



FENWICK & WEST LLP

Corporate and Securities Law Update

Time to Consider Revising Compliance and Ethics Programs in Light of New Federal Sentencing Guidelines

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Recent amendments to the Federal Sentencing Guidelines applicable to organizations went into effect on November 1, 2004. In light of these changes, companies should evaluate their compliance and ethics programs to determine what changes should be made.

One of the most significant developments in the guidelines is the requirement that a company's Board of Directors and executives take responsibility for oversight and management of the company's compliance and ethics programs. In addition, the standards for compliance and ethics programs have been made more rigorous.

The text of the recent amendments and the revised Organizational Guidelines (now codified at section 8B2.1) is available at http://www.ussc.gov/2004guid/RFMayo4_Corp.pdf.

What is the purpose of the Organizational Guidelines?

Federal judges use the Organizational Guidelines, which were adopted in 1991, to determine the type and severity of sentences imposed on companies convicted of federal crimes. These guidelines are designed, in part, to provide incentives for companies to develop compliance and ethics programs that will prevent and detect unlawful conduct. The mechanism for this incentive is the possibility that a company's sentence can be reduced if, among other things, it had an effective compliance and ethics program in place at the time of the wrongdoing. The revisions to the Organizational Guidelines respond in part to Section 805 of The Sarbanes-Oxley Act of 2002, which directed the U.S. Sentencing Commission to re-evaluate the guidelines to determine whether they were sufficient to deter and punish organizational misconduct.

The U.S. Supreme Court recently invalidated as unconstitutional the State of Washington's sentencing scheme, which was functionally equivalent to the Federal

Sentencing Guidelines. *Blakely v. Washington*, 124 S.Ct. 2531 (2004). The Court has granted certiorari in two other cases to determine if the Federal Sentencing Guidelines similarly violate Sixth Amendment guarantees. It is unclear whether this line of decisions would affect the Guidelines applied to corporate organizations, but regardless of the outcome, we expect that the existence of an effective compliance and ethics program will remain an important guidepost in the exercise of prosecutorial discretion.

What were the requirements for an effective compliance and ethics program before the most recent amendments?

The Organizational Guidelines in effect before the most recent amendments contained a set of criteria, known as the "seven minimum steps," which were used to define an effective compliance program:

- Comprehensive standards and procedures reasonably capable of reducing the prospect of criminal conduct.
- Oversight of program by high-level personnel.
- Due care in delegating substantial discretionary authority.
- Communication of standards and procedures that is effective to reach all levels.
- Reasonable steps to achieve compliance, including monitoring and auditing systems and systems for reporting suspected wrongdoing without fear of reprisal.
- Consistent enforcement of compliance standards, including disciplinary mechanisms.
- Taking reasonable steps to respond to an offense upon detection and to prevent further similar offenses.

The November 1, 2004 amendments provide more definition and include specific new requirements that a company must adopt in order to have an effective compliance program.

What must companies do now in order to obtain the benefits of an effective compliance and ethics program under the revised guidelines?

In order to qualify for reduced punishment under the revised Organizational Guidelines, a company must demonstrate that its compliance and ethics program includes the following elements:

- **Standards and Procedures:** The compliance and ethics program must include standards and procedures to prevent and detect criminal conduct.
- **Direct Board Oversight:** The Board of Directors must be knowledgeable about the content and operation of the compliance and ethics program; it must exercise reasonable oversight of the program's implementation and effectiveness.
- **Appointment of High-Level Compliance Officer:** High-level personnel must ensure the effectiveness of the compliance and ethics program; a specific director, executive or other high-level person must be identified and assigned ultimate responsibility for the program's effectiveness.
- **Periodic Reporting to Directors and Officers:** Individuals with day-to-day operational responsibility over the company's compliance and ethics program must report periodically to the company's executives and Board of Directors (or Board committee) on the effectiveness of the compliance and ethics program.
- **Periodic Auditing, Monitoring, Review and Risk Assessment Requirements:** Each company should engage in auditing, monitoring, review and risk assessment activities with respect to its compliance and ethics program, including:
 - Taking reasonable steps to ensure compliance with the program, including monitoring and auditing observance of the program.
 - Periodically evaluating program effectiveness.
 - If criminal conduct is detected, taking reasonable steps to prevent similar conduct in the future,

including modifying the program as necessary.

