

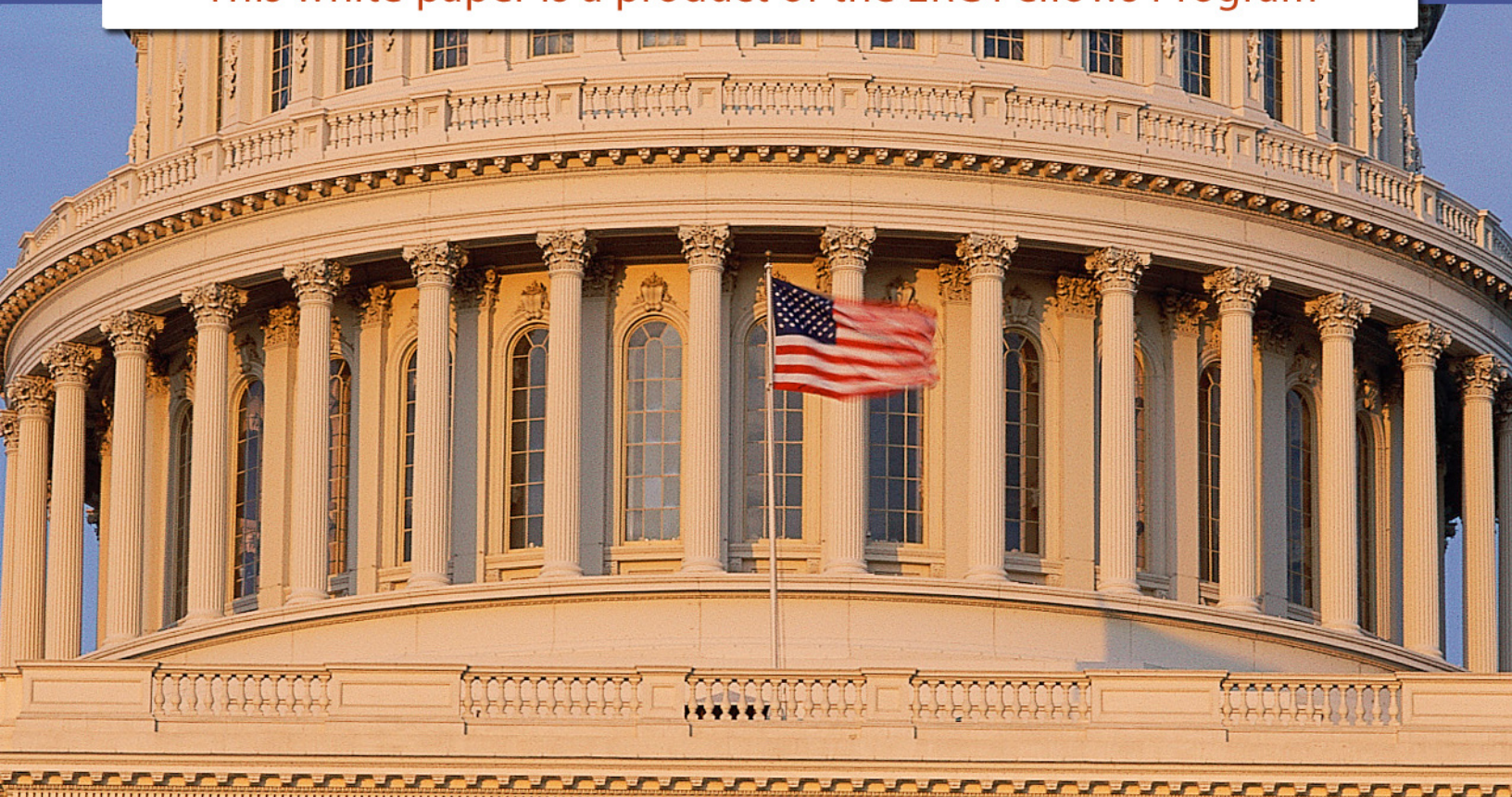


TOO BIG TO REGULATE?

