

BUSINESS ETHICS AND COMPLIANCE — ESTABLISHING AN EFFECTIVE PROGRAM*

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Business ethics and compliance. It's a topic on the minds of many — if not most or all — corporate executives. It looms large in the awareness of the chief legal officer of virtually every corporation. It's a primary goal of ethics officers in corporate America. Given the recent business scandals, it is even on the minds of shareholders.

For many, compliance occupies that position of interest because of government scrutiny. Government agencies such as the Securities and Exchange Commission, the federal Health and Human Services Administration and, most significantly, the U.S. Sentencing Commission have indicated the benefits that a company might enjoy as a result of having a comprehensive, effective ethics and compliance program in place.

Will a program that focuses on compliance, but not ethics, suffice? What is the difference? Many companies have established compliance programs and identified compliance officers. What do those programs lack, if anything?

From the perspective of assuring that the company's activities conform to the legal mandates of the government, compliance provides some assurance of meeting that standard, if the program is effective. From a broader perspective, however, that approach may serve the company's interests only partially. In reality, compliance with applicable law and regulation merely defines the floor for the acceptable behavior of the company and its employees and agents. A comprehensive ethics and compliance program, on the other hand, attempts to challenge the

organization continually to embrace true integrity and do what is right, not only what the law requires.

Further, a program designed to address the standards set by the government will be compliant only so long as those standards remain static. When government agencies revise their expectations, the compliance program must adapt, often under less-than-helpful time constraints. A program that incorporates ethical approaches, on the other hand, likelier will satisfy more than those agencies' currently expressed standards. If those standards become more demanding, the company will need to change its internal processes less dramatically than a company with a compliance-only approach.

While the establishment of an effective ethics and compliance process conveys very sound business benefits, other forces have brought this subject to the fore from a more mandatory perspective. In July 2002, Congress enacted the Sarbanes-Oxley Act of 2002 in an effort to eliminate at least some of the causes of corporate scandals of the past few years. Among other subjects, that new law enacted a requirement that an issuer of securities disclose whether it has enacted a "code of ethics" that applies to its principal executive officer and several other identified corporate executive positions. If a company has not adopted such a code, it must disclose that fact and an explanation of why it has not done so. The statute defines a "code of ethics" very specifically, and its definition does not cover a code that applies to all employees of a company. A code of ethics that satisfies that definition, however, might be part of a broader code that covers all

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employees./1/ The requirement that the existence of a code of ethics be disclosed to investors certainly increases the benefits gained by implementation of an effective ethics and compliance program.

The statute also mandates that the SEC adopt rules to require companies to disclose waivers granted to senior financial officers of the requirements of their ethics codes./2/ Congress intended, through that mandate in the Sarbanes-Oxley Act, to reduce the likelihood that corporate boards of directors would routinely waive ethics requirements for senior officers of their companies, as happened at Enron. See Pittman & Navran, "Corporate Codes of Ethics and Sarbanes-Oxley," *Wall St. Law.*, July 2003, at 1, 3. The possibility of public scrutiny of such decisions by a board of directors certainly provides considerable incentive to grant such waivers much more judiciously than might otherwise pertain.

Another provision of the Sarbanes-Oxley Act pertains to this discussion. Section 301 of the law requires that the audit committee of a publicly held company "establish procedures for ... (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." The SEC issued final rules to implement that provision in the statute/3/ and to provide some flexibility for companies in satisfying the law's mandate./4/ A hotline by which employees can report ethical lapses has constituted an element of an ethics program for some time though, and one that clearly constitutes the process that § 301 envisions./5/

The existence of such mandates in the Sarbanes-Oxley Act certainly provides considerable reason to review your company's means of assuring compliance with the developing standards of corporate governance. Identifying what other statutes and regulations might relate to your company's operations would require, of course, a company-by-company analysis./6/

If you accept the proposition that it is good to have a corporate business ethics and compliance process in your company, then you may ask the following: How do you put one together? Where do I start? How do I use limited resources to assure and document that the corporation is compliant with the numerous government requirements that apply? Which areas merit attention? What does an

effective program look like? Of what does a compliance program consist?

