

**THE PROPOSED AMENDMENT TO
THE SENTENCING GUIDELINES**

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I. Introduction

On April 30, 2004, the United States Sentencing Commission submitted to Congress an amendment to the existing Organizational Sentencing Guidelines (the “Guidelines”) that will change the way corporations create and manage compliance programs. As part of the Commission’s multi-year review of the effectiveness of the Guidelines and its ongoing response to the Sarbanes-Oxley Act, the amendment modifies and strengthens existing provisions that set forth seven minimum requirements for a corporate compliance program to be considered effective and to be deemed a significant mitigating factor in sentencing a corporate defendant. In addition to setting forth new requirements for an effective compliance and ethics program, the amendment provides guidance for the implementation of such a program. This amendment becomes effective on November 1, 2004.

Under the current Guidelines, the existence of an effective compliance program has often reduced the culpability of a business organization and the corresponding fine it pays when convicted of a crime. In many situations, the government has declined to prosecute an organization when the organization has been able to show that it had compliance safeguards in place designed to prevent, deter, and detect wrongdoing, even though the criminal act occurred.

Under the new Guidelines, a business organization that seeks reduced criminal fines will have to show that it had an effective and very comprehensive compliance program in place. The organization will have to show that the directors and executives took an active role in promoting compliance and general business ethics. The organization must also show in that areas where problems are most likely to arise, high-level officials have been assigned to manage compliance, and that the organization has given officials the resources necessary to carry out the mission of creating effective compliance and promoting ethical conduct.

II. A New Emphasis on Ethics

One of the most important changes in the Guidelines concerns a new emphasis on corporate ethics. Not only does the amendment retain the requirement that an organization exercise due diligence to prevent and detect criminal conduct, it adds the requirement that an organization shall also “otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” This change reflects the new emphasis on ethics and values incorporated into recent legislative and regulatory reforms, such as the Sarbanes-Oxley Act. Indeed, new language in the

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preamble to the Guidelines emphasizes that “[t]he prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in ultimately achieving compliance with all applicable laws.”

The addition of the terms “ethics” and “ethics program” provides new challenges in the implementation of compliance programs. In promoting “ethics,” the amendment goes so far as to state: “As appropriate, a large organization should encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective compliance and ethics programs.” It appears, therefore, that any effort to create effective compliance must include an effort to improve overall business ethics within the company and also may extend to an attempt to improve the ethics of entities with which a company does business.

III. Greater Accountability for Directors and Officers

Under the old Guidelines, only “specific individuals within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures.” Under the new amendments, directors, officers and other high-level employees are no longer able to turn a blind eye to unlawful conduct. The Guidelines now require personnel to have specific roles and define reporting relationships for particular categories of personnel. The new amendment establishes a clear chain of accountability that extends to the top.

For example, the Commission has directed that the “organization’s governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.” “Governing authority” is defined as “(A) the Board of Directors; or (B) if the organization does not have a Board of Directors, the highest-level governing body of the organization.” Thus, consistent with provisions in the Sarbanes-Oxley Act, the board of directors must take an active and transparent role in ensuring that the compliance and ethics program is working.

In addition, the amendment provides that an organization’s leadership as a whole, that is, high-level personnel, must ensure that the organization’s program is effective and that a specific high-level individual has overall responsibility for the program. High-level personnel are those who have “substantial control” or a “substantial role in the making of policy.” Furthermore, the proposed amendment requires that an individual be assigned day-to-day operational responsibility for the program. That individual must periodically report to organizational leadership and the governing authority on the effectiveness of the program. The individual who is appointed this operational responsibility (no matter what level) must “be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.” Once again, the board of directors must play an active role in ensuring that the compliance and ethics program is working properly.

The amendment also changes the current requirement that personnel with substantial authority be screened for their “propensity to engage in violations of law.” Now, the organization must screen individuals who have “engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program.” Thus, a company must be more proactive in screening individuals and look more closely at each individual’s conduct. The company can no longer turn a blind eye to employees who have created problems in the past without being held responsible.

IV. Ongoing Training and Monitoring for Everybody

The amendment requires compliance and ethics training within an organization and expands it to cover not just its employees and agents, but the governing authority and high-level personnel of the organization as well – no one is excluded. In addition, the new amendment makes it clear that the training must be effective and periodic.

The amendment further delineates what an organization must do to ensure that its compliance and ethics program is followed. First, the amendment mandates that organizations use auditing and monitoring to detect criminal conduct. Second, an organization must “evaluate periodically the effectiveness of [its] compliance and ethics program.” Finally, the amendment replaces the existing reference to creating “reporting systems” whereby employees could report “criminal conduct . . . without fear of retribution” with the more specific requirement for “a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization’s employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.” Thus, a corporation’s reporting system must be expanded to include not just reports of criminal conduct, but even questions seeking guidance regarding potential criminal conduct. The system must encourage employees to ask the necessary questions when they come upon conduct they view as questionable. Moreover, all organizations should seriously consider having an anonymous or confidential reporting system, as is now explicitly suggested by the guidelines.

The amendment also requires that the “compliance and ethics program shall be promoted and enforced” in two ways. First, the amendment directs the organization to employ “appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.” Thus, the government will expect a company to take disciplinary measures against any individual who has failed to prevent criminal conduct, not just those who failed to detect criminal conduct. Second, an organization must also employ “appropriate incentives to perform in accordance with the compliance and ethics program.” This new incentive approach broadens the existing requirement.