Preventing Misconduct in the Private Sector

2010

This white paper is a product of the ERC Fellows Program





ERC

ETHICS
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Founded in 1922, the Ethics Resource Center (ERC) is America's oldest nonprofit organization devoted to the advancement of high ethical standards and practices in public and private institutions. For 88 years, ERC has been a resource for public and private institutions committed to a strong ethical culture. ERC's expertise informs the public dialogue on ethics and ethical behavior. ERC researchers analyze current and emerging issues and produce new ideas and benchmarks that matter — for the public trust.

The ERC Fellows Program is a forum for chief ethics officers, senior ethics professionals and scholars dedicated to improving ethics in the workplace.

To learn more about the ERC Fellows Program, visit www.ethics.org/fellows

Executive Summary

The ERC Fellows Program, a select group of senior ethics professionals, meet twice a year to study and discuss issues that are likely to have a significant, lasting effect on business and the relationship between corporate America and the federal government. In light of events of the past two years, the ERC Fellows at their July 2010 meeting in Arlington, VA chose to delve into questions of government regulation and enforcement – their effectiveness and their limits. This paper grows out of those discussions.

The title “Too Big to Regulate?” refers not to company size but to a broader question: whether the U.S. government’s regulatory and enforcement mechanisms can keep pace with the lightning fast pace of change and the often complex and vast challenges that change creates. And, in addressing that question, we also consider whether there are ways that the private sector can help lawmakers, regulators, and prosecutors fulfill their oversight and enforcement responsibilities.

At the July meeting, ERC Fellows heard from senior officials of the US Department of Justice, the Securities and Exchange Commission and the U.S. Sentencing Commission. All three speakers upheld that the government’s responsibility is to deter misconduct and crime, to enforce the law, and to uphold the integrity of the American marketplace. But they acknowledged a key role for business, too:

“For us to be successful, we need you to be successful. We would rather prevent crime than show up after the train wreck,” U.S. Deputy Assistant Attorney General Greg Andres declared. Lorin Reisner, Deputy Director of the SEC’s Enforcement Division, similarly observed that business can support deterrence efforts with strong compliance programs that not only deter illegal behavior, but also discourage employees from straying into the “gray area” of borderline conduct. Kathleen Grilli, Deputy General Counsel at the U.S. Sentencing Commission, stressed the importance of good corporate culture in which leadership “walks the walk.”

The ERC Fellows had questions of their own:

- Do officials recognize and give enough credit to sincere efforts by companies to foster ethical conduct among employees?
- Could communication, and thus understanding, be improved between regulators and the regulated in a way that would add nuance to stereotypes on both sides?
- Do judges make effective use of Federal Sentencing Guidelines for Organizations and properly credit companies that have installed effective ethics programs and enable ethics officers to access top executives and the board?

In this paper, the Ethics Resource Center (ERC) draws some conclusions and makes recommendations of its own:

- No amount of regulation or enforcement resources will eliminate all wrongdoing, but there is little doubt that government and business share an interest in ethical conduct that gives investors confidence in the market's inherent integrity.
- Despite natural tension between businesses and the government enforcement officers who prosecute corporate misconduct, partnership between government and private sector compliance officials can help build ethical cultures in the private sector and reduce errant behavior.
- Ongoing dialogue between these sectors can provide government enforcement officers with a better understanding of how strong ethics programs can promote positive behavior in the private sector and discourage misconduct.
- Better communication by government enforcers can help the private sector build compliance programs that will earn credit and respect from federal agencies and judges. For example, DOJ and the SEC could broaden training for prosecutors about ethics programs and ethical culture and their impact on corporate governance by arranging for participation of private sector ethics and compliance officers.
- The enforcement agencies also might consider the formation of ethics and compliance advisory groups composed of academics, private sector ethics officers, and retired government enforcement officials.
- DOJ and the SEC might provide case studies and aggregate statistics that demonstrate the impact of corporate ethics and compliance programs on enforcement decisions. They also might provide additional guidance about what the department expects from business.
- The SEC could encourage publicly traded companies to increase the visibility of their ethics programs—for example distributing their codes of conduct to shareholders, or making portions of their compliance training available to investors.

- The US Sentencing Commission could create an advisory group on Chapter 8, similar to its advisory groups for other portions of the Federal Sentencing Guidelines. Chapter 8 defines an effective ethics and compliance program for consideration in sentencing, and it also provides a de facto template for the design of ethics and compliance programs more broadly.

