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Reporting to the board on the compliance and ethics program

- » Requiring the C&E officer to meet periodically in executive session with an appropriate board committee enhances C&E program independence and authority.
- » To oversee and evaluate the C&E program in an independent way, the board should also hear from other senior leaders about the C&E program.
- » The primary focus of reports to the board should be those areas where director oversight can have the greatest impact, such as incentives, discipline, resources, and senior management's involvement in the program.
- » Companies should establish systems to ensure that the audit committee is notified promptly of the most serious types of allegations.
- » Robust C&E programs require robust board oversight.

Board oversight of a compliance and ethics (C&E) program can be critical to ensuring that the program has an appropriate level of authority and independence within an organization, and that sufficient resources are devoted to C&E.



Walker

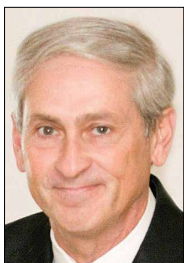
In recent years, the expectations for boards of directors with respect to oversight of C&E programs have increased, and board oversight has indeed become more robust at many companies. However, a large number of organizations continue to grapple with the questions of who should provide information to the board (or a committee of the board), what types of C&E-related information to provide, and how frequently. (This article uses the term “board” or “board of directors” to include both the board of directors and a committee of the board authorized to exercise C&E program oversight.) What follows are some

thoughts on these questions, including a discussion of the legal standards and guidance in this area and an examination of good practices.

In recent years, the expectations for boards of directors with respect to oversight of C&E programs have increased, and board oversight has indeed become more robust at many companies.

Who should report to the board?

One of the benefits of active board oversight of a C&E program is the enhanced level of independence that such oversight creates—independence from the business and from other functions. The impact of board oversight on program independence is affected by who within the organization



Kaplan

provides information to the board. (For this article, we will refer to the person who has operational responsibility for the C&E program as the C&E officer, although it could be another person within the company.)

If, for example, the C&E officer reports to the general counsel (GC), and the GC (and not the C&E officer) provides C&E program reports to the board, then the level of independence gained by board oversight is diminished

somewhat—at least as a general matter.

The same is true if the GC (or another member of high-level management) censors or edits the written or verbal reports provided by the C&E officer in order to keep sensitive information from the board.

Having the C&E officer provide reports directly to the board is discussed in several different legal standards. First, the Federal Sentencing Guidelines for Organizations (and, in particular, the 2010 revisions to the Guidelines) emphasize the importance of having the person with operational responsibility provide reports to the board. The commentary to the Guidelines provides that:

[i]f the specific individual(s) assigned overall responsibility for the compliance and ethics program does not have day-to-day operational responsibility for the program, then the individual(s) with day-to-day operational responsibility for the program typically should, no

less than annually, give the governing authority or an appropriate subgroup thereof information on the implementation and effectiveness of the compliance and ethics program.”¹

In addition, the Guidelines extend mitigation credit to those companies with effective C&E programs, even if high-level personnel were involved in the misconduct

at issue, as long as (among other things) those individuals who have operational responsibility for the C&E program have “direct reporting obligations” to the board or a board committee.² An application note to the Guidelines clarifies that an individual has “direct reporting obligations” to the governing authority if the

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individual has “express authority to communicate personally to the [board or a board committee] (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 C&E program.³ Thus, two types of reporting are contemplated—reporting to the board regarding misconduct or allegations of misconduct, and periodic reporting on program implementation.

The Resource Guide to the Foreign Corrupt Practices Act,⁴ promulgated by the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) in November 2012, also contains guidance on reporting to the board. Specifically, the

Resource Guide states that the compliance officer of an organization should possess adequate autonomy from management, and specifies that adequate autonomy generally includes direct access to an organization's governing authority, such as the board of directors or a committee of the board of directors (e.g., the Audit Committee).

