

## Corporate & Securities Law Update

November 2004

### AMENDMENTS TO THE FEDERAL SENTENCING GUIDELINES Setting Up An Effective Compliance and Ethics Program

On November 1, 2004, amendments to the Federal Sentencing Guidelines for Organizations take effect.<sup>1</sup> The primary purposes of the amendments are to:

- strengthen the requirements that must be met for a compliance program to be effective as a mitigating factor to reduce criminal penalties;
- increase the emphasis on board oversight of such programs;
- require ongoing risk assessment to identify those areas with the highest risk of unlawful behavior and to target resources accordingly; and
- require mandatory compliance training for all personnel.

The compliance program must be coordinated with other company policies, including a company's code of ethics, insider trading policy and whistleblower policy, to create a corporate culture with high legal and ethical standards.

#### BENEFITS OF AN EFFECTIVE COMPLIANCE PROGRAM

A company may be held responsible for the acts of its agents and employees whenever they act within the scope of

their employment and with the intent to benefit the company. In considering the appropriate penalty for a company, the amended guidelines assign a culpability score to the company.

Four aggravating factors that increase the culpability score and, therefore, could increase the penalty imposed are: (i) the

company's involvement in or tolerance of the criminal activity; (ii) the company's prior history of wrongdoing; (iii) whether an existing court order was violated; and (iv) whether there was obstruction of justice.

The amended guidelines provide two mitigating factors that reduce this culpability score and, therefore, could decrease the penalty imposed. These two factors are:

- the existence of an effective compliance and ethics program; and
- the company's efforts to self-report, cooperate with authorities and accept responsibility.

Mitigation is available only if senior management did not participate in the violation and the company did not unreasonably delay reporting the violation.

An effective compliance program:

- reduces the likelihood that a violation will occur;

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***An effective compliance and ethics program is an important measure of good corporate citizenship and should be considered obligatory rather than primarily a mitigating factor to reduce criminal penalties.***

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- reduces the likelihood that a criminal proceeding or SEC enforcement action will be commenced;<sup>2</sup> and
- enables an organization convicted of a criminal offense to receive a mitigated sentence.

In light of the importance of having an effective compliance program, the board's failure to implement such a program could give rise to a claim that the board had breached its duty of care or duty of good faith.<sup>3</sup>

### CRITERIA FOR AN EFFECTIVE COMPLIANCE AND ETHICS PROGRAM

Generally, an organization must exercise due diligence to prevent and detect criminal conduct and otherwise “promote an organizational culture that encourages a commitment to compliance with the law.” Under the amended guidelines, an effective compliance and ethics program must include at least the following seven minimum criteria:

- **There must be standards and procedures to prevent and detect violations of law.** The standards and procedures must be “reasonably capable of reducing the likelihood of criminal conduct.” An effective compliance program must start with identifying those areas that pose the most significant risk of unlawful behavior, and provide standards and procedures tailored to each such area.
- **Directors and senior management must be engaged in the design, implementation and maintenance of the compliance and ethics program.** Senior management is responsible for ensuring the compliance program’s design, implementation and effectiveness. Nevertheless, the board must be knowledgeable about the content and operation of the program and exercise reasonable oversight of the program. Furthermore, the individual to whom day-to-day responsibility for the program is delegated must have adequate resources and authority, and should report regularly (at least annually) to the board or a board committee overseeing the program.
- **Candidates for key positions must be screened to ensure they have not previously engaged in illegal or unethical conduct.** Companies must conduct reasonable diligence to exclude from management and other positions with substantial supervisory authority or discretion, persons whom the company knew, or should

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**The board's failure to implement an effective compliance program could give rise to a claim that the board had breached its duty of care or duty of good faith.**

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have known through such diligence, have a history of engaging in violations of law or other conduct inconsistent with an effective compliance program.

- **There must be an emphasis on compliance and ethics training.** The amendments contemplate compliance training, with periodic updates, for all personnel, including directors, officers, employees and even agents.
- **Efforts must be made to monitor, audit and evaluate the effectiveness of the compliance program.** Companies must take reasonable steps to ensure that employees adhere to the compliance program, including using monitoring and auditing systems that are designed to detect criminal conduct.

The compliance program should be evaluated periodically to assess its effectiveness. Anonymous and confidential systems should also exist for employees and agents to report concerns and seek guidance with respect to any questionable conduct without threat of retaliation for whistleblowing.

- **Incentives and discipline should be used to promote compliance.** The amendments emphasize the desirability of both appropriate disciplinary measures to sanction misconduct and appropriate incentives to encourage compliance. Any disciplinary measures should be enforced consistently.
- **A company must respond appropriately to criminal conduct and prevent similar conduct.** If criminal conduct occurs, companies must address both the specific instance of misconduct and any systemic shortcomings that may compromise the deterrent effect of its compliance program.

In addition to the criteria outlined above, the amendments provide that ongoing risk assessment is an essential component of the design, implementation and modification of an effective compliance program. Such risk assessment should include an evaluation of (i) the nature and seriousness of such criminal conduct; (ii) the likelihood that certain criminal conduct may occur because of the nature of the organization’s business; and (iii) the prior history of the organization.