These recommendations are a starting point toward greater collaboration between government enforcement officers and ethics and compliance officers in the private sector. Though operating with different missions and different mandates, the two sides share a common goal of building ethical cultures that protect investors by ensuring that businesses play by the rules. The paper that follows highlights some of the issues that pull them apart, but also offers ideas for bridging the gap.

Overview

As we approach 2011, the government is beginning to implement a sweeping overhaul of financial regulation to close key loopholes and clarify agency overlaps that many analysts say were major contributors to the financial meltdown of 2008-2009. The new law puts the Federal Reserve Board in charge of systemic oversight and also includes a new consumer protection agency, increased oversight of financial derivatives, protections for whistleblowers, limits on proprietary investments by banks and new mechanisms for liquidating failed financial institutions. Whether it will work is a matter of debate.

Supporters see a historic reform that will help restore shattered public trust that the government can deter wrongdoing, protect the public from fraud and punish transgressors. Others, including former Securities and Exchange Commission (SEC) chairmen Arthur Levitt and Richard Breeden, are dubious.

"I certainly don't think it would prevent the turmoil coming up, and I doubt very much it would have had much impact on the turmoil we have just experienced," Levitt, a Democrat, said at a recent Washington forum sponsored by the Bloomberg news agency. "You might surmise from that that I'm not a fan."¹

Breeden, a Republican, suggested that the 2008 collapse was less about rules than those who enforce them, observing: "Regulators had the authority to control that and eliminate it. We can keep passing laws, but if the regulators don't have the backbone to enforce the rules and to be realistic, then that's a different problem."² President Obama, a strong supporter of the new rules, concedes: "For these new rules to be effective, regulators will have to be vigilant."³

The Great Recession and the government response have focused our eyes on the financial sector, but doubts about regulatory effectiveness extend into other areas as well. Skeptics point to a number of other environmental and safety incidents to illustrate the limits of regulation in ensuring public safety. Among their evidence: the explosion at Massey Energy's Big Branch Coal Mine, which killed 29 West Virginia miners; the continuing questions about sticky accelerators in automobiles manufactured by Toyota; and the disaster on British Petroleum's (BP) Deepwater Horizon drilling platform in the Gulf of Mexico. Neither 65,000 citations from federal safety regulators nor a record \$20 million fine from the Environmental Protection Agency prevented the catastrophe in West Virginia.⁴ The saga of the U.S. Minerals Management Service (MMS), which approved the BP drilling site, now seems a textbook case of "regulatory capture," in which regulators begin to serve the interests of those they are supposed to regulate rather than represent the public interest.

An inspectors general report released this past May depicts a culture of corruption at MMS, which was responsible for enforcing safety and environmental rules on offshore rigs. The report says that many government inspectors routinely accepted and discussed job opportunities with those they were supposed to monitor, and even allowed industry representatives to fill out their own inspection forms.⁵

Combined, the financial fiasco and the separate safety issues have raised significant questions about the effectiveness of government regulation and the ability of regulators to prevent misconduct. Among the questions:

- Is former SEC Chairman Breeden right that even the best crafted regulations are only as good as the regulators who enforce them?
- Do regulatory adjustments make us safer or do they just provide the illusion of safety?
- Do government rules and fines make a difference in promoting safety, sound environmental practices, and other desirable conduct?
- What is the relative effectiveness of self-deterrence vs. enforcement?
- Can private sector efforts build on government regulation to successfully deter potential misconduct?
- Can government enforcement agencies and private sector compliance officers develop a partnership to strengthen deterrence?
- Are rules the answer? Or, do we need to do a better job of building a culture of ethics that instills a personal commitment to integrity?
- Have we simply reached the point where regulating corporate conduct is an impossible job?

“The Cops on the Beat”

Religious institutions preach the virtue of the Golden Rule, parents teach their children to “do the right thing,” and political candidates offer themselves as models of integrity. But history and headlines are replete with scandal and fraud. Corporate leaders manipulate financial data in order to hide failure, defraud shareholders, or to meet performance thresholds that trigger bonus payments.