Determining the scope of an ethics and compliance program is the first phase of the process. That scope depends on several factors. Some of those factors flow from the laws, regulations, and court decisions issued at various levels of government. What kind of industry are you in? Is it heavily regulated? What are the business risks? Are your employees aware of these risks? What potential impacts do its operations have? Who might be impacted by those operations (particularly if those operations do not proceed in accordance with law or other applicable requirements)? How significant (*i.e.*, harmful) might those impacts be?

After you've determined what substantive and operational areas merit attention, the next phase is to design a program that's appropriate to satisfy those compliance needs. That program should reflect the legal and operational challenges of your business (those identified in the first phase). You must understand those business operations well and determine the most effective means of assuring compliance with the applicable laws and other requirements and of ameliorating the potential adverse effects of those operations.

Let's explore that analysis in a hypothetical, but realistic, context. Assume that a company invests in real estate in a variety of ways. It purchases and sells improved real property (*i.e.*, it's an equity investor); it purchases property (either undeveloped or developed by former owners) and improves that land by constructing, improving, or renovating improvements on that property (housing, office buildings, or another type of structure); it lends money to others who own real estate, with repayment secured by a lien on the borrower's property; and it manages real estate owned by others. What compliance issues does that company face?

There are at least four primary purposes of an ethics and compliance program for such a company:

- (1) to achieve conformity with legal and regulatory requirements;
- (2) to achieve conformity with behavioral and values expectations expressed within the company;
- (3) to achieve consistency in its treatment of similar issues and similarly situated persons; and
- (4) to achieve full, careful responses to government inquiries./7/

How do those purposes animate the process of designing an appropriate ethics and compliance program for a company with the above-described activities? You canvas the laws and regulations that apply (or might apply) to those activities. As examples:

1. The lending activities may require licensure in one or more jurisdictions. They may be subject to certain behavioral constraints such as usury laws.
2. The ownership and management of real estate may trigger obligations *vis-à-vis* the physical safety of guests and licensees.
3. The sale of property may trigger obligations of disclosure (to purchasers and potential purchasers) and even of nondiscriminatory treatment (fair housing laws).
4. To develop unimproved real estate, one must be mindful of laws and rules that relate to navigable water (the need for permits to accomplish certain things), wetlands (the obligation to preserve, and in some cases restore, any such habitats that might be adversely impacted by the development), and other concerns.

Nearly deserving of separate, complete treatment are environmental responsibilities attendant to the real estate activities described above. The scope of environmental regulation by government at all levels^{8/} is very significant. The regulations are often detailed.

So, what would a real estate-related compliance program include? First, you must investigate for any applicable requirements among laws and regulations. Second, if any of the company's activities require that the company hold government-issued permits or licenses, establish a mechanism for securing and maintaining those permits or licenses. An ethics and compliance program requires that business activities be controlled in order that activities that require a license not be undertaken without a license, or that, if such activities are undertaken without permission, the company can secure a license in timely fashion, and that, if the license is held by the company, activities are conducted in accordance with terms of that license.

A company must be able to detect its own violations of applicable requirements (whether internally or externally generated). Any violations so discovered must be corrected and perhaps even disclosed.^{9/}

An effective record-keeping system is an important — and often overlooked — element of a comprehensive ethics and compliance program. If a company has complied with all applicable requirements fully — it has appropriate licenses, its decisions and actions accord with law, etc. — would it be able to establish that conformity if a government agency inquired? Every company should assure that its record-keeping procedures satisfy both external and internal requirements.

A mechanism by which a company can audit its operations for legal conformity is another critical component of a compliance program. Not only does a good audit function help to ensure substantive compliance with the law, but it can be particularly helpful in any dealings with government agencies. The more government officials believe that they can rely on a company's auditing and investigative functions to identify examples of noncompliance, the more likely they are to accept a company's representations in the course of an investigation.

Training is an important element of any ethics and compliance program. Inasmuch as such a program will be judged by its effectiveness, the degree to which its substantive terms inform the day-to-day actions of a company's employees might provide the critical difference between constituting an effective program and an ineffective one.^{10/}

Having identified the necessary components of a company's ethics and compliance program, you must create them. In doing so, you must take into account more than legal issues. Operational factors demand consideration. An ethics and compliance program that imposes on a business unattainable behavioral standards is not only doomed to fail, it may create liability beyond that of the substantive legal requirements.

