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Amendment of Federal Sentencing Guidelines Calls for Updating of Compliance Policies

By Curtis M. Dombek and Michael W. Emmick

On April 29, 2010, after a period of public comment, the United States Sentencing Commission ("USSC") issued proposed amendments to the United States Sentencing Guidelines ("USSG"). Absent Congressional action, those amendments will take effect on November 2, 2010. One of the proposed amendments relates to USSG § 8C2.5(f), which provides for a 3-point reduction in culpability score for companies that had an effective compliance and ethics program in place at the time of the offense of which they have been convicted. This amendment is part of the USSC's announced effort to reevaluate corporate sentencing and provide for greater reward and encouragement for compliance programs, self-reporting, and remediation of discovered offenses.

The proposed amendment to USSG § 8C2.5(f) would make a 3-point reduction in culpability score more readily available to companies whose compliance programs provide for "direct reporting obligations" from the head of that compliance program to the board of directors or the audit committee. A reporting obligation to a general counsel or other high-level corporate officer would not meet this description unless he or she also were a member of the board of directors. Although the actual beneficial impact of the change is somewhat speculative, it could be very helpful in a later criminal prosecution. Even without an outright prosecution, such "direct reporting" will probably be regarded favorably by other law enforcement agencies that evaluate the effectiveness of a company's compliance program in deciding whether to bring criminal charges or take civil or administrative courses of action. Thus, for most companies, making the contemplated change is advisable.

Although the subsection (f) reduction has been in the USSG for many years, it has reportedly been applied only three times between 1995 and 2008. The reason for this scant application is the existence of a looming exception under subsection (f)(3): The reduction was not available if "an individual within high-level personnel of the organization … participated in, condoned, or was willfully ignorant of the offense." The reason for that exception was the suspicion that if high-level personnel were involved, the compliance program must not have been very effective or trustworthy. More practically, if an internal investigation revealed the involvement of high-level personnel – even tangential or barely-knowing involvement – the company was then faced with a

difficult choice regarding self-reporting, because the 3-point reduction for an effective compliance program would not be available regardless of whether the offense was reported.

The proposed amendment substantially modifies that exception and in some ways eliminates it altogether. Under the amendment, the involvement of high-level personnel no longer operates as a mandatory disqualifying factor. Instead, the 3-point reduction remains available so long as:

1. the individual or individuals with operational responsibility for the compliance and ethics program had direct reporting obligations to the organization's governing authority or subgroup thereof;

2. the compliance program detected the offense before it was discovered outside the organization or before such discovery was reasonably likely;

3. the organization promptly reported the offense to the appropriate governmental authorities; and

4. no individual with operational responsibility for the compliance program participated in, condoned, or was willfully ignorant of the offense.

Viewed from a technical point of view, this amendment can be regarded as creating an "exception to an exception." As a practical matter, however, if companies provide for the required direct reporting the effect of this amendment will likely be to make the 3-point reduction available in the overwhelming majority of cases since it is unlikely that the head of the corporate compliance program will have participated in, condoned, or been willfully ignorant of the offense.

This amendment reflects two fundamental policy judgments about compliance programs: first, that compliance programs are more meaningful and trustworthy if the head of the program has "direct reporting obligations" to the board of directors or the audit committee of the board; and second, that more should be done to encourage companies to institute robust compliance programs.

How to Take Advantage of the Proposed Amendment

The Application Notes provide some guidance about what the compliance program must look like in order to make the 3-point reduction available. "Direct reporting authority" is defined as authority on the part of the individual in charge of the compliance program to communicate personally with the board of directors and/or the audit committee in any specific matter where there is potential criminal conduct. An additional requirement is that the person in charge of the compliance program must report to the board no less than annually on the general subject of the implementation and effectiveness of the compliance program. The key concept here seems to be unfettered personal access to those on the board – and not merely to management. Indeed, the amendment can be interpreted as reflecting an abiding suspicion of management and

encouraging a direct relationship between the board and the head of the compliance program, to the exclusion of management.

For many companies, satisfying this requirement would require changes in the corporation's structure and policy. A company whose current program provides for reporting by the head of the compliance program to an officer who does not sit on the board should make an explicit change in its written policy to provide for direct reporting to the board, assuming that it wants to maximize its chances of qualifying for a 3-point reduction in the event of a violation. To satisfy the requirement of a direct reporting obligation very clearly, companies may want to designate a specific board member to receive such reports from the head of the compliance program.

Whether to Revise a Company's Compliance Program to Take Advantage of the Amendment

It is always a bit speculative to assess the benefits supposedly made available by a change in a subsection of a sentencing provision. Many other factors would need to come together to bring the 3-point reduction into play: the company would have to suffer a conviction; detect the offense before it became public and disclose the offense to the proper authorities; and the head of compliance must not have been involved in the unlawful activity. Moreover, the real value of the reduction at sentencing depends on what the sentence would have been without the reduction, which depends on the various other characteristics of the offense, especially the resulting loss, which is difficult or impossible to predict prospectively.

Still, a 3-point reduction is very substantial in the USSG corporate sentencing scheme. Depending on the amount of the loss, the benefit could be a reduction of 30-50% of the fine range that is generated by the USSG sentencing formula. Without the corporate changes envisioned by the proposed amendment, the reduction is completely unavailable. (The other three criteria are essential too, but they can be known and/or accommodated only after the offense, not in advance.)

In addition to providing a benefit in a point-level calculation, direct reporting to the board should make for a more effective compliance program. This amendment to the USSG reflects a judgment by the USSC about what compliance programs are most effective. William Sessions, the current Chairman of the USSC, has said that the amendment reflects the view that direct communication between the board of directors and compliance officers is essential to effective corporate compliance programs.

If the USSG encourages this direct reporting, and if Chairman Sessions regards it as essential, then considerable weight will likely be given to that factor by prosecutors, law enforcement, and regulators (such as the SEC) in determining whether to regard a case as criminal or merely civil or administrative. Such direct reporting may even have a bearing on how plaintiffs evaluate whether to pursue charges against directors and other officials.

On the other side of the equation, there do not appear to be many disadvantages to implementing the adjustments contemplated by the amendment. Currently, many companies provide for a primary reporting obligation by their compliance officers to a corporate executive who does not

sit on the board of directors. To come within the coverage of this amendment, this reporting relationship will have to be modified. The new rule, however, does not require keeping the general counsel or other corporate officials out of the loop. It requires only that the head of the compliance program have a direct reporting obligation to the board or audit committee. It is possible that a few more borderline compliance questions will be brought to the board's attention directly rather than being corralled by management beforehand, but the inconvenience of that change is probably minimal.

In view of the prospective benefits made available by this USSG amendment, which could be quite substantial in a significant case, and the minimal cost of making the necessary changes, many companies may well find it advisable to change their compliance programs to take advantage of the additional point reduction.

For additional information on how these changes can be implemented in your company's compliance program, please feel free to contact us.

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