From manufacturing to mining, supervisors cut corners on safety despite risks to employees and customers alike. Political leaders are forced out by corruption and sexual misconduct. Even sports heroes lie and cheat, stealing game plans from opponents or taking banned drugs to enhance performance.

By themselves, promises of good behavior do not ensure an ethical society. Temptation often trumps our pledges to be good, and we turn to government for preemptive regulation and legal enforcement actions to bar transgressors. In the words of Securities and Exchange Commission enforcement director Robert Khuzami, government lawyers are “the cops on the beat.”⁶ In a world where private sector innovation often outpaces the regulation to go with it, Khuzami’s lawyers have one of the toughest jobs in government. As he observes:

“It is a complex and dynamic neighborhood that we police, where products are complicated and evolve with increasing velocity, where markets execute with incredible speed, and where transactions are global in scope.”

“If you want to catch the bad guys who live and work in this neighborhood, you have to learn everything you can about how those markets, products and transactions operate, the economic substance of that activity, and how money is made and how it is lost in each product or transaction.”⁷

As they review the wreckage of 2008, federal prosecutors are finding that identifying bad behavior and prosecuting can be distinctly different challenges. For all the public outrage over Wall Street’s mores and conduct, there have been relatively few criminal charges and almost no jail time to date. Some financial transactions of recent years – like selling a security you suspect will lose value or making a mortgage loan you doubt can be re-paid – may seem offensive. Some mortgage brokers and investment managers may have behaved in ways that violate our sense of ethics. But behaving badly, it turns out, is not always against the rules.

“I think, and I’ve always thought, that making successful criminal cases out of the financial meltdown is going to be very difficult for prosecutors,” former federal prosecutor David Siegal explained. “You have to prove that somebody intended to defraud their investors as opposed to just being horrible at their jobs.”⁸

This question of legality vs. ethics was also a critical issue in the SEC's lawsuit against Goldman Sachs, which many observers believe the government would have lost if the case had gone to trial. The case was resolved when Goldman agreed to a \$550 million settlement in exchange for the government's agreement to drop the lawsuit.

The SEC argued that Goldman Sachs acted illegally in failing to disclose potential conflicts when selling debt securities to German and Dutch banks. But private securities attorneys believed Goldman's case was strong because it was selling to peers who billed themselves as among the most sophisticated managers in the world. Jacob S. Frenkel, who runs the securities law practice at one major law firm, says the government is seeking to hold Goldman to standards designed to protect those who lack business acumen. "This case is at the opposite end of the sophistication spectrum," Frenkel says.⁹

Even as critics question the merits of specific cases, the SEC is making organizational changes that it says will improve its success rates, including a more disciplined use of incentives to win cooperation from potential witnesses.

"For the first time, we will have a formal framework of incentives – incentives to secure the cooperation of persons who saw, heard and witnessed securities fraud first-hand – and who can walk into a courtroom, raise their right hand and tell their story to the world," Khuzami said.¹⁰

Khuzami also has reorganized his division into specialized units to address the increasing complexity of the financial markets and the crimes that may be committed. If it works, the reorganization will enable attorneys to develop deep expertise in key areas in hopes that a tighter focus will enable them to spot problems that might be missed by someone who aims to cover a wider range.

Can Government Cope?

Given the ambiguity of the law, the size of the economy, the breadth and diversity of corporate entities and the resources a wealthy company can and will deploy to defend itself, the job of policing corporate conduct can be a daunting task. Many wonder if government can manage the task.

Getting the regulatory structure right is a challenge in itself. The correct regulations are not always clear, even in hindsight, and creating a political consensus for change is difficult. Even when laws or new regulations are enacted, the fighting over their validity may continue and implementation may be slow. This year, for example, the divisive health care reform law was challenged in the courts within weeks of becoming law. Eight years after Congress responded to massive corporate frauds at Enron and WorldCom by enacting the Sarbanes-Oxley law to enhance financial reporting, the fighting over that law continues. The law's requirement for an annual audit and public report on internal controls has still not been applied to smaller companies, and was modified again this year with enactment of the Dodd-Frank financial regulation measure. In addition, the legality of the Public Company Accounting Oversight Board, which was established by Sarbanes-Oxley, was resolved by the Supreme Court only in June 2010.