This is particularly true in situations to which the Federal Sentencing Guidelines apply. Those guidelines provide for beneficial treatment of a company that has an "effective" compliance program. Thus, an ethics and compliance program that, while well designed (intellectually, that is), cannot be satisfied by the operations to which it applies, will serve to highlight lapses more than it can eliminate them.

The more you can design ethics and compliance-related activities that build off activities that have independent, business-oriented purposes, the more successful that

compliance program will be. For example, requiring that a duplicate copy of a document that is already prepared as part of a transaction be filed in a compliance-related repository is far better than expecting that the business personnel will prepare an additional document solely for compliance purposes.

In other words, design your ethics and compliance program so that its elements represent the least additional burden for the company that you can. Creating more bureaucracy should never be a goal. Try to integrate these activities into existing processes as much as possible, rather than erecting a separate ethics and compliance-oriented process solely.

ENDNOTES

- /1/ See Griffith, "Recent Developments under the Sarbanes-Oxley Act of 2002," *Lawyer's Brief*, Mar. 31, 2003, at 2, 10-11.
- /2/ See § 406(b) of the Sarbanes-Oxley Act. The SEC issued rules to implement that requirement on January 23, 2003. See "Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002," SEC File S7-40-04, Rel. No. 33-8177, adding § 229.406(d) to its rules. That release appears at <www.sec.gov/rules/final/33-8177.htm>.
- /3/ See <www.sec.gov/rules/final/33-8220.htm#procedures>.
- /4/ The SEC noted that "[w]e do not believe that ... a 'one-size-fits-all' approach would be appropriate. As noted in the Proposing Release, we expect each audit committee to develop procedures that work best consistent with its company's individual circumstances to meet the requirements in the final rule. Similarly, we are not adopting the suggestion of a few commenters that, despite the statutory language, the requirement should be limited to only employees in the financial reporting area."
- /5/ Whether a hotline that predated the Sarbanes-Oxley Act satisfies all of the requirements of that law should be carefully reviewed. For example, among other things, the statute requires that the audit committee develop 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 the issuer of concerns regarding questionable accounting or auditing matters." See § 301 of that law, adding § 10A(m)(4) to the Securities Exchange Act of 1934.
- /6/ The Sarbanes-Oxley Act applies to companies the shares or securities of which are traded publicly and that are required to file various reports with the SEC. The extent to which privately held companies must or should satisfy that statute's mandates may depend on future developments.
- /7/ At first blush, this fourth purpose may seem to replicate the first (conformity with legal requirements), but we use the phrase to suggest a broader goal. A credible, effective compliance program is not only a significant factor in determining what penalty the government might apply when a company is found to have violated the law (see the discussion of the Sentencing Guidelines below), but it can affect the length, detail, scope, and seriousness of an investigation (or preliminary inquiry) by a government agency, even an investigation or inquiry that never results in sentencing under those guidelines.
- /8/ While the federal government's regulatory enactments are best known (e.g., the Clean Air Act, the Clean Water Act, Superfund), state and local laws, ordinances, and regulations have proliferated since 1970. Many of the requirements of the latter jurisdictions' enactments are even more stringent than those of federal agencies. Sometimes they are to some degree inconsistent. That they are not to be ignored is the salient point.
- /9/ Whether and, if so, how to report violations to a government agency is a separate subject that is beyond the scope of this article. The considerations involved in making that determination can be numerous and complex.
- /10/ The Office of the Inspector General of the U.S. Department of Health and Human Services and the American Health Lawyers Association jointly developed a document entitled "Corporate Responsibility and Corporate Compliance: A Resource for Health Care Boards of Directors," on page 8 of which they said as follows: "A critical element of an effective compliance program is a system of effective organization-wide training on compliance standards and procedures. In addition, there should be specific training on identified risk areas, such as claims development and submission, and marketing practices." That document is posted at <<http://oig.hhs.gov/fraud/docs/complianceguidance/040203CorpRespRscGuide.pdf>>. ■