The amendment further underscores the necessity that a compliance and ethics program not be a paper tiger, but instead be a viable, flexible foundation from which an

organization may encourage ethical conduct and full compliance with all laws. Organizations cannot set up a program and forget about it. Instead, an organization must “periodically assess the risk of criminal conduct and take appropriate steps to design, implement or modify [each of the seven requirements] to reduce the risk of criminal conduct.” In assessing relevant risks, organizations must assess the nature and seriousness of potential criminal conduct, the likelihood that certain criminal conduct may occur because of the nature of the organization’s business, and the prior history of the organization. Moreover, the organization must prioritize the actions taken to implement an effective compliance and ethics program and modify such actions in light of the risks identified.

For example, it now appears as though a compliance program needs to be tailored to the business it will cover. If a compliance program is created for commodities brokers, then in light of recent problems in the energy trading business, the program must address the propensity of others in the industry to break the law. The program would need to incorporate protections that are not only unique to the industry, but also tailored to stopping the particular types of misconduct that occurred at other companies doing similar work.

If the company has had prior legal problems, it must tailor the compliance effort to address those problems specifically. For example, if the company found in an earlier internal investigation that several senior employees discussed pricing with competitors, the new program would have to take additional measures (outside of the already onerous requirements created by the amendment) to make sure that no new antitrust issues arose. Even though all employees who were involved with the prior questionable conduct would have been dismissed based on the “appropriate” disciplinary measures found in the amendment, the company would have to put in additional protections based on this prior conduct. Also, because of the previous conduct, this part of the new effective compliance program would be a first priority.

These two examples demonstrate that for a company that does business in the real world, achieving effective compliance is not simple. Creating an effective compliance program is a never-ending process that requires constant vigilance and attention.

V. Small Companies Can Also Benefit from Effective Compliance

The Sentencing Commission’s amendment also provides additional guidance with respect to the implementation of compliance and ethics programs by small organizations. First, the new Guidelines make more frequent references to small organizations. Second, the Guidelines encourage large organizations to promote the adoption of compliance and ethics programs by smaller organizations with which they conduct or seek to conduct business. Third, small organizations are no longer automatically precluded from the compliance program credit even if a high-level person “participated in, condoned, or was willfully ignorant of the offense.” The new Guidelines now provide a rebuttable

presumption for a small organization (defined for purposes of this section only as an organization having fewer than 200 employees) that it did not have an effective program.

Even if a small organization does not judge the benefits of compliance to be worth the cost because the chance of getting in trouble is low, there is a business reason for a small organization to seriously consider implementing such a program. As noted above, the new Guidelines direct large organizations, as appropriate, to “encourage small organizations (especially those that have, or seek to have, a business relationship with the large organization) to implement effective compliance and ethics programs.” If a small company has an effective system in place, the large organization benefits by not having to use its own resources to encourage good behavior and may be more inclined to continue doing business with the small company.

VI. Waiver of Protections

The new Guidelines also address concerns about the relationship between obtaining cooperation credit from the sentencing court and waiver of the attorney-client and work-product protections. An organization’s culpability score may be reduced if it is found to have “fully cooperated in the investigation” of its wrongdoing. The new Guidelines state that waiver of attorney-client and work-product protections is not a prerequisite to such a reduction “unless such waiver is necessary in order to provide timely and thorough disclosure of all information known to the organization.” Further, “[t]he Commission expects that such waivers will be required on a limited basis” based on representations made by the Department of Justice. Ultimately, the sentencing court will have the final determination of whether an organization’s “timely and thorough” disclosure can occur without attorney-client or work-product waiver.

Although the amendment makes it clear that waiver will only be necessary in a limited number of cases, the possibility of exercising this waiver creates new challenges for organizations conducting internal investigations and even carrying out more ordinary compliance. It is difficult to believe that the government will not ask for these otherwise protected documents on more than just a few occasions. For a prosecutor, a company’s own admissions provide persuasive evidence that can facilitate a prosecution as much as any other type of evidence. Consequently, in carrying out compliance or a resulting internal investigation, a company that wishes to remain eligible for the full-cooperation reduction needs to keep in mind that any documents created may need to be turned over to the government. Language should be chosen with care to create clear and accurate documents. Speculation and other types of communications that could be open to interpretation should be confined to oral communications and should be put to paper only after careful deliberation.

It is also critical for a company to remember that anytime otherwise privileged materials are turned over to another party, including the government, the claim of privilege may be waived and the materials may be discovered in any subsequent civil litigation. Just as admissions are loved by the prosecutor, there is nothing more helpful to a civil plaintiff

than the company's own confessions. Civil damages can often dwarf criminal fines and a company needs to keep this in mind when deciding whether or not to turn over privileged material to the government. Although contrary to the intent of the amendment, this waiver provision will force corporations to weigh the benefits of cooperation more carefully as the cost of cooperation may rise dramatically.

VII. Conclusions

The changes created by the new Guidelines will alter the way that companies of all sizes operate. Although most companies have seen the necessity of having compliance programs in place for some time, very few business organizations have compliance programs in place that would withstand analysis based on the new criteria. Now achieving effective compliance has been moved to the forefront and will require constant vigilance. Corporations must now determine where their compliance programs fall short and take steps to rectify any inadequacies. Every individual must undergo periodic training. The revised compliance program must have a chain of command attached to it so company employees are responsible for the day-to-day operations, while a senior member of the corporation has direct oversight. The individuals charged with implementing compliance need to be given all of the tools necessary to do their jobs. If there have been problems in the past, steps must be taken to create additional safeguards and implement them effectively. These are just a few of the issues that must be carefully considered when putting a new compliance program in place.

Morgan Lewis has the experience and knowledge to help any company review and implement compliance programs and conduct internal investigations.

If you have any questions regarding this matter, please contact your primary Morgan Lewis attorney or one of the attorneys listed below:

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