- Periodically assessing, and addressing through appropriate modifications to the program, the risk of criminal conduct, including risks inherent in the nature of the company's business and risks associated with the company's prior history.
 - Periodically prioritizing, and modifying, the components of the compliance and ethics program to address the identified risks that the company believes are most likely to occur.
- **Training, Internal Reporting Systems and Enforcement Mechanisms:** Each company must incorporate training, internal reporting systems and enforcement mechanisms into its compliance and ethics program. In practice, this now means:
- Internal training programs on compliance and ethics matters are now required; they must include the company's directors, executives and other high-level personnel, as well as employees and agents generally. Training must be practical and ongoing, including periodic updates.
 - Individuals responsible for the day-to-day operation of the compliance and ethics program must be provided with adequate resources and authority, and with direct access to the company's Board of Directors, or appropriate Board committee.
 - The internal system for self-policing must be publicized. This system must allow for employee reporting of potential or actual criminal conduct without fear of retaliation, as well as a means for employees to seek guidance about this sort of conduct. Anonymous or confidential reporting should be considered.
 - The company must promote, and consistently enforce, compliance with the program, including providing appropriate incentives to encourage proper conduct and appropriate discipline of improper conduct (including failing to take reasonable steps to prevent or detect criminal conduct).
 - After criminal conduct has been detected, the company must take reasonable steps to respond appropriately to the conduct.

- **Scrutiny of Management:** The company must exercise due diligence to exclude from management any individuals whom the company knew or should have known had engaged in any illegal activities or other conduct inconsistent with an effective compliance and ethics program.

What is the benefit of adopting a compliance and ethics program that meets the criteria laid out in the Organizational Guidelines?

A significant benefit of an effective compliance and ethics program is that it may detect and prevent violations of law before they occur. Even in the event of unlawful conduct, however, the existence of a robust compliance and ethics program is an important factor used by the Department of Justice and the Securities and Exchange Commission in determining whether to charge a company for that conduct. As discussed above, such a program is also a mitigating factor that can reduce the punishment imposed on a company in the event that it is charged and convicted of criminal conduct.

What should be the objectives of a compliance and ethics program?

Compliance and ethics programs should be designed to prevent and detect not only criminal conduct, but also violations of any law, whether criminal or non-criminal, for which the company would be liable. They should also promote a culture that encourages ethical conduct and a commitment to compliance with the law.

Are the standards for all compliance and ethics programs the same?

Under the Organizational Guidelines, all companies are required to demonstrate the same degree of commitment to ethical conduct and compliance with the law. However, the Sentencing Commission recognizes that the formality and scope of an effective compliance and ethics program will vary depending upon the size of the organization. For example, smaller companies may satisfy the requirements of the guidelines by having the company's Board of Directors

directly manage the compliance and ethics efforts, relying on more informal training mechanisms, using available personnel to develop, administer and enforce the program, and modeling its program on well-regarded programs, and best practices, of other similar organizations. By contrast, larger companies may be expected to have more formal training mechanisms and to devote more significant resources to the development, administration and enforcement of the compliance and ethics program, including in some cases having personnel whose primary focus is the administration of the program.

Should our code of conduct or ethics be a part of our compliance and ethics program?

A code of conduct or ethics and regular ethics training are important aspects of any compliance and ethics program. However, these codes by themselves do not generally satisfy the requirements of the Organizational Guidelines. Rather, companies must ensure that their internal policies and procedures include and address each of the revised criteria set forth in the recent amendments to the Organizational Guidelines.

For further information on these amendments or how to implement an effective compliance and ethics program, please contact any member of your Fenwick & West LLP team or Donald Searles (dsearles@fenwick.com) or Brad Lewis (blewis@fenwick.com), each of whom assisted in the preparation of this update.

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