In a review of financial regulation, the Government Accountability Office (GAO) said flaws in U.S. banking rules had compromised their effectiveness. In testimony to the U.S. Senate Committee on Banking, Housing and Urban Affairs, GAO Managing Director of Financial Markets and Community Investment Richard J. Hillman explained:

“[W]e found that some regulators lacked sufficient resources and expertise, that the need to coordinate among multiple regulators slowed responses to market events, and that institutions could take advantage of regulatory arbitrage by seeking regulation from an agency more likely to offer less scrutiny. Regulators that are funded by assessments on their regulated entities can also become overly dependent on individual institutions for funding, which could potentially compromise their independence because such firms have the ability to choose to be overseen by another regulator.”¹¹

Others worry that there aren't enough government attorneys to get the work done. The SEC enforcement division, for example, is smaller than five dozen of the country's private law firms. The division can muster about 640 lawyers, compared to about 4,500 attorneys at the private firms hired by Goldman Sachs to defend itself against the SEC. While only a small percentage of the private attorneys will actually work on the Goldman case, the disparity in numbers signifies the resources a deep pocketed defendant can gather.¹²

Moreover, government enforcers must range over the entire economy to address such diverse issues as financial fraud, health and safety, consumer protection, civil rights and environmental rules. SEC lawyers alone have more than 4,300 pending investigations to contend with and some investigations stall because there just aren't enough people to handle them all.

"It's common to have cases where we produce millions of pages of material, but there's one lawyer reviewing it. It's incredibly frustrating," says Craig Warkhol, a former SEC attorney.¹³ David Martin, a former director the SEC's Corporation Finance Division, says the core challenge is that there's just too much fraud. "The work they could do is almost infinite," he said. "The SEC could be ten times as big and there would still be fraud."¹⁴

Tough Choices

Despite the challenges, the government has had success. The corporate financial and accounting frauds of 2001-2002 led to prosecutions and jail time for senior executives at major corporations such as Enron and WorldCom. Mythic leaders such as Bernard Ebbers of WorldCom and Enron CEO Jeffrey Skilling closed their rags-to-riches careers with the disgrace of a perp walk. In the end, despite the painful economic losses of employees and shareholders, there was a sense that the fraudsters paid.

At the same time, by contrast legal enforcement actions related to the 2008 financial crisis have failed so far to match the public appetite for punishment. There is a sense among some that the bad guys are going free. As author and commentator William D. Cohan complained in *The New York Times* when the government decided not to file charges against top leaders of bailed-out insurer AIG: "News that the Justice Department has dropped an investigation into the insurance giant makes one wonder if anyone will pay the price for destroying the economy."

The decision not to pursue AIG executives in court highlights the difficult decisions for the government's enforcement team in considering when to file suit, especially when addressing behavior that many consider callous or unethical, but may not be illegal.

Difficult decisions are not confined to the financial arena. For example, many Americans would like to see jail time, or at least some finding of guilt, for officials of British Petroleum and other companies involved in the DeepWater Horizon disaster. Some will expect punishment for the death of miners at West Virginia's Upper Big Branch Mine in April 2010.

But tragedies or other bad results do not always involve criminal misconduct or other illegalities that can be proven in court, and diligent prosecutors often must still settle for fines and other lesser sanctions.

Consider, for example, the different course of four recent cases in the financial services arena:

Countrywide Mortgage: On June 7, 2010, the Federal Trade Commission announced a \$108 million settlement with subsidiaries of Countrywide Mortgage on charges of collecting excessive fees from homeowners who had fallen behind in their mortgage payments. The funds will be distributed to more than 200,000 homeowners whose loans were serviced by Countrywide, which had been one of the nation's largest subprime mortgage lenders. In announcing the agreement, Federal Trade Commission Chair Jon Leibowitz said Countrywide had tried to have it both ways, profiting from risky loans during the boom and then extracting additional fees when homeowners couldn't keep up the payments.¹⁵

The settlement reflects the FTC's estimate of the overcharges. Countrywide was not assessed a penalty because the Commission lacks the legal authority to impose one.