### RELATED RULES AND POLICIES

The Sarbanes-Oxley Act of 2002 (“SOX”) and other recent regulatory initiatives have required the adoption of various

other policies, which must be coordinated with the requirements of the guidelines to develop an effective compliance program. Some of these include:

- a written code of ethics under Section 406 of SOX and the SEC's implementing regulations and a code of conduct and ethics under the NYSE and Nasdaq rules;
- whistleblower procedures under Section 301 of SOX and policies prohibiting any adverse actions or retaliation against whistleblowers, pursuant to Sections 806 and 1107 of SOX;
- procedures to enable management to assess the adequacy of the company's internal controls, together with the independent auditor's attestation of such assessment, as required by Section 404 of SOX;
- disclosure controls and procedures to enable management to provide the certifications required under Sections 302 and 906 of SOX;
- the corporate governance rules of the NYSE and Nasdaq; and
- policies regarding insider trading, communications with the public, political contributions, compliance with the Foreign Corrupt Practices Act, and document retention, which are maintained or should be maintained by every public company.

### RECOMMENDED ACTIONS

These amendments, together with SOX and other recent regulatory initiatives highlighted above, encourage companies to develop an appropriate "organizational culture" embodying high legal and ethical standards. Therefore, we recommend that the board (or an appropriate board committee) and management do the following:

- **Review current governance documents.** The board should direct management and counsel to review the company's code of conduct and related policies and procedures to assess whether they meet the criteria of the amended guidelines and to ensure that all the policies take a similar approach and provide consistent sanctions and incentives.
- **Establish a board committee to oversee the compliance program.** With the increased emphasis on board involvement, a board committee should be appointed to oversee all aspects of the compliance program.
- **Assign responsibility for compliance.** The board should (i) review the adequacy of the authority delegated and resources provided to the individual

charged with the day-to-day responsibility for compliance and ethics; (ii) appoint one or more senior managers to have overall responsibility for the program; and (iii) establish procedures for direct reporting by such senior managers to the board.

- **Educate the board on compliance.** As the amendments emphasize the need for the board to be knowledgeable about the compliance program and exercise reasonable oversight, it is imperative that the board be educated on the compliance program.
- **Review compliance training.** The board should review with management plans for periodic compliance and ethics training for all personnel, together with procedures for evaluating the effectiveness of such training programs. Efforts should be made to communicate the policy to all levels of employees.
- **Review screening methods used for hiring management personnel.** The board should review with management the screening methods used. While companies may already screen applicants for senior management positions, the amendments suggest that all high level personnel, all employees with substantial supervisory authority and all employees who have been delegated substantial discretion should also be screened.
- **Provide a reporting system.** The board should review with management the channels of communication available to employees for the reporting, by anonymous and confidential means, of concerns about actual and potential violations of law and ethics. To the extent that the present reporting system provides only for whistleblower procedures related to audit and accounting concerns as required by Section 301 of SOX, it may need to be broadened.
- **Review sanctions and incentives.** The board should consider what sanctions will be imposed for misconduct under the compliance program, together with possible incentives for compliance, which could include making performance under the compliance program a component of performance evaluations.
- **Evaluate the effectiveness of the program.** The board should review with management procedures to assess the effectiveness of the program, through supervision and monitoring through regular internal and external audits.
- **Create procedures to ensure a prompt response.** The board should discuss with management a

mechanism to deal promptly with any potential criminal conduct and a process to review conditions that led to any systemic shortcomings.

- **Conduct a risk assessment.** The new amendments require an ongoing risk assessment. By conducting the assessment, companies may prioritize their compliance and ethics resources to target potential criminal conduct that poses the greatest threat and modify their compliance and ethics program, as appropriate.

Although an effective compliance and ethics program may mitigate any penalties imposed, companies should focus on creating a corporate culture and related compliance and ethics programs which prevent prosecution altogether.

**End Notes**

1 The U.S. Sentencing Commission adopted the Federal Sentencing Guidelines for Organizations in 1991 as guidelines that federal judges must consider in sentencing an organization that has been convicted of a federal crime. The

amendments become effective automatically on November 1, 2004, unless Congress takes action to disapprove them. A Supreme Court decision on June 24, 2004 in Blakely v. Washington casts some doubt on the constitutionality of the federal sentencing guidelines. Even if the Supreme Court strikes down the sentencing guidelines, Congress will likely amend the guidelines to satisfy the court's constitutional requirements without changing the substance of the provisions discussed here.

- 2 An effective compliance and ethics program will be considered by federal prosecutors and the SEC when determining whether to bring criminal charges or an enforcement action against a company. See the DOJ Memorandum at <http://www.usdoj.gov/04foia/readingrooms/6161999a.htm>, and [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm), and the SEC release (Exchange Act Release No. 34-44969) at <http://www.sec.gov/litigation/investreport/34-44969.htm>.
- 3 The court in In re Caremark International Inc. Derivative Litigation, 698 A. 2d 959, 970 (Del Ch. 1996) held that directors could be held liable for failing in good faith to assure that appropriate information and reporting systems were in place at the company, noting that "[a]ny rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account [the Federal Sentencing Guidelines for Organizations] and the enhanced penalties and the opportunities for reduced sanctions that it offers."

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