

AMENDMENTS TO THE FEDERAL SENTENCING GUIDELINES IMPOSE NEW STANDARDS FOR COMPLIANCE AND ETHICS PROGRAMS

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The Amendments to the United States Sentencing Guidelines (the “Guidelines”) for organizations which became effective on November 1, 2004, emphasize the importance of implementing the mandatory effective compliance and ethics program.¹ These Amendments are in response to the requirements in Section 805 of the Sarbanes Oxley Act which directed the United States Sentencing Commission to review and amend the Guidelines to ensure that they are sufficient to deter and punish criminal misconduct by organizations. The Guidelines themselves made a minimum compliance program mandatory in 1991. As set forth in greater detail below, the Amendments add “rigor” to the prior treatment of compliance programs and require boards of directors and executives to assume greater responsibility for the oversight and management of compliance and ethics programs. In order to reduce corporate fines for criminal convictions and to create a culture of compliance, it is crucial for organizations to now review their compliance programs and to ensure that these programs comply with the requirements set forth in the amended Guidelines. It is important to note that corporate compliance with these Guidelines is also considered by both the Securities and Exchange Commission and the United States Department of Justice when making an initial enforcement decision.

BACKGROUND

The Guidelines for organizations first became effective in 1991 and mandated the imposition of fines and penalties on an organization for criminal violations of federal laws. The term “organization” is defined as “a person other than an individual,” and includes corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof and non-profit organizations.² Under the Guidelines, an organization’s punishment will be based on an analysis of the seriousness of the offense and the culpability of the organization. Two factors that mitigate the punishment of an organization are: “(i) the existence of an effective compliance and ethics program; and (ii) self-reporting, cooperation, or acceptance of responsibility.”³ Thus, an effective compliance and ethics program can be a significant factor in reducing an organization’s possible fines for criminal convictions. Moreover, a number of government and quasi-government entities consider an effective compliance program when deciding whether to

¹ A copy of the full text of the Guidelines for organizations is available at <http://www.ussc.gov/2004guid/tabconchapt8.htm>. The Amendments were submitted to Congress by the United States Sentencing Commission on April 30, 2004.

² U.S.S.G. § 8A1.1 application note 1.

³ U.S.S.G. Introductory Commentary to Chapter 8.

bring civil or criminal charges against a business or when otherwise deciding how to treat organizations that violate the law.

The original Guidelines promulgated in 1991 sought to provide incentives for businesses to adopt new practices designed to prevent crime. Under these original Guidelines, in order for a compliance program to be considered effective, the organization had to demonstrate that it had satisfied seven requirements.⁴ The Amendments “enhance[] the rigor and detail of these requirements.”⁵ In particular, the Amendments place greater responsibility on directors and executives for the oversight and management of compliance programs. Moreover, the Amendments demand that compliance officers be given “sufficient authority and resources to carry out their responsibilities.”⁶ In short, the Amendments require serious and continuing commitment to maintaining a compliance and ethics program.

THE 2004 AMENDMENTS

As originally adopted, the Guidelines required organizations to exercise due diligence in preventing and detecting criminal misconduct. Under the Amendments, in order to have an effective compliance and ethics program, an organization must also promote “an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”⁷ To that end, the Amendments clarify the seven requirements an organization must, at a minimum, take to develop and implement an effective compliance and ethics program.⁸ The minimum requirements are summarized below:

⁴ The seven requirements were: (1) The organization must have established 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) Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures; (3) The organization must have used 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) The organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents; (5) The organization must have taken reasonable steps to achieve compliance with its standards; (6) The standards must have been consistently enforced through appropriate disciplinary mechanisms, including as appropriate, discipline of individuals responsible for the failure to detect an offense; and (7) After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately to the offense and to prevent further similar offenses.

⁵ “Commission Toughens Requirements For Corporate Compliance And Ethics Programs,” U.S. Sentencing Commission News Release (May 3, 2004) available at <http://www.ussc.gov/PRESS/rel0504.htm>

⁶ *Id.*

⁷ U.S.S.G. § 8B2.1(a)(2).

⁸ U.S.S.G. § 8B2.1(b).