Lee Bentley Farkas, mortgage broker: Ten days after the Countrywide settlement, the Justice Department filed suit alleging that Lee Bentley Farkas, chairman of Florida-based mortgage lender Taylor, Bean & Whitaker, defrauded investors and the federal government of \$1.9 billion. The Department alleged that Farkas secretly shuffled funds among a variety of financial institutions to cover up financial weakness and falsified financial data in order to qualify for government bailout assistance. The government says that Farkas's schemes caused the failure of both Taylor Bean and Colonial Bank, a large regional bank based in Alabama.

AIG: A poster child for the credit markets' 2008 collapse when it was unable to pay off insurance contracts on a range of debt securities owned by major investment firms around the world. Scrutiny has focused on former AIG executive Joseph Cassano, who is credited for developing the practice that ultimately forced AIG into government receivership. Critics say that Cassano misled investors and failed to make required disclosures after receiving a warning from AIG's auditor about possible "material weaknesses" in the insurance portfolio.

Despite the villain hat assigned to Cassano by the news media and several books on the financial crisis, the Justice Department and the SEC closed separate investigations after concluding they lacked sufficient evidence.

Goldman Sachs: In April 2010, the SEC sued Goldman Sachs for allegedly misleading two European investment houses that purchased mortgage securities that the government says Goldman believed would fail. The Commission claimed that Goldman created the securities, known as Abacus, at the request of hedge fund trader John Paulson who then "shorted" the securities in the belief they would fall in value. Goldman allegedly then sold the securities to the banks and other institutional investors without disclosing that it had a client who was betting the package would fail.

"Goldman wrongly permitted a client that was betting against the mortgage market to heavily influence which mortgage securities to include in an investment portfolio," SEC enforcement director Khuzami said in announcing the lawsuit.¹⁶ The case was settled in July 2010 with Goldman's agreement to a \$550 million payment. Many Wall Street analysts had expected a price tag of \$1 billion or more and Goldman's share price rose with announcement of the settlement.

Deterrence vs. Enforcement

How do we best motivate ethical conduct, with the carrot or the stick?

Certainly, well-crafted government regulations can help by mapping clear bright lines between acceptable conduct and behavior that society considers harmful. Backed by disclosure rules and other transparency requirements, the mere existence of rules governing behavior can discourage misconduct by making it harder to conceal and, therefore, less enticing. Ethical lapses that might be winked at if the rules are murky may be identified or reported earlier if the conduct is clearly illegal. Bright lines also can help prosecutors by making it harder for defense attorneys to exploit ambiguities in the law.

Internal corporate codes of conduct can play a similar role by establishing clear expectations specific to an individual company. At a minimum, corporate codes reinforce standards set by the government and establish a commitment to full compliance. At their best, corporate codes use government rules as a floor to build on and add refinements that reflect a corporate culture uniquely tailored to business and the customers it serves.

Of course, drafting effective bright-line regulation is not simple. Society changes rapidly, and new business strategies and technologies can make regulations obsolete, irrelevant, or incomplete almost overnight. In telecommunications, for example, regulators and the companies they regulate are subject to laws drafted before the Internet age. The failure of financial regulation to prevent the 2008 credit debacle was due, in part, to a marketplace that had grown much more rapidly than the regulations that governed it. As the GAO observed in September 2009: "The increasing prevalence of new and more complex financial products has challenged regulators and investors and consumers have faced difficulty understanding new and increasingly complex retail mortgage and credit products."¹⁷

And, much as we wish for simple rules, complex activity may not lend itself to clear-cut rules. Testifying to Congress on a possible expansion of broker-dealers' fiduciary obligations, former U.S. Attorney Andrew Weismann pointed to Supreme Court Justice Antonin Scalia's tart observation about vague statutes. Said Scalia: "It is simply not fair to prosecute someone for a crime that has not been defined until the judicial decision that sends him to jail."¹⁸

Another challenge is getting the penalties right. The mere prospect of punishment may deter some misconduct, but the degree of deterrence is an open question because those who break the law do not plan on getting caught.

Assistant Attorney General Lanny Breuer argues that possible sanctions provide a strong deterrent effect and that fear of punishment convinces companies to enhance internal compliance programs. And, in remarks to the ERC Fellows in July 2010, the SEC's Lorin Reisner similarly said that effective

enforcement was the strongest type of deterrence. But University of California criminologist Henry Pontell worries that the deterrent effect is lessened by lax enforcement for white collar crime.