Recent deferred prosecution agreements and corporate integrity agreements similarly highlight the importance of having the C&E officer report to the board. For example, in the deferred prosecution agreement that the DOJ and Total, S.A., entered into in 2013, Total agreed to assign responsibility for oversight of the

anti-corruption compliance program to one or more senior corporate executives who have direct reporting obligations to independent monitoring bodies, including Internal Audit, the board of directors, or any appropriate committee of the board.⁵ Similarly, in the corporate integrity agreement entered into with GlaxoSmithKline LLC (GSK) in 2012, GSK agreed that its compliance officer will be responsible for monitoring the day-to-day compliance activities engaged in by GSK and that he/she will make periodic reports regarding compliance matters directly to the board of directors or an authorized committee of the board.⁶

Of course, deferred prosecution agreements and corporate integrity agreements are entered into during a time

of crisis and enormous vulnerability for an organization, and the requirements of these agreements are not necessarily appropriate for other organizations. Indeed, the specific type and extent of board oversight discussed in such agreements may not make sense for many organizations. However, the emphasis

in these agreements on the relationship between the board of directors and the compliance officer in ensuring the independence of the compliance function is worth noting, because it both accords with the experience of many compliance practitioners and contains an inherent logic. Moreover, for those considering whether to adopt the sort of approach

Another means of enhancing both overall program independence and the level of independence of board oversight is to create a requirement that the person with operational responsibility for the C&E program meet in executive session with the board or a board committee.

contemplated by these agreements, in the event that a company is later investigated by the DOJ or SEC, having voluntarily taken this type of approach could be helpful in receiving "credit" for the company's C&E program.

Another means of enhancing both overall program independence and the level of independence of board oversight is to create a requirement that the person with operational responsibility for the C&E program meet in executive session with the board or a board committee. In a survey conducted by the Society of Corporate Compliance and Ethics in late 2009, participants were asked whether their organization's C&E officer meets in executive session with the board or a board committee. Of the 560 respondents, 39% indicated that their C&E officers meet with

the board or a board committee in executive session per written requirement, and another 23% meet in executive session as requested, indicating that such meetings were already becoming a more common practice four years ago.⁷

Independence of board oversight

The identity of the person who reports to the board on a C&E program also impacts the level of independence of the oversight that the board provides to the program. This is a separate (although related) concept to the level of independence of the compliance function. Here, we are concerned with the board's ability to oversee and evaluate the C&E program in an independent way (an ability which is obviously bolstered by a strong relationship with an independent C&E officer). When the C&E officer reports to the board on the program, the level of independence of board oversight is enhanced. Interestingly, in order to exercise independent oversight of the C&E function, the board should also hear from other senior leaders about the C&E program.

The importance of independent board oversight is discussed in the DOJ's prosecution standards, which ask prosecutors to consider whether directors exercise independent review of the C&E program and whether they are provided with information sufficient to enable the exercise of independent judgment.⁸ This notion is also explored in the GSK corporate integrity agreement, which requires GSK's board to review and oversee GSK's compliance program, including the performance of the compliance officer and other compliance personnel and to evaluate the effectiveness of the program, including by receiving updates about the activities of the compliance officer and other compliance personnel, and

updates about adoption and implementation of compliance policies, procedures, and practices.

Who has operational responsibility?

For some organizations, suggesting that the person with operational responsibility should provide reports to the board does not necessarily resolve the reporting issue, as it can sometimes be unclear exactly *who* has operational responsibility for a program. At many organizations, the GC or someone else with another high-level position is also the C&E officer, but he/she may not be the person who is actually responsible for the program on a day-to-day basis. Determining who that person is may require assessment of a number of factors, including:

- ▶ The amount of time that the person spends on C&E program responsibilities;
- ▶ The range of the person's program responsibilities (i.e., the greater the range of program responsibilities, the greater likelihood that the person has operational responsibility for the program);
- ▶ Whether the person is involved in setting strategic goals and plans for the C&E program; and
- ▶ The perception of employees at the organization as to the person's role (i.e., is he/she primarily perceived as the GC, or the C&E officer?).