- Standards And Procedures. Under the Amendments, an organization “shall establish standards and procedures to prevent and detect criminal conduct.”⁹
- Board Of Directors’ Role And Responsibilities. The Amendments expand the board of directors’ responsibility over an organization’s compliance and ethics program.¹⁰ Indeed, the Sentencing Commission’s press release regarding the Amendments specifically states that the Amendments “require[] board of directors and executives to assume responsibility for the oversight and management of compliance and ethics programs.” The Amendments require that an organization’s board of directors be “knowledgeable about the content and operation” of the compliance and ethics program. Additionally, the board of directors must “exercise reasonable oversight” with respect to the program’s effectiveness and implementation.¹¹
- High-Level Personnel Responsible For Compliance And Ethics Program. The Amendments emphasize that high level personnel¹² of the organization shall ensure that the organization has an effective compliance and ethics program and requires that specific individuals shall be assigned responsibility for operation of the program.¹³ Personnel within the organization must be granted the day-to-day operational authority over the compliance and ethics program. Those with operational authority must have adequate resources and access to the board of directors and high-level personnel to report on the effectiveness of the compliance and ethics program.¹⁴ Further, the organization shall use “reasonable efforts” to exclude from the high-level personnel any individual that the organization knew or should have known has “engaged in illegal activities” or other activity inconsistent with the compliance and ethics program.¹⁵

⁹ U.S.S.G. § 8B2.1(b)(1).

¹⁰ The Amendments use the term “governing authority” to refer to the board of directors and, if no board of directors is in place, the highest-level governing body in the organization. U.S.S.G. § 8B2.1 application note 1.

¹¹ An individual with day-to-day responsibility for the compliance and ethics program (if this is not the person with overall responsibility for the program) shall update the board of directors (or a subgroup thereof) at least annually about the implementation and effectiveness of the program. U.S.S.G. § 8B2.1 application note 3.

¹² High-level personnel are defined as “individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization,” including directors, executive officers, individuals in charge of major business or functional units of the organization, and individuals with substantial ownership interests. U.S.S.G. § 8A1.2 application note 3.

¹³ U.S.S.G. § 8B2.1(b)(2)(B).

¹⁴ U.S.S.G. § 8B2.1(b)(2)(C).

¹⁵ U.S.S.G. § 8B2.1(b)(3).

- Training For Directors And Management. The Amendments require that the compliance and ethics program's standards and procedures be periodically shared with the board of directors, high-level personnel and other employees through training and other appropriate channels.¹⁶
- Monitoring, Evaluating And Reporting. An organization must take reasonable steps to continue to monitor and audit its compliance and ethics program to detect criminal conduct and periodically evaluate the effectiveness of the program. The organization must also allow for an anonymous reporting procedure, so that employees and agents may report suspected criminal conduct without fearing retaliation.¹⁷
- Enforcement. The compliance and ethics program must be "promoted and enforced consistently throughout the organization." Enforcement includes incentives and disciplinary measures.¹⁸
- Response to Criminal Conduct. If criminal conduct is discovered, the organization must respond to the conduct and take appropriate steps to ensure similar conduct does not occur in the future. Appropriate steps may include modifying the compliance and ethics program.¹⁹

The Amendments emphasize the need for periodic assessment²⁰ and require the organization to take steps to "design, implement, or modify" each of these seven requirements to "reduce the risk of criminal conduct."²¹

In addition, the Application Notes to the Amendments enumerate factors to be considered when determining what specific steps an organization must take to meet the minimum requirements.²² In order to determine what actions are necessary to meet the Guideline requirements, an organization should consider the following:

¹⁶ U.S.S.G. § 8B2.1(b)(4)(A).

¹⁷ U.S.S.G. § 8B2.1(b)(5).

¹⁸ U.S.S.G. § 8B2.1(b)(6).

¹⁹ U.S.S.G. § 8B2.1(b)(7).

²⁰ The assessment should include analysis of the nature and seriousness of such risk of criminal conduct, any risk that may occur because of the nature of the organization's business, and the prior history of the organization. U.S.S.G. § 8B2.1 application note 6.

²¹ U.S.S.G. § 8B2.1(c).

²² U.S.S.G. § 8B2.1 application note 2.

- Government Regulations And Industry Practices. An effective compliance and ethics program includes the incorporation of applicable government regulations and industry practices. Failure to incorporate and follow applicable industry practices “weighs against” finding that the organization has an effective compliance and ethics program.
- Organizational Size. Although both small and large organizations must implement compliance and ethics programs, large organizations must devote greater resources and create more formal procedures than small organizations. In addition, large organizations should encourage small organizations they conduct business with to implement an effective compliance and ethics program.
- Recurrent Misconduct. The effectiveness of an organization’s compliance and ethics program is called into question if there is recurrent, similar misconduct. Therefore, recurrent misconduct creates doubt whether the organization acted reasonably in meeting the minimum requirements.