"A central concern about white-collar and corporate crime is that the risk-reward ratio is out of balance - that is, potential rewards greatly outweigh the risks. Given the low probability of apprehension and the likelihood of no, or light punishment, white-collar crime is seen as a 'rational' action in many cases," Pontell told a Senate panel.¹⁹ Massey Energy, for example, paid \$13 million in federal fines in 2009 – or less than 1 percent of its \$2.7 billion in total revenues that same year.²⁰

Separately, Breuer indicated his own concerns about a trend toward lighter sentences for white collar crime than suggested by U.S. Sentencing Commission guidelines.²¹

And, rules that deter one party will not necessarily deter another.

For many corporations, the reputational damage from misconduct may be reason enough to build a strong ethical culture. For other companies, an occasional fine for some misconduct may be viewed as a cost of doing business if earnings generated by misdeeds outweigh the sanctions.

For example, a large Defense Department contractor was fined \$400 million in March 2010 for lying about a compliance program. While large by most measures, the payment represented a relatively small fraction of the \$7 billion in federal contracts the company was awarded in fiscal 2009. On the other hand, Siemens AG paid \$800 million in penalties for violating the Foreign Corrupt Practices Act (FCPA), the largest fine ever for an FCPA violation and more than the company won in new U.S. government awards in 2009.²²

And both companies escaped the ultimate penalty of debarment from government contract work. Critics say violations will continue until the General Services Administration shows it will use the debarment weapon. Mike Koehler, a law professor at Butler University and a former FCPA attorney, says that the fines are just a "façade" for an enforcement policy that lacks teeth. He asks: "What kind of message does that send? That you can negotiate your way out of an anti-bribery violation?"²³

Settlements of SEC cases also seem relatively small. A study by NERA Economic Consulting said companies paid an average of \$4.7 million to settle cases in the first quarter of 2010 and that the median settlement was \$400,000.²⁴ Some observers think that the possibility of private class action suits may be a bigger deterrent for misconduct by publicly traded companies than government enforcement. "The contingent fee is the real engine of enforcement in the United States," Columbia University Law Professor John Coffee said in 2007.²⁵

But SEC Chairman Mary Schapiro argues that government deserves more credit than it gets, and that its mere presence makes a difference because people tend to behave better if they know they are being watched.

"I believe most industry professionals appreciate the value of and the need for transparency and fairness," she says. "And, I know that the prospect of suspensions, bars or penalties helps to reinforce the importance and centrality of those obligations.

"But to me, enforcement actions are not just about righting a particular wrong, but sending a message that the SEC is watching."²⁶

Uncle Sam and CECOs: Credibility Gap or Ethics Partnership?

While we can debate the relative merits of regulation and government enforcement capabilities, there is little doubt that government and business share an interest in ethical conduct that gives investors confidence in the market's inherent integrity. Despite tension between business and the government enforcement officers who prosecute corporate misconduct, it seems equally evident that partnership between government and private sector compliance officials can help build ethical cultures in the private sector and also provide government enforcement officials with a better understanding of what's possible in private sector ethics and compliance work.

"For us to be successful, we need you to be successful. We would rather prevent crime than show up after the train wreck," U.S. Deputy Assistant Attorney General Greg Andres observed in remarks to the ERC Fellows in July 2010. Loren Reisner, deputy director of the SEC's enforcement division, similarly observed that business can support deterrence efforts with strong compliance programs that not only deter illegal behavior, but also discourage employees from straying into the "gray area" of borderline conduct.

There is constructive work to be done, however, to move beyond the two sides' institutional skepticism of each other. Many corporate ethics and compliance officers (CECO) say they doubt that prosecutors take account of existing compliance programs when considering whether to file charges against an organization. They also voice disappointment at the government's general failure to provide case studies or data that would help private sector compliance officers align their programs with government expectations.

Many say, further, that data demonstrating that effective compliance programs can be a mitigating factor in government enforcement decisions would help make the business case for companies to increase the resources dedicated to compliance. "What gets measured is what gets done," one ERC Fellow observed at the July meeting. "We need hard evidence of the benefits of compliance." A second Fellow similarly noted that management is often reluctant to commit a large number of dollars to compliance, unless enforcement activity suggests its importance. "Our CEO says we're not in business to do ethics. We do ethics to stay in business," he observed.