What types of program information should boards receive?

The Sentencing Guidelines contemplate the board's receipt of two types of program information: general information regarding the implementation and effectiveness of the C&E program, and information regarding allegations of misconduct.⁹ This guidance is consistent with other legal standards and with good practices.

General program information

In order for the board to oversee the C&E program, it needs to receive information regarding the design and implementation of a program or general program information. Many organizations find it helpful to organize this type of information around the Sentencing Guidelines' elements of an effective C&E program, in part because this is often the framework around which companies organize their programs, and in part because this better allows organizations to tie the information to leading legal standards. In addition, such an approach may also be helpful in the event the program is ever reviewed by an enforcement agency.

Boards should generally be presented with some amount of information regarding each of the program elements, but the focus of board reports should likely be those areas where director oversight can have a greater impact on effectiveness, such as incentives, discipline, and senior management's involvement in the program. In addition, knowledge that the board is receiving information about certain program elements can help underscore the importance of those elements within the company generally and to senior managers in particular, and thus ensure that they are treated seriously. In the area of training, for example, knowing that the board receives information regarding completion rates in different parts of a company (e.g., different business units or different geographies) may

help senior managers to ensure training completions within their respective business units or functions.

Information regarding program elements often includes information regarding recent accomplishments or shortfalls in each area, findings (if applicable), and plans for the coming months or years. For example, in

the area of training, the board may be presented with information regarding which categories of employees were trained on what subjects in the past year, completion rates, statistical information generated by quizzes or training surveys, and training plans for the coming year, including how training has been developed or modified in light

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of the C&E risk profile of the organization. Information about the results of individual compliance audits can be vital, too, to effective board oversight.

C&E personnel may also want to consider providing information to the board about important general attributes of the C&E program (i.e., important characteristics that are applicable to more than one program element). These include program characteristics such as authority, reach, resources, and independence; management's knowledge and support of the program; organizational culture; and having a true ethics component to one's program, as opposed to a purely compliance-based one. Information regarding program attributes can be critical to a thorough understanding of

program effectiveness, and directors can make a significant difference with respect to many of these.

In a survey conducted by the SCCE earlier this year,¹⁰ respondents were asked how positively they would rate the quality of the interaction of the board with the chief compliance and ethics officer (CECO). (The survey had 626 responses, which itself reflects the broad interest in this topic.) Overall, 48% of respondents rated the quality of the interaction as very positive, and another 27% rated it as somewhat positive. These numbers are overall quite good, but clearly many organizations still struggle with the relationship between C&E and the board.

In addition to general program information, C&E personnel should consider providing the board with appropriate risk area-specific information such as anti-corruption or competition law. This is the type of information discussed extensively by Delaware's Supreme Court in the *Stone v. Ritter* case. Which risk areas the board should hear about is a function of two considerations: (1) which risk areas provide the greatest overall risk to the company (which will obviously vary by industry/line of business and geography); and (2) in which risk areas, if any, are senior managers' and the company's interests not well-aligned. The latter are generally those areas where the likelihood of individual liability at a senior level is fairly low, and where there are potentially divergent

reputational concerns (e.g., where the senior manager may benefit reputationally from some conduct that may be detrimental to the company's reputation, such as in the area of political contributions). This is essentially a "moral hazard" analysis—areas where senior management may behave in a way that is risky to the company because the risk of that

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behavior falls more on the company itself than the senior manager.¹¹ It is in these areas where board oversight can be particularly helpful.