The Amendments create a rebuttable presumption that an organization’s program is not effective if high-level personnel of a small organization or personnel with substantial, but not high-level, authority²³ in any organization “participated in, condoned, or was willfully ignorant of” criminal misconduct.²⁴

The Amendments also clarify that waiver of the attorney-client privilege or the work product privilege is not a prerequisite to full cooperation and disclosure.²⁵ However, the commentary to the Amendments does recognize that waiver of these privileges may be “necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.”²⁶

AN EFFECTIVE COMPLIANCE PROGRAM IS CONSIDERED BY THE DEPARTMENT OF JUSTICE AND THE SECURITIES AND EXCHANGE COMMISSION

The need for an effective compliance and ethics program is not limited to the Guidelines. The Department of Justice has directed prosecutors to consider a corporation’s compliance program in determining whether to indict the organization. In a January 20, 2003 memorandum to United States Attorneys, Deputy Attorney General Larry D. Thompson (the “Thompson Memorandum”) directs prosecutors to consider nine factors in deciding whether to

²³ The determination of “substantial authority personnel” is a case-by-case analysis, but is defined as “individuals who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization.” U.S.S.G. § 8A1.2 application note 3.

²⁴ U.S.S.G. § 8C2.5(f).

²⁵ U.S.S.G. § 8C2.5 application note 12.

²⁶ *Id.*

indict a corporation including “the existence and adequacy of the corporation’s compliance program.”²⁷ While acknowledging that the Department of Justice has no formal guidelines for corporate compliance programs, the Thompson Memorandum states that the fundamental questions any prosecutor should ask are “Is the corporation’s compliance program well designed?” and “Does the corporation’s compliance program work?” In answering these questions, the Thompson Memorandum instructs prosecutors to consider “the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the seriousness, duration and frequency of the misconduct; and any remedial actions taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs.”

The Securities and Exchange Commission (“SEC”) has also announced that it will take into account a company’s effective compliance program when deciding whether and how to charge violations of the federal securities laws. In an October 23, 2001 report, the SEC stated that it would consider self-policing (which includes establishing effective compliance procedures), self-reporting, remediation and cooperation in making enforcement decisions, and would credit corporations for cooperative behavior by taking no enforcement action, bringing reduced charges, seeking lighter sanctions or including mitigating language in SEC releases.²⁸

Thus, in addition to reducing the punishment imposed on an organization under the Guidelines, an effective compliance and ethics program is an important factor used by the Department of Justice and the SEC in determining whether to charge a company if violations of law occur.

CONSTITUTIONALITY OF GUIDELINES PRESENTLY UNDER REVIEW

A recent Supreme Court case, *Blakely v. Washington*, has cast the Constitutional validity of the Guidelines into question.²⁹ Although the fate of the federal Guidelines may be uncertain, there is no question that the need for an effective compliance and ethics program will remain and that courts and regulators will look to the amended Guidelines for the standard by which to measure an effective compliance program. Accordingly, each organization should review

²⁷ A copy of the Thompson Memorandum is available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm

²⁸ See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions (Oct. 23, 2001) available at <http://www.sec.gov/litigation/investreport/34-44969.htm>

²⁹ See *Blakely v. Washington*, 124 S. Ct. 2531 (2004). In *Blakely* the Supreme Court invalidated a sentence imposed under the Washington State sentencing guidelines which was similar to the federal Guidelines. The *Blakely* decision states in a footnote that “the Federal Guidelines are not before us, and we express no opinion on them.” Nonetheless, the lower federal courts are split on whether and how *Blakely* applies to the federal Guidelines. On August 2, 2004, the Supreme Court granted certiorari in two cases that appear to address the impact of *Blakely* on the federal Guidelines. Oral argument in both cases took place on October 4, 2004. *United States v. Booker*, No. 04-104, 2004 WL 1713654 (Aug. 2, 2004); *United States v. Fanfan*, No. 04-105, 2004 WL 1713655 (Aug. 2, 2004).

and evaluate its internal compliance program to ensure that it complies with the amended Guidelines.

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If you have any questions about the subject matter of this memorandum or the Guidelines for organizations, please contact John J. Kenney (212-455-2588; jkenney@stblaw.com) or Michelle B. Cherande (212-455-3812; mcherande@stblaw.com).

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