The law enforcement officials insisted that they value ethics programs, but also want verification that ethics programs are active and effective, and not window dressing.

Kathleen Grilli, Deputy General Counsel of the U.S. Sentencing Commission, told the July ERC Fellows meeting that corporate leadership must "walk the walk." She said the Sentencing Commission has sought to encourage corporate ethics and compliance programs with guidelines that suggest reduced sentences for corporate defendants that have effective programs. For example, she noted that a program in which compliance officers have "a direct line to the Board" gets attention. But she added that

neither Sentencing Guidelines nor the existence of compliance programs have much impact when misconduct involves a company's most senior executives.

"A strong corporate culture will do more than anything the Sentencing Commission does. You're leadership has to be committed. It's like a parent and child –you have to walk the walk," Grilli said.

The SEC's Reisner noted the existence of "paper tigers" among compliance programs, adding: "We are surprised sometimes by the lack of action and seriousness with which some companies respond" to misconduct. Similarly, DOJ's Andres said prosecutors are not impressed by flow charts, but only by "living, breathing, practical programs." The officials also said they take account of the pervasiveness of misconduct and the level of those involved when deciding on enforcement action. Prosecutors expect compliance programs to be vigorously enforced, strongly supported by senior management and the board, to allow autonomy from management and provide direct board access for the senior compliance officer, Andres added.

Despite the mutual doubts, both government and private sector participants say closer cooperation could pay mutual dividends. ERC Fellows said they would be delighted to participate in education and training programs to help prosecutors at every level of government better understand the difference between strong compliance programs and weaker ones. They also said government officials could provide an important aid to corporate ethics and compliance programs by providing more information about what they look for in a compliance program and how it affects decision-making about enforcement actions.

Recommendations

In the interest of encouraging further discussion on the issues raised in this paper, including efforts to build ethical cultures through enhanced partnership between government and the private sector, the ERC suggests consideration of the following action items:

Department of Justice

- Create an advisory group of outside ethics and compliance experts to provide ongoing counsel on related ethics and compliance issues;
- Engage senior ethics officials from the private sector to add a new dimension to training for prosecutors, educating enforcement officials on best practice in the private sector;
- Develop an annual report and/or other mechanisms for providing corporate ethics and compliance officers with aggregate data and/or cases studies demonstrating the role of corporate ethics programs in enforcement decisions;
- Establish a joint public-private initiative to identify measures, including a possible “safe harbor” to enhance corporate self-evaluation and reporting on ethics and compliance.

Securities and Exchange Commission

- Create an advisory group of outside ethics and compliance experts to provide ongoing counsel on related ethics and compliance issues;
- Engage senior ethics officials from the private sector to add a new dimension to training for SEC auditors and enforcement officials;
- Work with business ethics officers to explore the possibility of annual ethics reports (similar to corporate social responsibility reports) by publicly traded companies;
- Encourage corporate distribution of their codes of conduct to shareholders, and increased public disclosure of compliance training required of employees.

U.S. Sentencing Commission

- Establish a standing advisory group of outside ethics experts on Chapter 8 of the Guidelines;
- Review and update Chapter 8 to include heightened emphasis on the establishment and measurement of corporate culture;
- Work with the private sector to develop and offer an educational outreach effort to provide judges with a fuller understanding of corporate ethics and compliance programs;
- Expand cooperation with Department of Justice and SEC to assure full awareness of Chapter 8 and the Guidelines for granting credit for effective corporate ethics and compliance programs.

Conclusions

Discussions at the July ERC Fellows meeting revealed frustrations among government enforcement officials and private sector ethics and compliance officers alike. But they also revealed common purpose and strong desire to build a stronger partnership.

Enforcement officers insisted that they need the input, support and cooperation of the private sector to do their job more effectively. Fellows voiced eagerness to help and offered to share their expertise with government.

ERC believes greater cooperation is an important goal that can increase the effectiveness of government regulation and enforcement and also help build ethical cultures in the private sector. This paper is offered in a spirit of cooperation to identify shared concerns and highlight ideas for collaboration.

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