees about good corporate citizenship.

5. Training: Of all things your compliance plan achieves, training may well top the list. A company gets into trouble basically for two reasons: it intentionally engaged in the bad conduct (in which case it deserves what it gets – the best compliance program in the world cannot stop intentional wrongdoing) or its employees were unaware of their obligations. The only way to truly avoid the latter situation, in addition to the other steps outlined here, is to educate your employees.

Training can be delivered in a myriad of ways. With the advent of web-based delivery media, online training has emerged as an efficient and cost-effective way to bring employees up to speed on the risks they face and what they need to do to avoid getting the company or themselves into trouble. Again, a balance must be struck. Not infrequently, employees will complain about the time and effort involved in taking training. Hopefully those complaints will not persuade management to lower its standards. If nothing else, an effective training program will reduce the overall risk level and demonstrate to the outside world that the company is committed to raise awareness, train its employees and shield the company from claims that its compliance program was merely window dressing.

6. Ongoing Due Diligence and Compliance Testing: Good compliance training is like environment: you have to do it continually in order to experience the benefits of a good program. All too often programs are put in place and forgotten. Sound and ongoing due diligence requires that you, as the lawyer, remain close to the business, understand the issues as they occur and respond quickly and effectively. In-house counsel also has to be aware of developments in the business in order to spot potential compliance issues. For instance, at a given point in time you may implement policies and training around a set of activities which you believe the business is conducting only to learn a year later that this activity was outsourced to a third party thereby requiring a different approach to the compliance problem. This may be the classic dilemma that the "left hand didn't know what the right hand was doing." In any case, it is not enough to stand idly by – the lawyer must be aware and constantly probe his or her corporate clients regarding the company's current and planned activities.

Additionally, the lawyer must test, on a continual basis, the efficacy of the company's compliance effort and ask, what is working and what is not? Query whether the policies are being reviewed and understood. Try to find out whether the training your clients have undergone was helpful and facilitated changes in behaviors. Be aware of ongoing legal developments so that compliance practices can be fine-tuned. The key is that the compliance program is getting constant care and attention and is being adjusted to meet changing conditions for the company, both internally and externally.

7. Hotlines and Whistleblowing: In the U.S., one of the key hallmarks of a successful compliance program is a reporting mechanism by which employees can report suspected wrongdoing or otherwise bring to the attention of

compliance staff issues, questions, comments or other observations that will lead to corrective action. However, the legal and cultural tensions which revolve around this issue for global companies have to be addressed, particularly as they relate to personal privacy, data privacy and similar concerns. For the most part, however, regulators will look to this feature of a compliance program as a critical aspect of effective self-monitoring. If employees do not have an easy, frequently anonymous means by which they can report possible violations, the ability of corporations to detect wrongdoing is severely hampered. With telephonic and on-line, web-based reporting tools (in most cases handled by an independent, third party), company employees have a convenient way of reporting their concerns and easily facilitating an inquiry by the company with a view towards resolving the issues at hand.

8. Transparency and Lessons Learned: Alleged and proven violations of law, internal and government investigations and lawsuits tend to be shrouded in secrecy by corporations. However, employees want to feel they can trust their management (and vice versa), and part of any good trust-building exercise requires a good deal of openness and transparency. An innovative approach to driving good behavior into the culture of a company suggests that exercises in "lessons learned" that are openly shared and discussed can be an effective tool for understanding what happened and, even more importantly, for fixing the problem and making sure it does not happen again. Town halls, newsletters and other open idea-sharing when things have gone wrong should all be considered as an integral part of creating a partnership between the company and its employees in the compliance-building process.

9. Discipline: An unfortunate aspect of any good compliance program is that eventually it will detect wrongdoing and identify the bad apples. Companies need to be prepared to take swift and decisive action, even against senior management, if violations of law or policy occur, even if that action may be perceived as hurtful to the business. In today's environment, employees, customers, suppliers, investors, regulators and other stakeholders expect companies to act with integrity. As has been seen time and again, companies who lose the confidence of those stakeholders cease to exist as viable entities. You, as the lawyer, need to understand that tough decisions need to be made and be prepared to stand behind those decisions.

CREATE AN ECOSYSTEM OF COMPLIANCE

The design and day-to-day functioning of strong compliance practices in a corporation takes time and effort. It requires the input of everyone in the value chain – the Board, senior management, the employee base, and just about everyone else with whom the company does business, including its customers, suppliers, strategic partners, distributors, and, yes, its regulators. Make sure everyone in that chain realizes what your company is about and give them a stake in the process. Build compliance language into your contracts. Plaster your walls with your safety procedures, your code of conduct, your hotlines. Reach out to your clients and customers and keep them in the loop on all you are doing in your company. Create an ecosystem of compliance. It will be difficult and challenging, but in the long run, it is good for business.

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