Reporting regarding allegations of non-compliance

In addition to reporting general program information to the board, the C&E officer should also provide the board with information regarding

allegations of criminal or other misconduct and the company's responses to those allegations. The board's responsibility for ensuring that organizations have effective avenues for employees and others to report concerns and for transmitting that information to the board, as appropriate, is at the heart of Delaware case law regarding board oversight of compliance and ethics. In the *Caremark* case and its progeny, the Delaware courts discussed directors' obligations to assure the existence of a corporate information and reporting system to alert the board to red flags or other evidence of serious misconduct.¹²

Building on that notion, section 301 of the Sarbanes-Oxley Act makes audit committees responsible for establishing reporting systems for accounting, internal controls, or auditing complaints. In particular, this provision

directs the national securities exchanges and associations to prohibit the listing of securities of any company where the Audit Committee has not established procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.¹³

As a matter of good practice, companies should consider establishing systems to ensure that the Audit Committee (or other appropriate committee of the board) is notified promptly of certain types of allegations beyond those contemplated by the Sarbanes-Oxley Act, such as allegations (1) of any violations by senior management, (2) where there is the potential for significant adverse financial impact (including reputational harm); or (3) any other circumstances suggesting a need for an independent investigation.

How frequently should the board hear about the program?

Legal standards vary regarding the appropriate level of frequency for reporting to the board about a C&E program. The Sentencing Guidelines provide that the C&E officer should report to the board or a board committee “no less than annually.” Deferred prosecution agreements and corporate integrity agreements tend to require four meetings per year, or quarterly reporting to the board. And 62% of respondents to the SCCE’s 2013 survey on board reporting indicated that there are four or more meetings per year between the board and the CEO, so frequent meetings seem to be fairly common.

With respect to reporting regarding allegations of misconduct, the Guidelines indicate that the C&E officer should have the authority to report “promptly,” although

that discretion would presumably only need to be exercised infrequently when, for example, an allegation is made against a high-level member of management. In addition, boards or board committees typically receive information regarding allegations of misconduct in summary form several times during the year (e.g., at each meeting of the Audit Committee). Prompt reporting on allegations is certainly consistent with section 301 of the Sarbanes-Oxley Act and Delaware case law, discussed above. Regardless of company policy in this area, it may be helpful to include standards governing reporting to the board, both regarding the program and with respect to allegations of misconduct in program governance documentation, such as C&E program charters or protocols governing reporting procedures.

Conclusion

Robust C&E programs require robust board oversight. To accomplish that, companies need to continue to consider how to ensure that the right person is providing the right information at the right frequency to the board. *

1. Federal Sentencing Guidelines Manual § 8B2, Application note 3
2. Federal Sentencing Guidelines Manual § 8C2.5(f)(3)(C)
3. Federal Sentencing Guidelines Manual § 8C2.5, Application note 11
4. United States Department of Justice and Securities and Exchange Commission: A Resource Guide to the U.S. Foreign Corrupt Practices Act. November 14, 2012. Available at <http://1.usa.gov/1mmdwHH>
5. *United States v. Total, S.A.*, Deferred Prosecution Agreement, Case No. 1:13 CR 239, Eastern District of Virginia, May 23, 2013
6. Corporate Integrity Agreement between the Office of Inspector General of the Department of Health and Human Services and GlaxoSmithKline LLC (2012). Available at <http://1.usa.gov/1l1uXDZ>
7. Rebecca Walker: “Compliance and Ethics Officer Positioning: A Benchmarking Survey.” *Compliance and Ethics Professional*, December 2009
8. United States Attorneys’ Manual, Principles of Federal Prosecution of Business Organizations, § 9-28.800
9. Federal Sentencing Guidelines Manual § 8B2.1(b)
10. SCCE Survey: The Relationship Between the Board of Directors and the Compliance and Ethics Officer. January 2014. Available at <http://bit.ly/PYERFh>
11. For more on the relevance of moral hazard to C&E programs see Kaplan: “Overconfidence, moral hazard and C&E risk.” *Corporate Compliance Insights*, August 24, 2010. Available at <http://bit.ly/1nRcY0r>
12. *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959, 970 (Delaware Chancery, 1996)
13. 15 U.S.C.A. §78j-1 (2010)

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